WATERFALL APPLICATION

Nos 7924 and 7945 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) and others

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

(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

WRITTEN OPENING SUBMISSIONS OF LEHMAN BROTHERS HOLDINGS, INC

BARRY ISAACS QC
MARK ARNOLD QC
South Square
Gray's Inn
London WC1R 5HP

24 October 2013

Weil, Gotshal & Manges
110 Fetter Lane
London EC4A 1AY

Contents

Introduction 3

Question 1 (proof of unsubordinated claim in administration) 6

Question 2 (proof of unsubordinated claim in liquidation) 17

Question 3 (proof of Subordinated Debt) 18

Question 9 (LBHI2's Potential Liability as Contributory) 27

Question 11 (order of application of surplus) 43

Question 12 (Currency Conversion Claims) 58

Appendix: The Regulatory Regime 74

Introduction

1. Lehman Brothers Holdings, Inc ("LBHI") is the ultimate parent of the Lehman Brothers group of companies worldwide. On 15 September 2008, it commenced Chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York, from which it emerged on 6 March 2012.

2. LBHI is an indirect creditor of many companies in the group and is the ultimate shareholder of all of them. Whilst it is dependent on the outcome of many events and variables, LBHI currently estimates that, by virtue of its indirect creditor claims and shareholdings, it will ultimately receive 87% of all distributions made by LB Holdings Intermediate 2 Limited ("LBHI2").[1]

3. LBIE is indebted to LBHI2 in the principal sum of US$2.225 billion (the "Subordinated Debt") under one or more[2] of three subordinated loan facility agreements entered into on 1 November 2006 (the "Subordinated Debt Agreements"). LBHI's primary interest on this application relates to LBHI2's right to recover the Subordinated Debt and, in particular, its ranking in priority relative to LBIE's other debts and obligations.

4. LBHI is principally concerned with the following issues raised by the Application:

---

[1] Jones/9

[2] The balance of the evidence shows that the Subordinated Debt outstanding when LBIE went into administration was drawn down under the Short-Term Subordinated Debt Agreement, but this is not accepted by LBIE. In any event, the terms of the Subordinated Debt Agreements are (save in respect of the Repayment Date) in all material respects identical.

(1) Whether debts owed by LBIE to LBHI2, both subordinated and unsubordinated, are provable by LBHI2 in LBIE's administration or any subsequent liquidation. LBHI submits that the answer to this question is: Yes.

(2) Whether the Subordinated Debt is payable in priority to interest payable in accordance with Rule 2.88(7) of the Insolvency Rules 1986 ("the Rules"). LBHI submits that the answer to this question is: Yes, because it is provable.

(3) Whether Currency Conversion Claims (as defined in the Application) are valid and payable. LBHI submits that the answer to this issue is: No.

(4) If so, whether Subordinated Debt is payable in priority to Currency Conversion Claims. Given the answer to (3) above, LBHI submits that this question does not arise. If it does, however, LBHI submits that the answer to this question is: Yes, whether or not Subordinated Debt is provable.

(5) Whether LBHI2's potential liability pursuant to section 74 of the Insolvency Act 1986 ("the Act"), in the event of LBIE going into liquidation, extends to (i) interest payable pursuant to Rule 2.88(7) ("Rule 2.88(7) interest"); (ii) Currency Conversion Claims; and/or (iii) the Subordinated Debt. LBHI submits that the answer to (i) and (ii) is: No. The answer to (iii) is: No, if the Subordinated Debt is not provable.

5. Accordingly, LBHI makes submissions in response to Questions 1-3, 9, 11

and 12 raised in the Application. LBHI adopts a neutral position in relation to Questions 4 - 8 and 10 but reserves the right to change its position if it considers that it would be in its interests to do so.

6. LBHI may also have a material economic interest in distributions made by Lehman Brothers Limited ("LBL"), although the extent of that interest is heavily dependent on issues which are not the subject of the Application. In light of this uncertainty, LBHI presently adopts a neutral position with respect to certain issues affecting LBL in the Application, but reserves the right to change its position if it considers that it would be in its interests to do so.[3]

[3] Jones/10

Question 1 (proof of unsubordinated claim in administration)

Is LBHI2, being a member of LBIE, entitled to prove in LBIE's administration in respect of its unsubordinated claim, notwithstanding its Potential Liability as Contributory?

Summary

7. LBHI2 has lodged a proof for an (unsubordinated) unsecured claim for £38 million in the LBIE administration ("the £38m Debt").

8. LBHI submits that:

   (1) The £38m Debt is provable in LBIE's administration in accordance with the Rules.

   (2) LBHI2 is not prevented from proving for the £38m Debt by section 74(2)(f) of the Act.

   (3) LBHI2 is not prevented from proving for the £38m Debt by section 74 of the Act or by the application of the rule in *Cherry v Boultbee* (referred to in LBIE's position paper and below as the "Equitable Rule").

The Rules

9. Proving a debt is merely the means by which creditors wishing to recover their debts submit their claims in writing to the administrator. The creditor who claims is "proving" for his debt; the document by which he seeks to establish his claim is his "proof": Rule 2.72(2). The administrator may then admit or reject the proof in whole or in part: Rule 2.77. A proof, therefore, is merely a

documented claim for payment made in the administration of the debtor. The position is the same in liquidation: Rule 4.73.

10. The £38m Debt is provable in LBIE's administration in accordance with the Rules. In particular:

(1) The £38m Debt is a claim within the meaning of Rule 12.3, which provides as follows:

> *"Subject as follows, in administration, winding up and bankruptcy, all claims by creditors are provable as debts against the company or, as the case may be, the bankrupt, whether they are present or future, certain or contingent, ascertained or sounding only in damages."*

(2) There is nothing in the remainder of Rule 12.3 which affects the status of the £38m Debt as a provable claim.

(3) The £38m Debt is a "debt" within the meaning of Rule 13.12(1)(a), which (for the purposes of LBIE's administration and as modified by Rule 13.12(5))[4] provides as follows:

> *"(1) "Debt", in relation to the [administration] of the company, means … any of the following –*
>
> *Any debt or liability to which the company is subject at the date on which it goes into [administration]."*

[4] Rules 13.12(1) and (5) were amended by SI 2010/686 with effect from 6 April 2010 (subject to transitional provisions). As LBIE's administration commenced on 15 September 2008, however, the 2010 amendments do not apply. Unless otherwise stated, references to the Rules in these written submissions are to the Rules as in force on 15 September 2008.

Section 74(2)(f)

11. It is common ground between the parties that the position is not affected in any way by section 74(2)(f) of the Act, which provides as follows:

> *"(f) any sum due to any member of the company (in his character of a member) by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories' among themselves."*

12. This is because, even if section 74 were otherwise to apply (as to which see below), section 74(2)(f) would not apply so as to prevent LBHI2 proving in respect of the £38m Debt. This is because the £38m Debt is not owed to LBHI2 in its character as member by way of dividends, profits or otherwise within the meaning of that provision, as it does not fall due under or by virtue of the statutory contract constituted by section 33(1) of the Companies Act 2006: see *Soden v British & Commonwealth Holdings plc* [1998] AC 298.

13. It is important to bear in mind in this context that the principle is not "members come last" but that "the rights of members as members come last". A member having a cause of action independent of the statutory contract is in no worse a position that any other creditors: *Soden* per Lord Browne-Wilkinson at 324B.

Section 74

14. LBIE relies on an equitable rule "that a person who owes an estate money

cannot claim a share in that estate without first making the contribution which completes it" ("the Equitable Rule").

15. Section 74(1) of the Act provides as follows:

> *"When a company is wound up, every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories among themselves."*

16. Section 74 creates no liability which falls to be taken into account for the purposes of the Equitable Rule in LBIE's administration, for the following reasons:

    (1) As the opening words of section 74(1) make clear ("*When a company is wound up…*"), section 74 does not apply unless and until LBIE goes into liquidation; it does not apply in an administration.

    (2) The court has the power "as soon as may be after making a winding up-order" to settle a list of contributories: section 148(1). The court also has the power make a call on the contributories for the time being on the list of contributories: section 150(1). The Court's powers to settle the lists of contributories and to make and enforce calls are delegated to the liquidator in compulsory and voluntary winding up, subject to the supervision of the Court or the liquidation committee: sections 160(1)(b), (d) and (2); 165(2), (4)(a) and (b); Rules 4.195 - 4.205. The liquidator has the power, with sanction, to compromise all

calls and liabilities to calls and to take any security for the discharge of any such call: Schedule 4, Part 1, paragraph 3. Indeed, it is the liquidator's duty in a winding up by the court to settle the list of contributories "as soon as may be after his appointment": Rule 4.196(1).

(3) In stark contrast, the Act and the Rules give an administrator no power to:

i. settle a list of contributories;

ii. make calls[5];

iii. enforce calls; or

iv. compromise calls and liabilities to calls.

(4) Nor is there any provision in the Act or the Rules which:

i. obliges an administrator to obtain leave or sanction in order to make a call;

ii. avoids the transfer of shares or alteration in the status of the company's members in administration (as there is in liquidation: sections 88, 127).

If an administrator did have the power to make a call, contributories and creditors would be deprived of the protection which the corresponding provisions afford to them in liquidation (cf *Rudge v*

[5] Save for the power given to an administrator and administrative receiver to call up uncalled capital: Schedule 1, paragraph 19. The directors have a similar power when the company is a going concern.

Bowman (1868) LR 3 QB 689 at 696).

(5) As was said in *Re Pyle Works* (1889) 44 Ch D 524 (CA), per Lindley LJ at 584:

> *"Those moneys which are payable only on a winding-up, and which by the Act are excluded from the capital of the company, are never under the control of the directors, and cannot, I apprehend, be dealt with in any way by them. Those moneys form a statutory fund which only comes into existence when the company is in liquidation - that is to say, when the powers of the directors have ceased."*

and per Cotton LJ at 574:

> *"It was argued that the liability "to contribute to the assets of the company," in the 38th section of the Act, is something entirely different from a call made by the directors before the winding-up, and that a call made after the winding-up has commenced is not to be considered as a call of part of the capital of the company. In my opinion, that view is wrong as regards a case like this. We are considering the case of a call made in the winding-up of a limited company - not of a company limited by guarantee nor of an unlimited company. In the case of an unlimited or of a guarantee company, what can be called for in the winding-up may not be, and I think is not, considered as part of the capital of the company…*

(6) Administrators are in the same position as directors in the respects discussed in *Re Pyle Works*: a call on a contributory of an unlimited company under section 74 is payable only on a winding up; is never under the control of administrators; and cannot be dealt with in any way by them. The moneys called by the liquidator form a statutory

fund which only comes into existence when the company is in liquidation.

(7) The power to make a call under section 74 on the contributory of an unlimited company is analogous to the powers conferred on administrators and liquidators pursuant to sections 214, 238 and 239 of the Act (save that no power to make a call is conferred on an administrator). This reflects the fundamental distinction between assets of a company and rights conferred upon a liquidator in relation to the conduct of the liquidation (*Re Ayala Holdings (No 2)* [1996] 1 BCLC 467; *Re Oasis Merchandising Services Ltd* [1998] Ch 170; *Re International Championship Management Ltd* [2007] 2 BCLC 274, 282); and between liabilities of a company and obligations of a liquidator in relation to the conduct of the liquidation (*Re Lines Brothers Ltd* [1984] BCLC 215 at 223).

17. In any event, the Equitable Rule does not operate to prevent payment of a debt which is presently due (ie the £38m Debt) in circumstances where the liability to the estate (ie LBHI2's potential liability to contribute pursuant to section 74) is not immediately payable: *Re Abrahams* [1908] 2 Ch 69, 73; *Re Kaupthing Singer & Friedlander Ltd (No 2)* [2012] 1 AC 804 per Lord Walker at [45]. The liability of a contributory is "payable at the times when calls are made for enforcing the liability": section 80. Calls may be made for enforcing the liability "at any time after the making of a winding-up order": section 150(1). So the liability of LBHI2 as a contributory is not payable before LBIE's winding up; cannot therefore be immediately payable in LBIE's administration;

and the Equitable Rule does not apply for this reason also.

18. If, contrary to the submissions above, LBHI2's potential liability under section 74 did fall to be taken into account in LBIE's administration, the results would be bizarre.

19. In the first instance, LBIE's Administrators would have to estimate LBHI2's potential liability under section 74. If LBHI2's potential liability under section 74 were payable to LBIE in LBIE's administration, the amount paid would be applied by LBIE's Administrators first towards payment of the expenses of LBIE's administration; and the balance would be applied towards LBIE's other debts and liabilities. This would be bizarre: there is no indication in the Act or the Rules or elsewhere that contributories are intended under section 74 to contribute to debts and liabilities in administration or the expenses of the administration. Indeed, the existence of section 74 and the absence of any provision imposing an obligation on contributories to contribute to debts and liabilities in administration and the expenses of the administration indicate the very opposite.

20. If LBIE entered winding up following its administration, its liquidators would be expected to make a call on LBHI2 under section 74 in "an amount sufficient for payment of [LBIE's] debts and liabilities and the expenses of the winding up". Having regard to the amount which (on this hypothesis) would already have been paid by LBHI2 as contributory to LBIE in administration, payment of this further amount could have the result that LBHI2 would be liable to pay an amount *greater* than was sufficient for payment of LBIE's debts and liabilities and the expenses of the winding up. This would also be bizarre: it is

inconsistent with section 74, and there is no indication in the Act or the Rules or elsewhere that contributories have a liability under section 74 to pay an amount greater than the amount specified therein. This can be demonstrated by reference to the example of a company in administration with the following balance sheet:

Assets:	20
Debts and Liabilities:	50
Expenses:	30

21. The administrator would apply the assets towards payment of the expenses, leaving unpaid expenses of 10 and debts and liabilities of 50. If he estimated that the expenses of the winding up would be 5, he would make a call for 55. This sum would be applied first towards unpaid expenses of 10, and the balance of 45 would be applied towards the debts and liabilities of 50. The company would then enter liquidation with unpaid debts and liabilities of 5 and expenses of (say) 5. The liquidator would make a call for 10. The result is that the contributories would have been subject to calls for 65, which is greater than the amount sufficient for the payment of the debts and liabilities and the expenses of the winding up, ie the amount payable by contributories would be greater than the amount specified in section 74.

22. Yet another bizarre consequence would follow from the fact that a past member has no liability to contribute under section 74 if he ceased to be a member for one year or more before the commencement of the winding up: section 74(2)(a). Consider the following example of a company and sometime

member ("X") of the company:

15 September 2008:	company enters administration
1 January 2014:	X ceases to be a member of the company
15 October 2015:	company is wound up

23. Since X ceases to be a member of the company one year or more before the commencement of the winding up, X has no liability to contribute under section 74. However, if LBIE's argument is correct, and an account of what is due between the company and X is taken and settled before X ceases to be a member, section 74 will impose a liability on X to contribute in the company's administration. Any such liability is greater than and inconsistent with the express terms of section 74(2)(a).

The Equitable Rule

24. Even if any potential liability on the part of LBHI2 to contribute pursuant to section 74 were to be taken into account in LBIE's administration as a contingent liability owed by LBHI2, however, the Equitable Rule would not apply to prevent LBHI2 proving as a creditor in LBIE's administration. If it were to apply at all, its effect would be confined to preventing LBHI2 from participating in any distribution ie from receiving anything, until it has paid everything it owes as contributory: *Re Kaupthing Singer & Friedlander Ltd (No 2)* [2012] 1 AC 804 at [20] and [52], where Lord Walker cited with approval *Re Auriferous Properties Ltd (No 2)* [1898] 2 Ch 428, and the judgment of Buckley J in *Re West Coast Gold Fields Ltd* [1905] 1 Ch 597 at 602.

25. In any event, the Equitable Rule does not operate to require actual payment by the contributory: nothing is retained by the liquidator, but the contributory is paid by holding in his hands that part of the fund which, if the fund were completed by payment of his liability to the fund, the contributory would receive back: *Re Akerman* [1891] 3 Ch 212 at 219. It is "basically a simple technique of netting-off reciprocal monetary obligations, even where there is no room for legal set-off, developed in giving directions for the administration of estates (originally of deceased persons): *Re Kaupthing Singer & Friedlander Ltd (No 2)* [2012] 1 AC 804 at [8].

26. For all these reasons, therefore, LBHI submits that the answer to Question 1 is: Yes.

Question 2 (proof of unsubordinated claim in liquidation)

If LBIE were wound-up, would LBHI2, being a member of LBIE, be entitled to prove in LBIE's liquidation in respect of the £38m Debt, notwithstanding its Potential Liability as Contributory?

27. LBHI submits as follows:

    (1) Just as the £38m Debt is provable in LBIE's administration for the reasons explained in response to Question 1, so too it would be provable in LBIE's liquidation in accordance with Rules 4.73, 12.3 and 13.12(1)(a).

    (2) LBHI2 is not prevented from proving for the £38m Debt by section 74(2)(f) of the Act: section 74(2)(f) would not apply for exactly the same reasons as already explained.

    (3) LBHI2 would not be prevented from proving for the £38m Debt by section 74 of the Act or by the application of the Equitable Rule.

28. For the purposes of (3), it is accepted that LBHI2 would become subject to a contingent liability pursuant to section 74 upon LBIE going into liquidation. Nevertheless, for the reasons already explained, the Equitable Rule would not operate to prevent LBHI2 proving in respect of the £38m Debt in LBIE's liquidation.

Question 3 (proof of Subordinated Debt)

Is LBHI2 entitled to prove in LBIE's administration, or would it be entitled to prove in any subsequent liquidation of LBIE, in respect of the Subordinated Debt notwithstanding (i) the terms of the Subordinated Debt; and (ii) LBHI2's Potential Liability as Contributory? What (if any) is the effect of section 74(2)(f) of the Act?

29. LBHI2 has lodged a proof for £1,254,165,598.48 in the LBIE administration in respect of the Subordinated Debt.[6]

30. LBHI submits as follows:

    (1) The Subordinated Debt is provable in LBIE's administration (and would be provable in any liquidation of LBIE) in accordance with the Rules.

    (2) It is common ground that section 74(2)(f) of the Act does not apply and does not affect the position: see paragraphs 11 - 13 above.

    (3) There is nothing in the terms of the Subordinated Debt Agreements themselves which prevents LBHI2 from proving in LBIE's administration or any subsequent liquidation in respect of the Subordinated Debt. On the contrary, they clearly contemplate that LBHI2 is able to prove for the Subordinated Debt.

    (4) The Equitable Rule does not operate to prevent the Subordinated Debt being provable in LBIE's administration (and would not so operate in any subsequent liquidation) of LBIE.

---

[6] Lomas 1/23.2

The Subordinated Debt is provable in accordance with the Rules

31. The Subordinated Debt qualifies as a provable claim for the purposes of Rules 12.3 and 13.12(1)(a) in substantially the same way the £38m Debt does: see paragraph 10 above. The only difference is that the Subordinated Debt was not yet due for payment when LBIE entered administration. However, the fact that a debt is not due for payment at the date of administration does not mean that the creditor cannot prove for it: Rule 2.89 specifically permits the creditor to prove for such a debt, subject to Rule 2.105 (pursuant to which a discount is applied for the purpose of dividend if the debt is still not due for payment at the date of the declaration of dividend).

32. Similarly, the Subordinated Debt would be provable in any subsequent liquidation of LBIE as a debt payable at a future time pursuant to Rules 4.75, 4.94, 12.3 and 13.12.

Section 74(2)(f)

33. It is common ground that section 74(2)(f) would have no effect in relation to the Subordinated Debt, even if section 74 of the Act were otherwise to apply. This is because the Subordinated Debt is not owed to LBHI2 "by way of dividends, profits or otherwise" for the purposes of that provision: *Soden v British & Commonwealth Holdings plc* [1998] AC 298.

The Subordinated Debt Agreements

34. LBHI submits that the evidence leads to the conclusion that the Subordinated Debt outstanding as at the date LBIE entered administration was drawn under the US$8 billion short-term subordinated loan facility agreement dated 1

November 2006 ("the Short-Term Subordinated Debt Agreement").[7] For the purposes of Question 3, however, it does not matter under which Subordinated Debt Agreement(s) the Subordinated Debt is outstanding because their terms (apart from the Repayment Date) are in all material respects substantially the same.

35. It is apparent from the terms of the Subordinated Debt Agreements that:

(1) LBHI2 is referred to as "Lender" and LBIE is referred to as "Borrower" (Schedule 1, paragraphs 3 and 5; Schedule 2, paragraph 1(1)).

(2) Funds drawn down in accordance with their terms constitute debts which are repayable (Schedule 1, paragraph 9; Schedule 2, paragraph 4), on which interest accrues (Schedule 1, paragraph 8; Schedule 2, paragraph 3).

(3) LBIE acknowledges its indebtedness to LBHI2 in respect of the Subordinated Debt (Schedule 2, paragraph 2(1)).

(4) In the event of non-payment, LBHI2 may enforce payment by instituting proceedings for the administration or liquidation of LBIE upon prior notice to the FSA (now the FCA) (Schedule 2, paragraph 4(4)).

(5) Subject to certain other conditions (including a 60-day period of grace), LBHI2 may enforce obligations other than payment obligations by instituting proceedings for the administration or liquidation of LBIE (Schedule 2, paragraph 4(5) and (6)).

---

[7] Jones/13 - 45. The Short-Term Subordinated Debt Agreement is at AVL/241.

(6) The fact that LBHI2 may "enforce payment" by instituting proceedings for administration or liquidation against LBIE necessarily contemplates that LBHI2 will be able to prove in either form of insolvency. Enforcing or obtaining payment in administration or liquidation simply could not be achieved in the absence of proof in respect of the Subordinated Debt. If it were intended that LBHI2 should not be able to prove for the Subordinated Debt, the institution of insolvency proceedings would not constitute a means of "enforcing payment", and would not have been referred to as such.

36. The Subordinated Debt is subordinated in accordance with the provisions of Schedule 2, paragraph 5 ("Paragraph 5"). Paragraph 5 is set out in full and considered at length in the response to Question 11 below. For present purposes, however, it suffices to refer to the opening words of Paragraph 5(1), which state as follows:

> *"(1) Notwithstanding the provisions of paragraph 4, the rights of [LBHI2] in respect of [the Subordinated Debt] are subordinated to the Senior Liabilities and accordingly payment of any amount (whether principal, interest or otherwise) of the [Subordinated Debt] is conditional upon – [various conditions set out in (a) and (b)]"* (emphasis added)

37. Paragraph 5 does not purport, therefore, to prohibit or postpone LBHI2's right to prove in respect of the Subordinated Debt. Its effect is confined to the payment of the Subordinated Debt, and it does not affect at all LBHI2's right to participate in the proof process.

The factual matrix: IPRU(INV) 10

38. There is nothing in the factual matrix which alters this conclusion. According to the recital in each of the Subordinated Debt Agreements, the Subordinated Debt was intended by LBHI2 and LBIE to be used in accordance with FSA Rule IPRU(INV) 10-63. Reference in the Subordinated Debt Agreements to any rules of the FSA is to be read as a reference to them as in force from time to time: Schedule 2, paragraph 1(2).

39. IPRU(INV) was the FSA's Interim Prudential Sourcebook for Investment Businesses. Its purpose was to set out rules and guidance to assist the FSA to meet its statutory objectives of protecting consumers and maintaining market confidence by setting minimal capital and other risk management standards thereby mitigating the possibility that firms would be unable to meet their liabilities and commitments to consumers and counterparties: IPRU(INV) 1.1.2.

40. IPRU (INV) 10 made provision for the Initial Capital and Financial Resources of investment firms for the purposes of ensuring their compliance with applicable capital adequacy requirements. IPRU (INV) 10-63 (Subordinated Loan) permitted an investment firm to take into account subordinated loan capital in its financial resources for the purposes of Rule 10-62 (Financial Resources), subject to certain conditions.

41. None of the conditions, which are set out in Rule 10-63(2) - (12), purports to prohibit or postpone LBHI2's right to prove in respect of the Subordinated Debt. In particular, although Rule 10-63(2) provided that a firm could include a subordinated loan in its financial resources only if it was drawn up in

accordance with the FSA's standard forms, the standard forms themselves made no provision to the effect that the subordinated debt should not be provable in the administration or liquidation of the borrower. On the contrary, the fact that the lender may "enforce payment" by instituting proceedings for administration or liquidation against the borrower (Schedule 2, paragraph 4(4) of the standard forms) necessarily contemplates that the lender will be able to prove in either form of insolvency.

GENPRU

42. At the time LBIE went into administration, IPRU(INV) 10 had been replaced by the FSA's General Prudential Sourcebook (GENPRU) and Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). GENPRU 2.1 set out the minimum capital resources requirements for a firm, while GENPRU 2.2 set out how capital resources were defined and measured for the purpose of meeting the requirements of GENPRU 2.1: GENPRU 1.2.18G. GENPRU 1.2.26R provided as follows:

> *"A firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due."*

43. As stated above, LBHI submits that the evidence leads to the conclusion that the Subordinated Debt outstanding as at the date LBIE entered administration was drawn under the Short-Term Subordinated Debt Agreement. For the purposes of the provability of the Subordinated Debt, however, it does not matter under which Subordinated Debt Agreement(s) the Subordinated Debt

is outstanding. This is because the Subordinated Debt must qualify either as a lower tier 2 capital instrument (if drawn under the Long-Term Subordinated Debt Agreement) or as a tier 3 capital instrument (if drawn under the Short-Term Subordinated Debt Agreement). Even if the Subordinated Debt is long-term subordinated debt, it would not be eligible as upper tier 2 capital because it would not satisfy the requirements of GENPRU 2.2.177R. These include, amongst other things, the condition that the loan must have no fixed maturity date, whereas the Repayment Date in the Long-Term Subordinated Debt Agreement is fixed at 10 years from 1 November 2006.

44. The requirements to be satisfied in relation to lower tier 2 capital are set out in GENPRU 2.2.159R and 2.2.194R (including an original maturity of at least five years). The requirements to be satisfied in relation to tier 3 capital are set out in GENPRU 2.2.242R (including an original maturity of at least two years), 244R and 245R. GENPRU 2.2.245R applies 2.2.159R to tier 3 capital with certain adjustments (which are immaterial for present purposes). This is important because GENPRU 2.2.159R provides (in relevant part) as follows:

> *"A capital instrument must not form part of the tier two capital resources of a firm unless it meets the following conditions:*
>
> *(1) the claims of the creditors must rank behind those of all unsubordinated creditors;*
>
> *(2) the only events of default must be non-payment of any amount falling due under the terms of the capital instrument or the winding-up of the firm and any such event of default must not prejudice the subordination in (1);*

(3) to the fullest extent permitted under the laws of the relevant jurisdictions, the remedies available to the subordinated creditor in the event of non-payment or other breach of the terms of the capital instrument must (subject to GENPRU 2.2.161R) be limited to petitioning for the winding-up or the firm <u>or proving for the debt in the liquidation or administration</u>;

(4) any:

remedy permitted by (3) …

must not prejudice the matters in (1) and (2) …" (emphasis added)

45. Far from prohibiting or preventing the lender from proving in respect of the subordinated debt, GENPRU 2.2.159R specifically envisages that the lender may prove in relation to it in the borrower's administration or liquidation. It is true that the subordination provisions apply, but their effect is confined to the question of priority rather than the question of provability, and they are addressed separately below in response to Question 11.

<u>The Equitable Rule</u>

46. For the reasons already explained in response to Questions 1 and 2, the Equitable Rule does not operate to prevent the Subordinated Debt being provable in LBIE's administration (and would not so operate in any subsequent liquidation) of LBIE.

<u>Conclusion</u>

47. In conclusion, therefore, LBHI submits that the answer to Question 3 is: Yes.

The Subordinated Debt is provable in LBIE's administration and would be provable in any subsequent liquidation of LBIE.

Question 9 (LBHI2's Potential Liability as Contributory)

Whether, and in what circumstances LBHI2's Potential Liability as Contributory extends to contributing to LBIE's assets an amount sufficient for payment of:

(a) interest provable and/or payable pursuant to Rule 2.88 of the Rules on the principal of the debts and liabilities owed to LBIE's creditors by LBIE; and/or

(b) the Subordinated Debt; and/or

(c) Currency Conversion Claims, to the extent that Question 12 is answered in the affirmative.

Summary

48. LBHI submits that the debts and liabilities (but not the expenses) to which liability to contribute extends pursuant to section 74, in the event that the company is unable from its own resources to pay them, are only those which are or would be provable in LBIE's liquidation. In the event of LBIE's liquidation, therefore, LBHI2's potential liability pursuant to section 74 (in the event of LBIE suffering a shortfall) would extend to:

    (1) interest provable pursuant to Rule 4.93(1) (being the same interest as would be provable pursuant to Rule 2.88(1));

    (2) the Subordinated Debt if it is provable, but not otherwise.

49. LBHI2's potential liability to contribute would not extend to:

(1) interest payable (if at all) pursuant to Rule 2.88(7);

(2) the Subordinated Debt if it is not provable; or

(3) Currency Conversion Claims (even if such claims exist).

Rule 2.88(7) interest

Rule 2.88(7) interest is not payable in a winding-up

50. LBHI2's potential liability under section 74 would arise (if at all) only if LBIE were wound up. If LBIE were to go into liquidation, Rule 2.88(7) interest would be neither provable nor payable.

51. Rule 2.88(7) interest is not provable in liquidation because Rule 4.93(1) forbids it. Rule 4.93(1) (in the terms in force when LBIE entered administration) provided as follows:

> *"Where a debt proved in the liquidation bears interest, that interest is provable as part of the debt except in so far as it is payable in respect of any period after the company went into liquidation or, if the liquidation was immediately preceded by an administration, any period after the date the company entered administration."* (emphasis added)

52. It is to be assumed for present purposes that any liquidation of LBIE would immediately follow its administration. In that event, the effect of Rule 4.93(1) is beyond argument: Rule 2.88(7) interest, which necessarily relates to the period after LBIE entered administration, would not be provable in LBIE's liquidation.

53. The payment of statutory interest in liquidation is governed by section 189, which provides (so far as material) as follows:

> *"(1) In a winding up interest is payable in accordance with this section on any debt proved in the winding up, including so much of any debt as represents interest on the remainder.*
>
> *(2) Any surplus remaining after the payment of the debts proved in a winding up shall, before being applied for any other purpose, be applied in paying interest on those debts <u>in respect of the periods during which they have been outstanding since the company went into liquidation</u>."* (emphasis added)

54. A company goes into liquidation when it passes a resolution for voluntary winding up or an order is made for its winding up by the Court when it has not already gone into liquidation by passing such a resolution: section 247(2). There is, for these purposes, no provision which deems the liquidation to commence at the time of prior entry into administration. Rule 2.88(7) interest would be payable (if at all) in relation to the period before LBIE goes into liquidation. It follows that it cannot be payable pursuant to section 189(2), which provides that statutory interest is only payable in liquidation in relation to the period after LBIE goes into liquidation.

55. As there would be no obligation on the part of LBIE to pay Rule 2.88(7) interest in the event of it going into liquidation, it must follow that, even assuming LBHI2 is otherwise potentially liable to contribute pursuant to section 74, it has no potential liability to contribute extending to Rule 2.88(7) interest, contingent or otherwise.

Section 74 liability is confined to debts and liabilities which are provable

56. LBHI submits that a member's liability to contribute to a company's debts and liabilities (but not the expenses of the winding up) for which section 74 provides is confined to those debts and liabilities which are provable in LBIE's liquidation. As statutory interest is not provable, the member's liability to contribute pursuant to section 74 does not extend to it.

57. The phrases "debt and liabilities" or "debts and other liabilities" or simply the word "liabilities" are used elsewhere in the Act to refer to provable debts. Thus:

   (1) The reference to "liabilities" in section 107 is a reference to provable debts, for it is those debts which are proved and paid pari passu in accordance with the provisions of Chapter 9 of Part 4 of the Rules. As Patten LJ said in *Re Danka Business Systems plc* [2013] 2 WLR 1398 at [37]:

      > *"The reference to the company's liabilities in section 107 must be to the liabilities as determined in accordance with the 1986 Rules. Otherwise they serve no useful purpose."*

   (2) The same is true of the references to "debts and [other] liabilities" in sections 2(3)(b)(i), 47(2)(a), 66(2)(a), 95(4)(a), 99(2)(a), 131(2)(a) (statement of affairs); 123(2) (proof that assets less than liabilities); 214(6) (wrongful trading); 216(7) (restriction on re-use of company names); 272(2)(a) (debtor's petition); and 421(4) (insolvent estates of deceased persons).

58. Furthermore, it is noteworthy that whenever it is intended that statutory interest should be taken into account for the purposes of a provision in the Act, it is expressly referred to. Thus:

(1) It is expressly referred to in section 89(1) as “interest at the official rate”. The “official rate” is defined in section 251 by reference to section 189(4), which is the provision relating to statutory interest payable in liquidation.

(2) It is expressly referred to in the same terms in section 149(3).

(3) Section 215(4) permits the Court to direct that the whole or any part of the debt owed by the company to someone found liable for fraudulent trading or wrongful trading shall rank in priority after all other debts owed by the company and after “any interest” on those debts. The reference to “any interest” is less specific but is nevertheless wide enough to include statutory interest. The important point is that section 215(4) expressly refers to interest whereas section 74(1) does not refer to interest at all.

(4) Rule 12.3(2A) also makes specific reference to statutory interest.

59. The omission of any reference to statutory interest in section 74(1) must therefore be taken to have been deliberate. This conclusion is inescapable when it is considered that section 74(1) is based on section 212(1) of the Companies Act 1948 and that, despite the fact that other changes have been introduced, no change has been made to refer to statutory interest. The position is to be contrasted in this respect with sections 89(1) and 149(3),

referred to above, which are derived from sections 283(1) and 259(3) respectively of the 1948 Act, but into which express references to statutory interest have been inserted: see paragraph 58 above.

60. Rule 2.88(7) interest is not provable in administration (*Re Kaupthing Singer & Friedlander Ltd* [2010] 1 BCLC 222 at [21]; [2011] 1 BCLC 12 (CA) at [14]). This is clear from Rule 2.88(1) and (7), which provide as follows:

> *"(1) Where a debt proved in the administration bears interest, that interest is provable as part of the debt <u>except in so far as it is payable in respect of any period after the company entered administration</u> ...*
>
> *(7) Any surplus remaining <u>after payment of the debts proved shall</u>, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the company entered administration."* (emphasis added)

61. Rule 2.88(7) interest is not a "debt" for the purposes of Rule 13.12(1):

(1) Whether payable pursuant to section 189(2) or Rule 2.88(7), statutory interest is not a debt or liability to which LBIE was subject when it entered administration.

(2) It is a not a debt or liability to which LBIE may become subject by reason of any obligation incurred before it entered administration, for the reasons given below.

(3) Although it is interest, statutory interest is not interest provable as mentioned in Rule 4.93(1), which expressly excludes interest in so far as it is payable in respect of any period after the date the company

enters administration.

62. The conclusion that Rule 2.88(7) interest does not fall within the definition of "debt" in Rule 13.12(1) is not surprising when it is understood that, read with Rule 12.3, the rule is concerned with the question what qualifies as a provable debt, and Rule 2.88(7) interest is not provable.

63. It is for the same reason that other debts or liabilities to which the company may become subject after it goes into liquidation are not "debts" within the meaning of Rule 13.12(1), notwithstanding that they arise by reason of an obligation incurred before that date. This applies to:

(1) certain costs of the winding up, eg:

i. those arising under contracts of employment adopted by the administrator (Schedule B1, paragraph 99(5));

ii. debts which are deemed to be expenses of the liquidation, eg those arising under agreements entered before the administration which are retained for the benefit of the administration (*Goldacre (Offices) Ltd v Nortel Networks UK Ltd* [2010] 2 BCLC 248; *Re Portsmouth City Football Club Ltd* [2013] 1 BCLC 572 at [95]);

(2) the liability to pay any surplus to shareholders[8].

64. LBIE asserts in its Position Paper (paragraph 9(e)) that Rule 2.88(7) interest falls within the definition in Rule 13.12(4), presumably as a liability under an

[8] Alternatively, as explained at paragraphs 16 and 109, these obligations (as with Rule 2.88(7) interest) are properly to be considered not as liabilities of the company, but as obligations of a liquidator in relation to the conduct of the liquidation.

enactment. “Liability” is defined in Rule 13.12(4) in the following terms:

> *“In any provision of the Act or the Rules about winding up, except in so far as the context otherwise requires, “liability” means (subject to paragraph (3) above) a liability to pay money or money’s worth, including any liability under an enactment, any liability for breach of trust, any liability in contract, tort or bailment, and any liability arising out of an obligation to make restitution.”*

65. As already stated, however, Rule 13.12 is concerned with what constitutes a provable debt. The definition of “liability” in Rule 13.12(4) is ultimately derived from section 31 of the Bankruptcy Act 1869. In the context of construing that provision, Lord Halsbury LC said in *Hardy v Fothergill* (1888) 13 App Cas 351 at 355 - 6:

> *“the legislature has been engaged in the effort to exhaust every conceivable possibility of liability under which a bankrupt might be, to make it provable in bankruptcy against his estate and relieve the bankrupt for the future from any liability in respect thereof.”*

See also *Re Nortel* [2013] UKSC 52, per Lord Neuberger at [90].

66. When Rule 13.12(4) defines “liability”, therefore, it does so in the context of providing the means of determining whether the liability is provable as a debt. In that context, it does not matter what the source of the liability is, so long as it arises under statute or otherwise as mentioned in Rule 13.12(4).

67. Moreover, interest is expressly referred to as a “debt” in Rule 13.12(1)(c). It follows that interest of any kind would be classified as a debt rather than as a liability. As already highlighted, however, the reference in Rule 13.12(1)(c) is

confined to interest provable as mentioned in Rule 4.93(1), which excludes interest in respect of any period after the company entered administration. The absence of any reference to statutory interest, taken together with the express reference to provable interest, show that it was not intended by the legislature that statutory interest should qualify as either a debt or a liability for the purpose of Rule 13.12 or, therefore, Rule 12.3.

68. In any event, to include statutory interest within the phrase "debts and liabilities" in section 74(1) would be circular. Section 74(1) imposes a liability on members to contribute sufficient to pay the company's debts and liabilities. Unless and until there is a surplus after payment of the debts proved, there is no liability to pay statutory interest; and any such liability is limited to the extent of the surplus. The result of imposing liability on the member to contribute in relation to statutory interest would therefore be that his contribution actually creates the very liability to which the contribution itself is intended to relate. Had that been what section 74(1) was intended to achieve, it is to be expected that it would have stated as much in clear terms, which it does not. When section 74(1) refers to "debts and liabilities", therefore, it does not include statutory interest.

<u>"Debts and liabilities" in section 74(1) cannot be read literally</u>

69. The requirement to contribute "sufficient for the payment of its debts and liabilities" in section 74(1) cannot be read literally so as to require payment in full of the nominal value of all debts and liabilities. If "debts and liabilities" were to be read literally, there would be no need to refer to the expenses of the winding up. The fact that separate reference is made to such expenses

means that "debts and liabilities" are confined to those which are provable. Furthermore, there are various categories of debts and liabilities of the company which do not fall within section 74, thereby demonstrating that section 74 is confined to debts and liabilities proved for the purposes of dividend.

70. The first such category is future debts. The administrator (or liquidator) is not obliged (or permitted) to pay the value of such debts *in full*. Rather he is obliged to pay dividend on the amount discounted in accordance with Rules 2.89 and 2.105 (or Rules 4.94 and 11.13). The amount of the discount is not provable or payable and could not be caught by section 74.

71. This may be illustrated by an example. Suppose the company owes a creditor ("FC") a debt of £1,000, which falls due for payment 20 years after the date the company enters administration (the "administration date"). In accordance with Rule 2.105, the amount of FC's admitted proof for the purpose of dividend is £1,000/1.05^{20} = £376.89. If dividends were paid on the administration date, and the company was able to pay all its debts as they fell due, FC would receive £376.89. Even if the company had a massive surplus after payment of the amount payable to FC (and any other debts and liabilities), no further sum would be payable to FC, which would not receive payment of the nominal amount of its debt of £1,000. For the same reason, if the company had sufficient assets to pay £376.89 to FC (and the company's other debts and liabilities), contributories would not be liable to contribute in respect of the difference between the nominal amount of the debt owed to FC (ie £1,000) and the amount paid to FC.

72. A similar analysis applies to contingent debts, which the administrator (or liquidator) is likewise not obliged (or permitted) to pay in full. Such debts must be estimated in accordance with Rule 2.81 (or Rule 4.86).

73. Suppose the company owes a creditor ("CC") a debt of £1,000, which is payable in 20 years in the event that a remote contingency takes place. In accordance with Rule 2.81, the administrator estimates the likelihood that the contingency will occur at 5%. He therefore estimates the value of the debt at 5% x £1,000 = £50, which he discounts for accelerated receipt (at, say, 5% pa), giving £50/1.05^{20} = £18.84. CC's proof is admitted for that amount. If dividends were paid on the administration date, and the company was able to pay all its debts as they fell due, CC would receive £18.84. Even if the company had a massive surplus after payment of the amount payable to CC (and any other debts and liabilities), no further sum would be payable to CC, which would not receive payment in full of its contingent debt of £1,000. For the same reason, if the company had sufficient assets to pay £18.84 to CC (and the company's other debts and liabilities), contributories would not be liable to contribute in respect of the difference between the amount of the debt contingently owed to CC (ie £1,000) and the amount paid to CC.

74. The third category of debts comprises non-provable debts, such as those which are statute-barred (*Re Art Production Co Ltd* [1952] Ch 89) and liability to pay foreign (non-EU) taxes (*Government of India v Taylor* [1955] AC 491). Since it is not incumbent on the administrator or liquidator to pay such liabilities (which are not enforceable in the courts of this country), it cannot sensibly be suggested that contributories are liable to contribute to the company's assets in order for them to do so.

75. The fourth category is (fully) secured liabilities. It would be bizarre if members were obliged to contribute to the company's assets in respect of secured liabilities, because the administrator (and liquidator) are not obliged to cause the company to pay such liabilities unless the creditor gives up his security and proves.[9] So any such payment by members would be returned to members.

76. The final such obligation is the obligation to distribute any surplus to members. If "debts and liabilities" included this obligation, it would follow that, where there was a surplus after payment of the debts proved, members would be obliged to contribute in respect of that surplus, which would be absurd. Rather, the company's "debts and liabilities" within the meaning of section 74(1), are limited to provable debts and liabilities.

77. As statutory interest is not provable, it is not included in the "debts and liabilities" to which members are liable to contribute pursuant to section 74.

Currency Conversion Claims

78. LBHI submits that LBHI2's potential liability to contribute pursuant to section 74 does not extend to Currency Conversion Claims (as defined in the Application). There are two reasons for this:

    (1) First, a Currency Conversion Claim (as defined) does not exist and cannot therefore be pursued, for the reasons given in response to Question 12 below. It follows that there can be no liability on the part of members to contribute in relation to the same pursuant to section 74(1).

[9] The position of secured creditors is governed by Rules 2.83 and 2.90 - 2.94 (administration) and 4.88 and 4.95 - 4.99 (liquidation).

(2) Alternatively, even if a Currency Conversion Claim does exist, it is not provable. As the reference to "debts and liabilities" in section 74(1) only extends to provable debts, for the reasons already explained, it follows that it does not include Currency Conversion Claims which are not provable in any event, whether in the administration or a liquidation of LBIE.

79. A Currency Conversion Claim is not provable in administration. This much is common ground and necessarily follows from the provisions of Rule 2.86, which imposes for the purpose of proof the official exchange rate prevailing on the date when the company entered administration for the conversion of a debt incurred in a currency other than sterling.

80. A Currency Conversion Claim would not be provable in a liquidation either. This is because, for the purposes of proof, such a claim would be subject to the provisions of Rule 4.91, which require that it should be converted into sterling at the official exchange rate prevailing on the date LBIE entered administration (it being assumed that the liquidation of LBIE would immediately follow its administration). Converted at that date, there would be no provable Currency Conversion Claim at all: such a claim necessarily relies for its existence on a fluctuation in exchange rates from and after the date of entry into administration, and will not arise if subsequent fluctuations are ignored.

Post-administration contractual claims for interest

81. LBIE appears to assert that a member's potential liability to contribute pursuant to section 74 extends to contractual liability on the part of LBIE to

pay interest in respect of the post-administration period (albeit such interest is neither provable nor payable as an expense).

82. LBHI submits that LBHI2's potential liability as member pursuant to section 74(1) does not extend to any such contractual claim for interest because:

(1) There is a statutory regime which governs the payment of interest in respect of the period after the company enters administration. That statutory scheme replaces any contractual entitlement to interest, such that the only respect in which the contract remains relevant (if at all) is if it provides for a higher rate of interest than the judgment rate apart from the administration for the purposes of Rule 2.88(9).

(2) Accordingly, save to the limited extent of the rate of interest payable apart from the administration, there is no scope for the continuing availability of a contractual entitlement to post-administration interest, at least where (as in the case of LBIE) the administrators have given notice of their intention to make a distribution pursuant to Rule 2.95.

(3) In any event, even if such a contractual claim for interest existed, it would not be provable. For the reasons already explained, therefore, LBHI2's potential liability to contribute pursuant to section 74(1) would not extend to such a claim.

83. Provision for the application of any surplus following payment of proven debts in paying interest on such debts in respect of the period after the company went into liquidation was first introduced by section 189(2) of the Act. Similar provision was introduced in respect of a company in administration (in which a

distribution is to be made) following the enactment of the Enterprise Act 2002: Rule 2.88(7).

84. Prior to the Act, similar provision was made in relation to bankrupt individuals by the Bankruptcy Act 1914, section 33(8) of which provided as follows:

> *"If there is a surplus after payment of the foregoing debts, it shall be applied in payment of interest from the date of the receiving order at the rate of four pounds per centum per annum on all debts proved in the bankruptcy."*

85. The Cork Report noted at paragraph 1384 that there was no similar provision relating to companies, and that section 33(8) of the 1914 Act was not imported into the Companies Acts. What happened instead was that a creditor entitled to interest could recover post-petition interest as if there had been no winding up at all, while a creditor not entitled to interest on its debt at the commencement of the liquidation had no means of recovering interest at a later stage at all.

86. The Cork Report considered that there should be a common code of rules for situations which occur both in personal insolvency and in winding up proceedings and that, in particular, interest should be payable on debts in the same way in both administrations (paragraph 1386). In its formulation, simplicity and certainty were essential (paragraph 1392). It recommended (paragraph 1395(c)) that:

> *"during the insolvency, in the event of there being a surplus after payment of all admitted debts and liabilities (including interest prior*

to the commencement of the insolvency, where applicable) interest should run on all such debts and liabilities until a final dividend is declared, the rate being that currently applicable to judgment debts at the commencement of the insolvency."

87. As a result of the legislative changes described above, it is no longer the case that the creditor of a company in liquidation may recover interest as if there had been no winding-up at all (the pre-1986 position). The same must hold true in administration. Entitlement to interest is governed not by any pre-liquidation/administration agreement or arrangement but by Rule 2.88(7). Rule 2.88(9) relates only to the rate of interest payable: it does not govern entitlement to interest and makes no mention of the period over which interest is payable. That too is provided for in Rule 2.88(7).

88. The Act makes no mention of any continuing contractual entitlement to interest in respect of the period after the company enters administration. The provisions of Rule 2.88 do not permit the co-existence of any such continuing contractual entitlement. It is not to be supposed that, when legislating in the manner provided for by Rule 2.88(7) (and section 189(2) and Rule 4.93 in the context of liquidation) that the legislature either envisaged or intended that a non-statutory scheme relating to the payment of post-administration interest should operate either in place of the statutory scheme or in parallel to it.

Question 11 (order of application of surplus)

In the event that there are sufficient funds in LBIE's administration to permit the LBIE Joint Administrators to make payment in full to LBIE's general, unsecured creditors in respect of the principal of the debts and liabilities owed to them by LBIE, in what order would the LBIE Joint Administrators be required to apply any surplus in discharging the following:

(a) interest payable on such debts and liabilities in respect of the periods during which they have been outstanding since LBIE entered administration pursuant to Rule 2.88(7)?

(b) Currency Conversion Claims (as defined in Question 12 below), to the extent that Question 12 is answered in the affirmative;

(c) to the extent that the Members have been unable to prove in respect of them, debt(s) owed by LBIE to LBHI2 (other than in respect of the Subordinated Debt); and

(d) to the extent that LBHI2 has been unable to prove in respect of it, the Subordinated Debt.

89. LBHI submits that, if there are sufficient funds in LBIE's administration, the LBIE Joint Administrators would be required to pay claims in the following order:

(1) The £38 million Debt, as a provable debt.

(2) The Subordinated Debt, as a provable debt, after payment of all other unsubordinated provable debts.

(3) Interest payable pursuant to Rule 2.88(7).

(4) If, for any reason, LBHI2 has been unable to prove in respect of the same, the £38 million Debt and the Subordinated Debt.

(5) Currency Conversion Claims (if Question 12 is answered in the affirmative).

Subordinated Debt v statutory interest

Rule 2.88(7)

90. The critical question is whether the Subordinated Debt is subordinated to statutory interest payable pursuant to Rule 2.88(7). Rule 2.88(7) provides as follows:

> *"… any surplus remaining after payment of the debts proved shall, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the company entered administration."*

91. It is clear from the words of Rule 2.88(7) itself that statutory interest is payable on debts proved only when all debts proved in the administration have been paid in full. When payable, statutory interest ranks equally whether or not the debts on which it is payable rank equally: Rule 2.88(8).

92. For the reasons advanced in response to Question 1 and Question 3, LBHI submits that each of the £38m Debt and the Subordinated Debt respectively are provable in LBIE's administration. That being so, it must follow that they must be paid first before any statutory interest is payable pursuant to Rule

2.88(7).

The Subordinated Debt Agreements

93. LBHI accepts that the Subordinated Debt is payable after other debts proved (including the £38m Debt) have been paid in full, as a result of the subordination provisions contained in the Subordinated Debt Agreement(s). It does not follow, however, that the Subordinated Debt is also contractually subordinated to statutory interest payable on debts proved. On their proper construction, the provisions of the Subordinated Debt Agreements do not have this effect.

94. The statutory order of priorities was described in *Re Nortel; Re Lehman Brothers International (Europe) Ltd* [2013] 3 WLR 504, per Lord Neuberger at [39] as follows:

> *"In a liquidation of a company and in an administration (where there is no question of trying to save the company or its business), the effect of insolvency legislation (currently the 1986 Act and the Insolvency Rules, and, in particular, sections 107, 115, 143, 175, 176ZA, and 189 of the 1986 Act (as amended), and paras 65 and 99 of Schedule B1 (as inserted by section 248 of and Schedule 16 to the Enterprise Act 2002), and rules 2.67, 2.88, 4.181 and 4.218 of the Insolvency Rules, as various amended), as interpreted and extended by the courts, is that the order of priority for payment out of the company's assets is, in summary terms, as follows:*
>
> *(1) Fixed charge creditors;*

(2) Expenses of the insolvency proceedings;

(3) Preferential creditors;

(4) Floating charge creditors;

(5) Unsecured provable debts;

(6) Statutory interest;

(7) Non-provable liabilities[10]*; and*

(8) Shareholders."

95. LBHI contends that the Subordinated Debt Agreements do not alter this order of priority: rather, they relegate the Subordinated Debt behind other provable debts *within* the fifth tier; liabilities at the sixth and lower tiers are not provable (save that liabilities at the seventh tier are provable in the restricted sense set out in Rule 12.3(2A)), and are paid after provable debts.

96. LBIE contends that the Subordinated Debt Agreements alter this order of priority, so that one provable debt (viz the Subordinated Debt) is relegated from the fifth tier to a lower tier (it is not clear whether it is said to be payable before or after non-provable liabilities and shareholders). For the reasons given below, this contention is not supported by the language of the Subordinated Debt Agreements or the factual matrix.

97. The question of construction turns on whether Paragraph 5 of the Subordinated Debt Agreements prohibits the payment of the Subordinated

[10] This refers to postponed debts within the meaning of Rule 12.3(2A). Truly non-provable liabilities, such as statute-barred debts, are not payable in liquidation or administration at all.

Debt in priority to statutory interest payable pursuant to Rule 2.88(7). LBHI submits that it does not because:

(1) statutory interest does not constitute a “Liability” as that term is defined in the Subordinated Debt Agreements;

(2) alternatively, LBIE would be “solvent” (as that term is defined in the Subordinated Debt Agreements) after payment of the Subordinated Debt, because statutory interest is not payable or capable of being established or determined in LBIE’s administration (so that it is disregarded in assessing whether LBIE is “solvent” for the purposes of Paragraph 5). This is because statutory interest is not provable.

98. Paragraph 5 provides (so far as relevant) as follows:

> *“(1) Notwithstanding the provisions of paragraph 4, the rights of [LBHI2] in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities and accordingly payment of any amount (whether principal, interest or otherwise) of the Subordinated Liabilities is conditional upon –*
>
> *(a) (if an order has not been made or an effective resolution passed for the Insolvency of [LBIE] …) …; and*
>
> *(b) [LBIE] being “solvent” at the time of, and immediately after, the payment by [LBIE] and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that [LBIE] could make such payment and still be “solvent”.*

(2) For the purposes of sub-paragraph (1)(b) above, [LBIE] shall be "solvent" if it is able to pay its Liabilities (other than the Subordinated Liabilities) in full disregarding -

(a) obligations which are not payable or capable of being established or determined in the Insolvency of [LBIE]; and

(b) the Excluded Liabilities."

99. "Senior Liabilities" is defined as meaning "all Liabilities except the Subordinated Liabilities and Excluded Liabilities". "Liabilities" is defined as meaning "all present and future sums, liabilities and obligations payable or owing by [LBIE] (whether actual or contingent, jointly or severally or otherwise howsoever)". The "Subordinated Liabilities" comprise the Subordinated Debt. For present purposes, it may be assumed that there are no "Excluded Liabilities".

<u>The construction of Paragraph 5</u>

100. When Paragraph 5(2) refers to the payment "in full" of LBIE's "Liabilities", it cannot be read literally; it does not mean payment in full of the nominal value of the "Liabilities". It means payment in full of the amount of the "Liabilities" (other than the Subordinated Debt itself) provable and presently payable in accordance with the Act and the Rules. Properly understood, it does not include statutory interest nor require statutory interest to be paid before the Subordinated Debt itself becomes payable.

101. It is clear that Paragraph 5(1)(b) was intended to apply in the event that LBIE (as borrower) had gone into administration or liquidation. This is because the

words expressly excluding such a possibility for the purposes of Paragraph 5(1)(a) are not to be found in, and do not apply to, Paragraph 5(1)(b).

102. Paragraph 5(1)(b) makes provision for the Subordinated Debt to be paid only if LBIE is "solvent" at the time of and immediately after such payment. Given that requirement and the reference to "Liabilities" in the definition of "solvent", the Insolvency Rules relating to the quantification and payment of debts in administration and liquidation are part of the factual matrix relevant to the construction of paragraph 5.[11] It follows that the proper construction of Paragraph 5(1)(b) must be consistent with these Rules: the Subordinated Debt Agreements cannot have been intended to provide for the payment of sums which are greater than the sums which are payable in accordance with the Rules.

103. This may be illustrated by reference to sums which are future or contingent. Such sums constitute "Liabilities" for the purposes of the Subordinated Debt Agreements.

104. Payment "in full" of a contingent sum cannot mean payment in full of the nominal amount of that sum. That would be inconsistent with Rule 2.81, which requires the value of contingent debts to be estimated so that a present value is attributed to it for the purposes of proof and distribution. The statutory scheme has been designed to place a present value on uncertain future claims in order to enable the administration of the liquidation process to be brought to a speedy conclusion. The alternative would mean waiting until the

[11] Goode describes the acceleration of creditors' rights to payment upon liquidation as one of the principles of corporate insolvency law: see *Principles of Corporate Insolvency Law* 4th Edition, paragraph 3-11.

contingency had occurred (if it ever did), delaying the conduct of the insolvency process indefinitely. That alternative would be wholly at odds with the statutory insolvency scheme and the efficient conduct of the insolvency process: *Re House Property and Investment Co Ltd* [1954] Ch 576 at 612; *Re Lines Brothers Ltd* (Slade J, 15 April 1981, unreported[12]); *Re Danka Business Systems plc* [2012] EWHC 579 (Ch) at [40] and [47] and [2013] 2 WLR 1398 (CA); Schedule B1, paragraphs 4 and 76. There can be no justification for reading Paragraph 5(2) so as effectively to trump the statutory insolvency scheme relating to the payment of LBIE's debts.

105. Just as the nominal amount of contingent debts is not payable in full in an administration, so too the nominal amount of a future debt is not payable in full. Such debts are discounted for the purposes of dividend on the basis of an assumption that they are treated as paid as at the date the company enters administration: Rules 2.89 and 2.105. It cannot have been intended that Paragraph 5.2 should operate in any different way such as to require payment in full of the nominal amount notwithstanding that the debt is not yet due for payment, or to require a delay in payment until the debt has become payable.

[12] *"… When the winding-up occurs, the creditor obtains new statutory rights to participate under the statutory scheme of distribution in respect of his debt, as it exists at the winding-up date. For reasons already given, however, the nature of this right will not necessarily be the same as his original contractual right; the statute may compel some adjustment of that right, so that practical effect may be given to what I have described as the two central features of the statutory scheme. In some cases the adjustment will in the event be shown to have operated to the advantage of the creditor concerned. In other cases it will be shown to have operated to his disadvantage, as it has unfortunately operated to the disadvantage of the Bank in the present case. The creditor, however, who lodges with the liquidator a claim to be admitted as a creditor must, in my judgment, accept the rights conferred on him by the statutory scheme of distribution in respect of preliquidation debts, for better or for worse. Once the liquidation has intervened, it is a fallacy for him to assume that his original contractual rights against the company are necessarily preserved intact under the statutory scheme, even if, in the event, there proves to be a surplus available for a return to the contributories or for the payment of post-liquidation interest."*

In either case, such a result would conflict with the treatment of such debts as provided for by the statutory insolvency regime.

106. This construction is consistent with the words “is able to pay” in Paragraph 5(2), which connote a present (rather than a future or contingent) obligation.

107. If the position were otherwise, there would be no reason in principle why “Liabilities” could not extend to the obligation to distribute any surplus to LBIE’s members. Yet that cannot have been intended. The payment of members while obligations to creditors (even subordinated creditors) remain unpaid would be wholly at odds with the statutory scheme in the context of which Paragraph 5(1)(b) and (2) is to be construed: see for example section 143(1), which makes clear that only after creditors have been paid is the surplus to be distributed to those entitled to it. There is nothing in Paragraph 5 which suggests that it was ever intended that the repayment of the Subordinated Debt should be postponed until after any surplus had been distributed to members. The reason is obvious: once the company has distributed its surplus, there would be nothing left with which to repay the Subordinated Debt. Such a bizarre result is plainly not contemplated by the Subordinated Debt Agreements.

108. The construction of Paragraph 5 so as to require the payment of all provable debts and liabilities in accordance with the Act and the Rules is also consistent with the ordinary meaning of the word “solvent”. This does not connote the ability to pay in full future debts which are not payable until long in the future, or to pay in full contingent debts which may never fall due for payment. It is not to be supposed that the definition of “solvent” in Paragraph

5(2) was intended to alter this in any way.

109. By contrast, statutory interest is not a sum, liability or obligation payable or owing by a company in any conventional sense and does not fall to be taken into account for the purposes of determining solvency. It is exclusively a creature of statute. It is not a right or claim in respect of which a creditor may at any stage sue or proceed against the company. Prior to administration, no question of entitlement arises because statutory interest only becomes payable (if at all) if the company not only goes into administration but has a surplus after paying its proved debts. Even then, however, no creditor has any right to prove or claim in relation to statutory interest: it is merely payable (if at all) by the administrator (or liquidator) out of the assets of the company as part of the formal insolvency process: see *Re Lines Bros Ltd* [1984] BCLC 215 per Mervyn Davies J at 223d - e (in relation to the obligation to pay interest under section 33(8) of the Bankruptcy Act 1914):

> *"At no stage can statutory interest be regarded as a debt or liability of the company. A liquidator's obligation under s 33(8) to pay interest out of a surplus is pursuant to a statutory direction to him, being an obligation which is part of the statutory scheme for dealing with a company's assets which comes into operation at the outset of the winding up."*

110. Statutory interest is not a liability which falls to be taken into account for the purposes of ascertaining the company's inability to pay its debts under section 123 of the Act. The reason for this was explained by Mervyn Davies J in *Re Lines Bros Ltd* (supra) at 223e - f:

> *"it is not right to consider 'insufficiency' (or insolvency) by reference to any obligation to pay statutory interest under s 33(8) because that is to presuppose that s 33(8) applies in the winding up. The true position is that one decides whether or not the winding up is the winding up of an insolvent company before one takes account of the rules that will be brought into account if it is insolvent."*

111. He concluded (at 224e) that a company is solvent if, when the assets admit of paying the debts as they existed at the date of the winding up, there is a surplus. In reaching that conclusion, Mervyn Davies J referred to *Re WW Duncan & Co* [1905] 1 Ch 307, where Buckley J said at 315:

> *"Now what do you admit to proof for dividend in the winding up of a company? The amount of the debt at the commencement of the winding up. That had nothing whatever to do with the payment of interest accruing due after the winding up if the company turns out to be solvent. There could not until the fact of solvency was ascertained be a right to claim that interest."*

112. Both statements are consistent with the ordinary meaning of the word "solvent" and are consistent with the use of that term, and the meaning ascribed to it, in Paragraph 5(2).

<u>Capital Adequacy</u>

113. The Subordinated Debt was intended to be used for capital adequacy purposes in accordance with FSA rule IPRU(INV) 10-63 (the FSA's Interim Prudential Sourcebook for Investment Businesses). The regulatory regime is

described in the Appendix hereto. When read in this context, it is clear that "Senior Liabilities" was not intended to extend to statutory interest and should not be interpreted as doing so.

114. In particular, Recital (12) of the 2006 Capital Adequacy Directive makes clear that the purposes of own funds (which include subordinated debt) are: (i) to absorb losses; (ii) to ensure the continuity of institutions and the protection of investors, and (iii) as a yardstick for the assessment of the solvency of the institution. The regulatory regime was not concerned with the payment of statutory interest, which necessarily arises only upon cessation of business in circumstances where the firm has gone into administration or liquidation and has a surplus after paying all proved debts; and which is intended to compensate creditors for the lapse of time between the company entering administration (or liquidation) and the payment of dividends by way of distribution.

115. It was not contemplated that own funds (including subordinated debt) would be postponed to statutory interest, for the following reasons:

(1) Payment of statutory interest is not relevant to the absorption of losses as it is only payable in the event that there is a surplus after all proven debts have been paid. To that extent, once proven debts have been paid, the purpose of the regulatory capital requirements has been achieved and no further protection is required.

(2) Payment of statutory interest is not relevant to the continuity of institutions as, by definition, it only becomes payable (if at all) when the company's assets have been realised in its administration and the

proceeds distributed as a prelude to dissolution of the company.

(3) Payment of statutory interest is not relevant in the assessment of the company's solvency, at least for the purposes of determining whether it should enter a formal insolvency process. It would be illogical for statutory interest to be taken into account when determining the company's solvency because any entitlement to it presupposes not only a formal insolvency process but also that the company is able to and has paid all its proven debts in full. It also presupposes that it is possible to determine in advance the amount of statutory interest payable, but this is not possible because it inevitably depends on the time that elapses between the date the company enters administration and the date of payment, which is unlikely to be known at any time prior to the commencement of the administration.

116. In relation to the assessment of the company's insolvency, statutory interest fundamentally differs from subordinated debt, which qualifies as lower Tier 2 or Tier 3 capital. In particular, there is no prohibition against lower Tier 2 or Tier 3 subordinated debt:

(1) constituting a liability under section 123(2); or

(2) being taken into account to determine whether the company is or is likely to become insolvent; or

(3) forming the basis of a petition to wind up the company or an application to have it placed in administration.

117. It must follow that the Subordinated Debt may have all or any of these

characteristics. Analysis of the terms of the Subordinated Debt Agreements reveals that the Subordinated Debt does indeed have these characteristics. The consequence of this is that if the Subordinated Debt *is* to be taken into account for the purposes of determining solvency, no relevant surplus arises for the purposes of Rule 2.88 unless and until it is paid.

118. For these reasons, statutory interest does not constitute a "Liability" for the purposes of the Subordinated Debt Agreements and would not fall to be taken into account for the purposes of determining whether LBIE was "solvent" at the time of or immediately after payment of the Subordinated Debt. Accordingly, Paragraph 5 does not operate to subordinate the Subordinated Debt to statutory interest.

Subordinated Debt v Currency Conversion Claims

119. LBHI submits that the Subordinated Debt takes priority over Currency Conversion Claims:

(1) For the reasons given in response to Question 12 below, Currency Conversion Claims are neither valid nor payable.

(2) Even if Currency Conversion Claims were valid and payable, they would not be provable (as Lydian accepts). As the Subordinated Debt is provable for the reasons given in response to Question 3, it follows that the Subordinated Debt must be paid in priority to Currency Conversion Claims.

(3) Again, even if Currency Conversion Claims were valid and payable, they would not be provable and thus would not qualify as "Liabilities" for

the purposes of the Subordinated Debt Agreements, as that term is confined to provable debts for the reasons explained above. It follows that they would not be taken into account for the purposes of determining whether LBIE was “solvent” at the time of or immediately after payment of the Subordinated Debt. That being so, Paragraph 5 would not subordinate the Subordinated Debt to Currency Conversion Claims.

Question 12 (Currency Conversion Claims)

Is an unsecured creditor, with a contractual entitlement to payment from LBIE in a currency other than sterling (the "Contractual Currency"), entitled, following payment in full of:

(i) all creditors' proved debts; and

(ii) interest on such debts in respect of periods during which they have been outstanding since LBIE entered administration pursuant to Rule 2.88(7)

to payment from LBIE in a sum equal to the difference between (a) the amount of its contractual entitlement to payment in the Contractual Currency and (b) the amount received by it in respect of its proved debt against LBIE, converted into the Contractual Currency as at the date of payment (such claim being referred to as a "Currency Conversion Claim")?

120. The type of Currency Conversion Claim envisaged is one where an unsecured creditor with a provable claim, and with a contractual entitlement to payment in a currency other than sterling in respect of that claim, wishes also to claim payment of a sum equal to the difference between (a) the amount of its contractual entitlement to payment in the Contractual Currency and (b) the amount received by it in respect of its proved debt, converted into the Contractual Currency as at the date of payment. Even if such a claim exists, its proponents accept that it is neither provable nor payable ahead of statutory interest payable on proved debts pursuant to Rule 2.88(7).

121. LBHI submits that Currency Conversion Claims are not valid or payable.

Accordingly, the answer to Question 12 raised in the Application is: No.

122. In summary, this is because:

(1) The Rules expressly require conversion of foreign currency debts to take place at the date of entry into administration. This applies whether the administration is solvent or insolvent.

(2) To the extent that obiter dicta in *Re Lines Bros Ltd* [1983] Ch 1 suggest the contrary, the legislative framework has fundamentally changed since that case was decided and the result tentatively suggested by those dicta is not available.

(3) A Currency Conversion Claim, if it were to exist, would work only to the advantage of the creditor with such a claim. To apply a later conversion date only where the rate has moved to the advantage of the creditor concerned would be unprincipled, discriminatory and unfair.

The Rules

123. Rule 2.86 provides as follows:

> *"(1) 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 or, if the administration was immediately preceded by a winding up, on the date that the company went into liquidation."*

124. Rule 2.86 expressly requires conversion to take place as at the date of entry into administration, and this applies whether the administration is solvent or

insolvent. There is no separate provision that some other rule is to apply in the event that the company remains solvent after payment of all debts which have been proved together with statutory interest pursuant to Rule 2.88(7). There is but one rule which applies in all circumstances, and it is mandatory ("*shall be converted*"). That being so, there is simply no room for any other rule to operate, particularly one which is neither to be found in nor contemplated by the legislation.

125. This approach is entirely consistent with the position as it applies to a company in liquidation, which may be summarised as follows:

(1) Rule 4.91 is in materially the same terms as Rule 2.86, save that the exchange rate is that which prevails when the company goes into liquidation (in the absence of an immediately preceding administration).

(2) Rule 4.91 is to be found in Chapter 9 of part 4 of the Rules, which relates to proof of debts in a liquidation. Unless specific provision is made to the contrary, the provisions of Chapter 9 apply in creditors' voluntary (insolvent) liquidation as they do in compulsory liquidation: Rule 4.1(2).

(3) Significantly, the provisions of Chapter 9 also apply in a members' (solvent) voluntary winding up, in the same way as they apply in a creditors' voluntary winding up: Rule 4.1(1).

(4) It follows that Rule 4.91 applies for the purposes of proof as much in a solvent liquidation as it does in an insolvent liquidation. The position is thus consistent in relation to every type of liquidation: there is no

different rule that applies according to whether distribution in liquidation is conducted where the company is solvent or insolvent.

126. The introduction of one rule applicable in all situations was no mere accident but the result of detailed review, as explained below.

Re Lines Bros Ltd in context

127. Lydian has indicated that its argument in support of there being a Currency Conversion Claim is founded on certain obiter dicta of Brightman and Oliver LJJ in the case of *Re Lines Bros Ltd* [1983] Ch 1. Brightman LJ said the following at 21F - 22A:

> *"It may well be the duty of the liquidator, in the case of a wholly solvent liquidation, if a foreign currency creditor has been paid less than his full contractual foreign currency debt, to make good the shortfall before he pays anything to the shareholders. I do not say that this is necessarily the solution to the problem posed, but I have not heard any convincing objection to that solution …*
>
> *"I do not think, therefore, that a foreign currency creditor can base a claim on the depreciation in the cross rate between sterling and the foreign currency until the liquidator has assets in his hands which will otherwise go to the shareholders. At that stage, but not earlier, as it seems to me, it would be entirely just to allow the foreign currency creditor to recover the same amount as he would have been able to recover if no liquidation had ever taken place."*

128. Oliver LJ said at 26E:

> *"We are not, however, here concerned with a solvent company and the point must be left for decision when it arises. Certainly for my part I do not dissent from the proposition that the answer to*

> *[Counsel's] criticism may well be found in the way suggested in the judgment of Brightman LJ."*

129. *Re Lines Bros* was concerned with the situation where all provable debts (including the bank's foreign currency claims converted at the exchange rate prevailing at the date of the resolution to wind up) had been paid in full, leaving a surplus. The question arose as to whether the surplus should be applied in payment of statutory (post-liquidation) interest or in payment of the difference between what the bank had actually received and what it would have received if its claim had been converted at the date of payment, sterling having depreciated against the Swiss franc in the meantime. The issue was thus whether, for the purposes of proof, the correct date of conversion was the date of the winding-up, or the date of payment. Dismissing the bank's appeal, the Court of Appeal concluded that a foreign currency debt should be proved in a liquidation according to its sterling value as at the date of the resolution to wind up (as the bank's claim had been) and, accordingly, the surplus should be applied in payment of post-liquidation interest. Nothing would remain after payment of interest. Thus the question whether the bank might have a residual claim (in respect of which Brightman and Oliver LJJ made their obiter remarks) did not in fact arise.

130. It is important to place *Re Lines Bros* in context. At the time the case was decided, the treatment of foreign currency claims in liquidation or bankruptcy was not expressly provided for in the insolvency legislation. It was governed instead by judge-made law dating back to the 1860s, intended to give effect to the pari passu principle of distribution.

131. In *Re Humber Ironworks and Shipbuilding Co* (1869) LR 4 Ch App 643 at 646 - 647*,* Selwyn LJ said the assets held on the statutory trusts should be distributed as if they had all been collected and distributed on the date of the winding-up order:

> *"I think the tree must lie as it falls; that it must be ascertained what are the debts as they exist at the date of the winding up, and that all dividends in the case of an insolvent estate must be declared in respect of the debts so ascertained."*

132. In *Re Dynamics Corporation of America* [1976] 1 WLR 757 Oliver J decided, in the wake of the decision of the House of Lords in *Miliangos v George Frank (Textiles) Ltd* [1976] AC 443, that foreign currency claims should be converted into sterling as at the date when the company went into liquidation. He did so, not on the basis that it was a convenient date to choose, but because it was part of the process of valuing claims which, in order to give effect to the basic principle of a pari passu distribution, has to take place as at one date. Oliver J explained (at 764) that the rule that debts are valued at the date of winding up is to give effect to the principle of pari passu distribution, which is a principle of fairness between creditors:

> *"It is only in this way that a rateable or pari passu distribution of available property can be achieved, and it is, as I see it, axiomatic that the claims of creditors amongst whom the division is to be effected must all be crystallised at the same date …, for otherwise one is not comparing like with like."*

133. *Re Dynamics Corporation* was approved by the Court of Appeal in *Re Lines Bros*. The reasoning is apparent from these passages in the judgment of Brightman LJ at 16 and 19:

> *"There is no particular reason, in the field of abstract justice, why the currency risk should be borne by one description of creditor rather than by another description of creditor when they are all directed to rank pari passu. They do not rank pari passu if the sterling creditors are required to underwrite the exchange rate of the pound for the benefit of the foreign currency creditors. The just course, as it seems to me, is to value the foreign debt once and for all at an appropriate date, and to keep that rate of conversion throughout the liquidation until all debts have been paid in full."*

> *"I have quoted at length from authorities on a proposition which is accepted as axiomatic, in order to underline the point that the winding up date is the date of valuation of liabilities. As an account can only be struck in a single currency, it must follow that the scheme of company liquidation requires that a foreign debt shall be converted into sterling (if sterling is the currency of the liquidation) as at the date of liquidation and at no other date."*

134. In *Wight v Eckhardt Marine GmbH* [2004] 1 AC 147, Lord Hoffmann said:

> *"[29] The image of collecting and uno flatu distributing the assets of the company on the day of the winding-up order is a vivid one, but the courts apply it to give effect to the underlying purpose of fair distribution between creditors pari passu and not as a rigid rule..."*

135. On this principle, no allowance is made for interest accruing after the date of the winding-up order (*Re Humber Ironworks*) or subsequent exchange rate fluctuations which affect the sterling value of a debt in foreign currency (*Re Dynamics Corporation*; *Re Lines Bros*: *Wight v Eckhardt Marine* per Lord Hoffmann at [24]).

<u>Rules 4.91 and 2.86: the legislative background</u>

136. The Law Commission in its Working Paper No. 80 Private International Law

Foreign Money Matters ([1981] EWLC C 80), after addressing the question at what date the exchange rate should be applied for the purposes of proof in insolvent liquidation, went on to consider whether the position should be the same if it transpired that the company in liquidation was solvent. It is worth quoting the relevant section in full:

> *"3.45 The second question for consideration relates to the conversion of foreign debts in the liquidation, whether voluntary or compulsory, of solvent companies. It may be argued that the reasoning of Oliver J. in Re Dynamics Corporation of America could apply to solvent, as well as to insolvent, companies: in both situations the purpose of winding-up is to ascertain the company's liability as at the date of its liquidation and to distribute its property among the claimants according to the value of their claims as at that date. The only major distinction between the two kinds of situation, which is immaterial in the context of this Working Paper, is that in the case of an insolvent company the creditors may receive payment of only part of their claims. It could, on the other hand, be argued that where a company is solvent the creditors will be paid in full and that, consistently with the Miliangos principle, the appropriate date for conversion is that of actual payment. The real difficulty comes with companies whose solvency is in doubt and where it is not known whether they are solvent until the winding-up process is completed. Indeed, there may be companies whose solvency could depend on the conversion date for a foreign currency debt. In the case of winding-up, we do not think that it would be practicable to devise different conversion dates dependent on the solvency of the company. The initial conversion date must, in our view, be that of the winding-up order in every case. We believe that similar rules should be applied in bankruptcy in cases where it transpires that the debtor is solvent.*
>
> *3.46 It may turn out in a small minority of cases that, conversion of*

foreign currency debts having been duly made as at the date of the winding-up order, the company is found to be solvent. This raises a third question - namely, whether in such cases foreign currency creditors should be compensated from the assets of the company or the bankrupt for adverse exchange rate fluctuations between the date of the relevant order and the date of actual payment. This would involve a second, later, conversion of these debts as at the date of actual payment, or as close thereto as is practicable. We have explained in paragraphs 3.41-3.43 above why we do not favour this approach in regard to a foreign currency debt, irrespective of whether in terms of sterling it has increased or decreased in value after its original conversion. To apply a later conversion date only in the case where a change in the relative value has been adverse to the creditor in question would, in our view, be even more unacceptable, since it would involve a discrimination between foreign currency debts depending on whether the exchange rates have moved to the advantage or disadvantage of the creditors. There appears to be no justification in principle for such a step, which would run counter to the generality of the Miliangos rule. In our view any alternative to the date of the winding-up order or of the receiving order as the conversion date must not only be practicable but must also be based on the application of the same conversion date to every foreign currency debt.

3.47 To summarise: we support the view of Oliver J. in the Dynamics Corporation case that the date of the winding-up order is the appropriate, once-for-all, date for the conversion of every foreign currency debt on the winding-up of both solvent and insolvent companies: and we believe that similar rules should apply to bankruptcy, whether or not it transpires that the debtor is solvent..."

137. The Cork Committee agreed. The relevant parts of the Cork report are as follows:

"1308. In Miliangos v George Frank (Textiles) Limited [1976] A.C. 443, the view was expressed in the House of Lords, though in the form of obiter dicta, by Lord Wilberforce and Lord Cross of Chelsea, that in a bankruptcy and winding up the appropriate date for the conversion into sterling of a creditor's foreign currency claim should be the date when the creditor's claim in terms of sterling was admitted by the trustee or liquidator. In two subsequent cases the Courts have declined to follow these dicta, holding that conversion should be effected as at the date of the winding up order. The basis for both those decisions is that it is a primary purpose of the winding up of an insolvent company to ascertain the company's liabilities at a particular date and to distribute its assets pro rata amongst the creditors as at that date. Accordingly, the relevant date, on this basis, must be the same for every creditor, namely the date of the winding up order. To adopt the course suggested by Lord Wilberforce and Lord Cross of Chelsea would create inequality between the sterling creditors and the 'foreign' creditors. It is also clear from those two decisions that the principles are applicable equally to a compulsory and to a voluntary liquidation as well as to a bankruptcy, and that the valuation of any set-off should also be made at the date of the winding up order.

1309. We are firmly of the view that the principles stated in the two most recent cases provide an appropriate solution to the problem of the conversion of foreign money claims into sterling in the context of insolvency proceedings. We strongly recommend that any future Insolvency Act should expressly provide that the conversion of debts in foreign currencies should be effected as at the date of the commencement of the relevant insolvency proceedings. Furthermore, we take the same view as the Law Commission (Working Paper No. 80) that conversion as at that date should continue to apply, even if the debtor is subsequently found to be solvent. To apply a later conversion date only in the case where the exchange rate has moved to the advantage of the creditor, but

> *(necessarily) not where it had moved against him, would, in our view, be discriminatory and unacceptable."*

138. The two cases referred to (but not identified) in the Cork Report must have been *Re Dynamics Corporation* and *Re Lines Bros* (decided in February 1982).

139. In its subsequent Report No. 124 Private International Law Foreign Money Matters ([1983] EWLC 124), the Law Commission concluded that it remained of the view expressed in its Working Paper and that the law as it then stood in relation to the conversion of foreign currency claims in relation to solvent and insolvent companies was satisfactory (paragraphs 3.34 - 3.37).

140. Following the recommendations of the Cork Report, provision was made for the treatment of claims advanced by foreign currency creditors in insolvency in the Rules relating to liquidation, as set out and explained above. The same rule was extended to administrations upon the enactment of the Enterprise Act 2002, and Rule 2.86 came into being.

<u>Currency Conversion Claims are neither valid nor payable</u>

141. Against this legislative background, LBHI submits that Currency Conversion Claims are neither valid nor payable.

142. First, as already stated, the legislation expressly requires conversion to take place at the date of entry into administration and this applies whether the administration is solvent or insolvent. There is simply no room for any other rule to operate, particularly one which is not to be found in the legislation.

143. This approach is entirely consistent with the position as it applies to a

company in liquidation: as stated above, Rule 4.91 applies whether the company is solvent or insolvent. It cannot have been intended that a different approach should be adopted in an administration in which a distribution is to be made but it transpires that the company is solvent.

144. This rule gives full effect to the pari passu principle of distribution, which requires that all the company's liabilities are to be determined as they exist at the date of entry into administration or, in case of liquidation, at the date of liquidation. Thus:

(1) The debt to be proved is the total amount of the creditor's claim as at the date the company enters administration: Rules 2.72(3)(b)(ii), 4.75(1)(b).

(2) It is for this reason that any debt which does not bear a certain value because it is subject to a contingency or for any other reason must be estimated: Rules 2.81(1), 4.86(1). The estimation is undertaken as at the date of entry into administration or liquidation, and this remains the case even though it is legitimate to have regard to subsequent events if the contingency occurs thereafter.

(3) For set-off purposes, an account is taken as at the date the administrators give notice of their intention to make a distribution, but mutual dealings exclude debts which arise out of an obligation incurred after entry into administration or earlier liquidation, or earlier if the creditor had prior notice of relevant events: Rules 2.85(2), 2.85(3).

145. Secondly, the Currency Conversion Claim appears to work only to the advantage of the unsecured creditor with such a claim: if the exchange rate has moved *against* the creditor in the period between the date of administration (being the relevant date for the purposes of proof) and the date of payment, there is no suggestion that the creditor should repay the balance. To apply a later conversion date only where it has moved to the advantage of the creditor concerned would be unprincipled, discriminatory and wrong.

146. Thirdly, the availability of a later conversion date would be inconsistent with, and would render unworkable, the provisions for set-off in the event that the company itself had a claim against the foreign currency creditor. In particular:

(1) The account is to be taken as at the date of notice of intention to make a distribution under Rule 2.95. There is no provision for the account to be taken at any other time, or at different times according to the nature of the claim being made: Rule 2.85(3).

(2) For set-off purposes, Rule 2.86 is to apply in relation to any sums due to the company which are payable in a currency other than sterling: Rule 2.85(6)(a). Rule 2.86 requires the conversion to take place as at the date of entry into administration (or earlier liquidation). It does not permit or require or contemplate conversion at any later date. It follows that if the debt payable to the company is to be converted as at that date but the debt payable by the company to the creditor is to be converted at a later date (both debts being payable in a currency other than sterling), the result would be that like is not being compared with like, and it would not be possible for the requisite account to be taken.

(3) The account is automatic and requires no procedural step to be taken: *Stein v Blake* [1996] AC 243. The result is to extinguish the cross-claims as separate choses in action. The account having been taken, only the balance is provable or payable, as the case may be: Rule 2.85(8). If it transpires that the two debts exactly cancel each other out so that nothing is provable or payable, it must follow that the debts have been extinguished. It cannot be right in principle in those circumstances for one claim in effect to be resuscitated by virtue of a subsequent fluctuation in the exchange rate such as would give rise to a different result in the event of a subsequent account being taken. Yet that would be the consequence of an affirmative answer to Question 12 in a case where both the creditor and the company have claims against the other.

147. Fourthly, Brightman LJ's dicta were based on an analogy drawn with the rule which existed before the Act in relation to interest: in the event of a surplus in the liquidation, the creditor whose debt carried contractual interest was remitted to his rights under the contract, while someone with no such entitlement would receive no post-liquidation interest at all. That rule was swept away by the Act, save to the extent only that the rate of statutory interest payable in the event of a surplus is whichever is the higher of the rate under the Judgments Act 1838 (currently 8% per annum) or the contractual rate: Rule 2.88(9). The entitlement to statutory interest as such is one conferred by statutory rule, rather than by contract, and is conferred on all creditors regardless of their contractual position.

148. The previous position relating to post-liquidation interest thus provides no safe basis for an analogy to be drawn suggesting that creditors with claims payable in a currency other than sterling should also be remitted to their rights under the contract in the event of solvency.

149. Fifthly, there is no invariable rule that, in the event of a surplus, creditors are remitted for all purposes to their rights under the contract and entitled to receive their full contractual entitlement even if that were to exceed the amount in respect of which they could prove. Even at the time of the *Lines Bros* decision, the scheme of the insolvency legislation was such that in certain circumstances creditors might receive less than their full contractual entitlement, as Slade J (15 April 1981, unreported, see footnote 12 above) and Oliver LJ at 26E recognised: see eg *Re House Property and Investment Co Ltd* [1954] Ch 576 and, more recently, *Re Danka Business Systems plc* [2013] 2 WLR 1398 (CA) at [32].

150. Finally, recognising such a claim would lead to arbitrary and unsatisfactory results. They would be arbitrary in that the very existence of a Currency Conversion Claim would depend entirely on foreign exchange rates at the time of distribution. Timing of a distribution falls to be determined by the administrator (or liquidator). Difficult as it may be to pursue a complaint arising out of the administrator's decision to make a distribution at a particular time, the existence in principle of a Currency Conversion Claim would serve as an encouragement to make such a complaint, thus delaying completion of the administration.

Conclusion

151. For all these reasons, therefore, Question 12 should be answered in the negative.

Appendix: The Regulatory Regime

BASEL I

1. The Basel Accord of 1988: International Convergence of Capital Measurements and Capital Standards ("Basel I") was produced by the Basel Committee on Banking Supervision, comprising the banking supervisory authorities of the G10 countries. It identified (at paragraph 3) two fundamental objectives at the heart of the Committee's work on regulatory convergence. These were, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks.

2. Basel I set out a framework directed towards assessing capital in relation to different types of risk (paragraph 8). The target standard ratio of capital to weighted risk assets was set at 8%, half of which was to be comprised of the core capital element, or Tier 1; it was expected this would be observed by the end of 1992 (paragraphs 44, 46).

3. Tier 1 (core capital) comprised equity capital and published reserves. In addition, however, other elements of capital were permitted to form Tier 2. These included subordinated term debt, about which Basel I said the following (paragraph 23; see also Annex 1(e)):

> *"The Committee is agreed that subordinated term debt instruments have significant deficiencies as constituents of capital in view of their*

fixed maturity and inability to absorb losses except in a liquidation. These deficiencies justify an additional restriction on the amount of such debt capital which is eligible for inclusion within the capital base. Consequently, it has been concluded that subordinated term debt instruments with a minimum original term to maturity of over five years may be included within the supplementary elements of capital, but only to a maximum of 50% of the core capital element and subject to adequate amortisation arrangements."

4. The categories of risk captured in the framework were described in paragraph 30, which said that there are many different kinds of risks against which banks' managements need to guard. For most banks the major risk is credit risk, that is to say the risk of counterparty failure, but there are many other kinds of risk - for example, investment risk, interest rate risk, exchange rate risk, concentration risk. The central focus of the framework was credit risk and, as a further aspect of credit risk, country transfer risk.

DIRECTIVE 89/299/EEC

5. Directive 89/299/EEC was intended to give effect to Basel I. It introduced certain basic standards applicable to determine own funds (ie capital) requirements for credit institutions. According to its recitals, own funds serve to ensure the continuity of credit institutions and to protect savings; criteria for determining the composition of own funds must not be left solely to Member States and the adoption of common basic standards would strengthen the Community banking system. The Directive formed part of a wider international effort to bring about approximation of the rules in force in major countries

regarding the adequacy of own funds.

6. Article 2(1)(8) of Directive 89/299/EEC provided that unconsolidated own funds of credit institutions shall consist of (amongst other things) subordinated loan capital referred to in Article 4(3) ("Article 4(3)") of Directive 89/299/EEC.

7. Article 4(3) stated as follows:

> *"Member States or the competent authorities may include … subordinated loan capital referred to in [Article 2(1)(8)] in own funds, <u>if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled</u>."* (emphasis added)

8. Article 4(3) went on to set out further criteria, including the following:

> *"(b) the loans involved must have an original maturity of at least five years, after which they may be repaid; … The competent authorities may grant permission for the early repayment of such loans provided the request is made at the initiative of the issuer and the solvency of the credit institution in question is not affected; …*
>
> *(d) The loan agreement must not include any clause providing that in specified circumstances, other than the winding up of the credit institution, the debt will become repayable before the agreed repayment date."*

DIRECTIVE 93/6/EEC

9. Directive 93/6/EEC (the "1993 Capital Adequacy Directive") extended the definition of own funds in Directive 89/299/EEC to investment firms. In addition and as explained below, however, it permitted a different definition to be adopted "*in order to take account of the particular characteristics of the activities carried on by those institutions which mainly involve market risks*".

10. According to its recitals, it was a stated purpose of the 1993 Capital Adequacy Directive to provide for common basic standards for the own funds of relevant institutions (investment firms and credit institutions), as they "*serve to ensure the continuity of institutions and to protect investors*". The 1993 Capital Adequacy Directive adopted the same definition of own funds (capital) as that in Directive 89/299/EEC. By Article 4(1), competent authorities were to require investment firms to provide adequate own funds. Annex V stated that own funds were to be defined in accordance with Directive 89/299/EC: Annex V, paragraph 1; see also Article 2(26). In addition, however, paragraph 2 made provision for an alternative definition, which included in addition to "own funds" as defined by Directive 89/299/EEC (excluding items in Article 2(1)((12) and (13)), subordinated loan capital subject to the conditions set out in paragraphs 3 - 7. In so far as material, paragraphs 3 - 7 provided as follows:

> *"3. The subordinated loan capital referred to in paragraph 2(c) shall have an initial maturity of at least two years. It shall be fully paid up and the loan agreement shall not include any clause providing that in specified circumstances other than the winding up of the institution the debt will become repayable before the agreed repayment date,*

unless the competent authorities approve the repayment. Neither the principal nor the interest on such subordinated loan capital may be repaid if such repayment would mean that the own funds of the institution in question would then amount to less than 100% of the institution's overall requirements.

In addition, an institution shall notify the competent authorities of all repayments on such subordinated loan capital as soon as its own funds fall below 120% of its overall requirements …

5. The competent authorities may permit institutions to replace the subordinated loan capital referred to in paragraphs 3 and 4 with items 5 to 8 of Article 2(1) of Directive 89/299/EEC."

<u>BASEL II</u>

11. International Convergence of Capital Measurement and Capital Standards: A Revised Framework ("Basel II") set out the details of an agreed framework for measuring capital adequacy (Introduction, paragraph 1). The Committee's fundamental objective was stated to be to revise Basel I, so as to strengthen the stability of the international banking system while "*maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks*" (Introduction, paragraph 4). The Committee stated that it retained key elements of the 1988 capital adequacy framework, including the definition of eligible capital (Introduction, paragraph 5). The revised Framework was designed to establish minimum levels of capital, leaving national authorities free to adopt more stringent arrangements (Introduction, paragraph 9).

12. The provisions relating to minimum capital requirements were set out in Part 2, paragraphs 40 - 49(xviii) and Annex 1a. Paragraph 41 provides as follows:

> *"The definition of eligible regulatory capital, as outlined in the 1988 Accord and clarified in the 27 October 1998 press release on "Instruments eligible for inclusion in tier 1 capital", remains in force except for the modifications in paragraphs 37 to 39 and 43. The definition is outlined in paragraphs 49(i) to (xviii) and in Annex 1a."*

13. A distinction is drawn between Tier 1, Tier 2 and Tier 3 capital. Tier 1 represents core capital, meaning equity capital and disclosed reserves: paragraph 49(i). While recognising the emphasis to be placed on such core capital, the Committee considered that there are a number of other important and legitimate constituents of a bank's capital base, which may be included within the system of measurement subject to conditions set out in paragraphs 49(iv)-(xii), and would form Tier 2: paragraph 49(ii).

14. Paragraph 49(xii) relates to subordinated term debt, which is permitted within Tier 2, but only if it has a maturity of over 5 years. Paragraph 49(xii) states as follows:

> *"The Committee is agreed that subordinated term debt instruments have significant deficiencies as constituents of capital in view of their fixed maturity and inability to absorb losses except in a liquidation. These deficiencies justify an additional restriction on the amount of such debt capital which is eligible for inclusion within the capital base. Consequently, it has been concluded that subordinated term debt instruments with a minimum original term to maturity of over five*

years may be included within the supplementary elements of capital, but only to a maximum of 50% of the core capital element and subject to adequate amortisation arrangements."

15. The Committee accepted that national authorities should have discretion to employ a third tier of capital (Tier 3) consisting of short-term subordinated debt covering market risk. Paragraph 49(xiii) states (so far as material) as follows:

> *"The principal form of eligible capital to cover market risks consists of shareholders' equity and retained earnings (Tier 1 capital) and supplementary capital (Tier 2 capital) as defined in paragraphs 49(i) to 49(xii). But banks may also, at the discretion of their national authority, employ a third tier of capital ("Tier 3"), consisting of short-term subordinated debt as defined in paragraph 49(xiv) below for the sole purpose of meeting a proportion of the capital requirements for market risks, subject to the following conditions:*
>
> - *Banks will be entitled to use Tier 3 capital solely to support market risks as defined in paragraphs 709 to 718(Lxix). This means that any capital requirements arising in respect of credit and counterparty risk in the terms of this Framework, including the credit counterparty risk in respect of OTCs and SFTs in both trading and banking books, needs to be met by the existing definition of capital base set out in paragraphs 49(i) to 49(xii) above (ie Tiers 1 and 2);*

- *Tier 3 capital will be limited to 250% of a bank's Tier 1 capital that is required to support market risks."*

16. Paragraph 49(xiv) defines short-term subordinated debt as follows:

> *"For short-term subordinated debt to be eligible as Tier 3 capital, it needs, if circumstances demand, to be capable of becoming part of a bank's permanent capital and thus be available to absorb losses in the event of insolvency. It must, therefore, at a minimum:*
>
> - *be unsecured, subordinated and fully paid up;*
> - *have an original maturity of at least two years;*
> - *not be repayable before the agreed repayment date unless the supervisory authority agrees;*
> - *be subject to a lock-in clause which stipulates that neither interest nor principal may be paid (even at maturity) if such payment means that the bank falls below or remains below its minimum capital requirement."*

17. Annex 1a adds nothing material for present purposes.

<u>DIRECTIVE 2006/48/EC</u>

18. Basel II was implemented in relation to credit institutions by Directive 2006/48/EC. Title V, Chapter 2, Section 1 (Articles 56 - 67) made provision for own funds (capital).

19. Article 56 of Directive 2006/48/EC states as follows:

"Wherever a Member State lays down by law, regulation or administrative action a provision in implementation of Community legislation concerning the prudential supervision of an operative credit institution which uses the term or refers to the concept of own funds, it shall bring this term or concept into line with the definition given in Articles 57 to 61 and Articles 63 to 66."

20. Article 57(h) provides that subordinated loan capital "*as referred to in Article 64(3)*" may be included in determining (unconsolidated) own funds (see also Article 61). Article 64(3) states as follows:

"Member States or the competent authorities may include fixed-term cumulative preferential shares referred to in [Article 57(h)] and subordinated loan capital referred to in that provision in own funds, <u>if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled</u>.

Subordinated loan capital shall fulfil the following additional criteria:

(a) only fully paid-up funds may be taken into account;

(b) the loans involved shall have an original maturity of at least five years, after which they may be repaid;

(c) the extent to which they may rank as own funds shall be gradually reduced during the last five years before the repayment date; and

(d) the loan agreement shall not include any clause providing that in specified circumstances, other than the winding-up of the credit institution, the debt shall become repayable before the agreed repayment dated.

For the purposes of point (b) … if the maturity of the debt is not fixed, the loans involved shall be repayable only subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the competent authorities is specifically required for early repayment. The competent authorities may grant permission for the early repayment of such loans provided the request is made at the initiative of the issuer and the solvency of the credit institution in question is not affected." (emphasis added)

21. The words of Article 64(3) underlined in the extract above reproduce those to be found in Article 4(3) of Directive 89/299/EEC.

DIRECTIVE 2006/49/EC

22. The 1993 Capital Adequacy Directive was repealed and replaced by Directive 2006/49/EC (the "2006 Capital Adequacy Directive"), which came into force in July 2006: Articles 52 and 53. It was intended in relation to investment firms to give effect to the principles formulated in relation to banks/credit institutions in Basel II. It was considered that as investment firms face in respect of their trading book business the same risks as credit institutions, similar provisions should apply (Recital (11)). In particular, it was considered that the definition of own funds in Directive 2006/48/EC should apply, and that provision should be made for supplementary specific rules taking into account the different

scope of market risk related capital requirements (Recital (13)).

23. Recital (12) is important to understanding the underlying purpose of the 2006 Capital Adequacy Directive. It states the following:

> *"The own funds of investment firms or credit institutions … can serve to absorb losses which are not matched by a sufficient volume of profits, to ensure the continuity of institutions and to protect investors. The own funds also serve an important yardstick for the competent authorities, in particular for the assessment of the solvency of institutions and for other prudential purposes … Therefore, in order to strengthen the Community financial system … it is appropriate to lay down common basic standards for own funds."*

24. The provisions relating to own funds are set out in Chapter IV, of which Article 13 is most material for present purposes. Article 13 effectively provides Member States with a choice between:

    (1) applying to investment firms the own funds requirements set out in Directive 2006/48/EC in respect of credit institutions: Article 13(1); or

    (2) permitting investment firms which are obliged to meet capital requirements calculated in accordance with provisions relating to certain risks (Articles 21 and 28-32) to use an alternative determination of own funds for that purpose only: Article 13(2).

25. For the purposes of the alternative determination of own funds, subordinated loan capital may be taken into account, subject to conditions set out in Article 13(3) and (4): Article 13(2)(c). Article 13(4) provides that subordinated loan

capital should not exceed a maximum of 150% of original own funds left to meet the requirements of Articles 21 and 28 - 32. Article 13(3) states as follows:

> *"The subordinated loan capital referred to in [Article 13(2)(c)] shall have an initial maturity of at least two years. It shall be fully paid up and the loan agreement shall not include any clause providing that in specified circumstances, other than the winding up of the institution, the debt will become repayable before the agreed repayment date, unless the competent authorities approve the repayment. Neither the principal nor the interest on such subordinated loan capital may be repaid if such repayments would mean that the own funds of the institution in question would then amount to less than 100% of that institution's overall capital requirements."*

IMPLEMENTATION IN THE UK

26. IPRU (INV) set out the detailed financial and prudential resources and prudential standards applied by the FSA to certain firms, including investment firms. The rules and guidance it contained were to assist the FSA to meet its statutory objectives of protecting consumers and maintaining market confidence, and would do so by setting minimum capital and other risk management standards thereby mitigating the possibility that firms would be unable to meet their liabilities and commitments to consumers and counterparties: 1.1.1-2G. The chapter applicable to investment firms was Chapter 10.

27. IPRU (INV) 10-62(1)R contained the following general rule:

"A firm must, at all times, maintain financial resources in excess of its financial resources requirement as detailed in rule 10-70 below."

28. A firm's financial resources had to be calculated in accordance with Table 10-62(2)A, unless it had been granted a waiver from Rules 10-200 to 10-203 (in which case Table 10-62(2)B applied), or it had notified its intention to use 10-62(2)C: 10-62(2)R.

29. IPRU (INV) 10-63(1)R stated that:

"A firm may take into account subordinated loan capital in its financial resources in accordance with Tables 10-62(2)A, B and C subject to (2) to (12) below."

30. In so far as material, IPRU (INV) 10-63(2)-(12)R provided as follows:

(1) A firm may include a subordinated loan in its financial resources only if it is drawn up in accordance with the standard forms obtained from the FSA: 10-63(2)(a).

(2) The subordinated loan must come from an approved lender, which includes the firm's controller: 10-63(3).

(3) A firm's subordinated loans must be classified as either a long-term subordinated loan (original maturity of at least 5 years) or a short-term subordinated loan (original maturity of at least 2 years): 10-63(4), (5) and (8).

(4) A firm must not (except in accordance with the terms of the loan):

i. repay, prepay or terminate a short-term subordinated loan before the agreed repayment date; and

ii. make any payment of interest or principal if after such action the firm's financial resources will fall below 120% of its financial resources requirement (10-63(9)).

31. The standard forms for long-term and short-term subordinated loans appeared in Annex D, together with guidance notes for their completion. The Subordinated Debt Agreements are each in the standard forms.

32. Member States were to adopt laws implementing the provisions of the 2006 Capital Adequacy Directive by 31 December 2006, which were to apply from 1 January 2007. The supervisory requirements of the 2006 Capital Adequacy Directive were implemented in the UK by the Capital Requirements Regulations 2006 (2006/3221), but these contain no specific provisions relating to the constituent elements of own funds.

33. By the CRD (Consequential Amendments) Instrument 2006, the FSA introduced the General Prudential Sourcebook (GENPRU) and the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU), which took effect (subject to certain transitional provisions) from 31 December 2006.

34. GENPRU 2.2 (capital resources) implements minimum EC standards for the composition of capital resources required to be held by a BIPRU firm, including in particular Articles 56 - 61 and 63 - 4 of Directive 2006/48/EC and Articles 12 - 16 (ie including Article 13) of the 2006 Capital Adequacy

Directive: GENPRU 2.2.4G. GENPRU 2.2 distinguishes between three tiers of capital for the purposes of defining and measuring a firm's capital resources for the purpose of meeting its minimum capital resource requirements, identified as Tiers 1, 2 and 3.

35. As explained at GENPRU 2.2.8G, the FSA has divided its definition of capital into categories, or tiers, reflecting differences in the extent to which the capital instruments concerned meet the purpose and conform to the characteristics of capital listed in GENPRU 2.2G.

Tier 1

36. It is to be noted that subordinated loan capital is not amongst the categories of capital instrument permitted in relation to Tier 1: GENPRU 2.2.62R-2.2.63R.

Tier 2

37. The characteristics of Tier 2 capital are described in GENPRU 2.2.11G as including forms of capital that do not meet the requirements for permanency and absence of fixed servicing costs that apply to Tier 1 capital. By way of example it is said to include (amongst other things):

> *"capital which is not perpetual (i.e. it has a fixed term) or which may have fixed servicing costs that cannot generally be either waived or deferred (eg most subordinated debt), normally of a medium to long-term maturity of at least 5 years…"*

38. The general (cumulative) requirements for eligibility for Tier 2 capital are set out in GENPRU 2.2.159R, which is to be read with GENPRU 2.2.180R (upper

Tier 2) and 2.2.194R (lower Tier 2). They include the following:

> *"A capital instrument must not form part of the tier two capital resources of a firm unless it meets the following conditions:*
>
> *(1) the claims of the creditors must rank behind those of all unsubordinated creditors;*
>
> *(2) the only events of default must be non-payment of any amount falling due under the terms of the capital instrument or the winding-up of the firm and any such event of default must not prejudice the subordination in (1);*
>
> *(3) to the fullest extent permitted under the laws of the relevant jurisdictions, the remedies available to the subordinated creditor in the event of non-payment or other breach of the terms of the capital instrument must (subject to GENPRU 2.2.161R) be limited to petitioning for the winding-up of the firm or proving for the debt in the liquidation or administration;*
>
> *(4) any:*
>
> *(a) remedy permitted by (3);…*
>
> *must not prejudice the matters in (1) and (2) …*
>
> *(7) to the fullest extent permitted under the laws of the relevant jurisdictions, creditors must waive their right to set off amounts they owe the firm against subordinated amounts included in the firm's capital resources owed to them by the firm;*

(8) the terms of the capital instrument must be set out in a written agreement that contains terms that provide for the conditions set out in (1) to (7).” (emphasis added)

39. The purpose of GENPRU 2.2.159R(7) (relating to waiver of set-off) is stated as being “*to ensure that all of the firm’s assets are available to consumers ahead of subordinated creditors. The waiver should apply both before and during liquidation or administration*”: GENPRU 2.2.167G.

40. Tier 2 is subdivided into upper Tier 2 and lower Tier 2. For the purposes of upper Tier 2, GENPRU 2.2.180R applies. Amongst the applicable requirements is the requirement that if the obligations under the capital instrument constitute a liability under section 123(2) of the Act, the terms of the instrument are such that the holder of the instrument (amongst others) cannot petition for the winding up or administration of the firm on the grounds that the firm is or may become unable to pay any such liability: GENPRU 2.2.180(2)(b). Examples of upper Tier 2 capital resources given in GENPRU 2.2.176G include perpetual subordinated debt.

41. Given the express power conferred on LBHI2 by paragraph 4.4 of the Subordinated Debt Agreements, they cannot qualify as upper tier 2 capital.

42. For the purposes of lower Tier 2, GENPRU 2.2.194R provides that:

“A firm may include a capital instrument in its lower tier two capital resources if (in addition to meeting the requirements of the rules about eligibility for inclusion in tier two capital) either the holder has no right to repayment or it satisfies either of the following conditions:

(1) it has an original maturity of at least five years; or

(2) it is redeemable on notice from the holder, but the period of notice of repayment required to be given by the holder is five years or more."

43. It is to be noted that the requirements of GENPRU 2.2.180R (upper Tier 2), do not apply to lower Tier 2 capital instruments. In particular, there is no provision that imposes in relation to lower Tier 2 capital instruments the prohibition that applies to upper Tier 2 and Tier 1 capital instruments that the obligations to which they give rise do not constitute liabilities for the purposes of determining the firm's insolvency or, if they do, prohibiting the holder of the instrument from petitioning for the firm's winding up of administration on the grounds that it is or may become unable to pay any such liability.

Tier 3

44. The characteristics of Tier 3 capital are described in GENPRU 2.2.12G:

"Tier three capital consists of forms of capital conforming least well to the characteristics of capital listed in GENPRU 2.2.9G: either subordinated debt of short maturity (upper tier three capital) or net trading book profits that have not been externally verified (lower tier three capital)."

45. For the purposes of lower Tier 2, GENPRU 2.2.242R provides that:

"a BIPRU firm may include subordinated debt in its upper Tier 3 capital resources only if the following conditions are met:

(1) it has an original maturity of at least two years or is subject to at least two years' notice of repayment; and

(2) payment of interest or principal is permitted only if, after that payment, the firm's capital resources would be not less than its capital resources requirement."

46. GENPRU 2.2.245R sets out a table referring to GENPRU 2.2.159R-2.2.161R, 163R, 169R, 171R-172R and 174R, together with certain adjustments, the principal one of which is that references to the maturity or notice period should be to two years rather than five. The rules referred to in the table apply to short-term subordinated debt included in Tier 3 capital resources in the same way that they apply to a firm's Tier 2 capital resources, with the adjustments set out in the table: GENPRU 2.2.244R.

47. It follows that GENPRU 2.2.159R(1) applies to Tier 3 capital instruments so that they must satisfy the following condition: the claims of the (Tier 3) creditors must rank behind those of all unsubordinated creditors.

48. It is to be noted, however, that there is no reference in the table in GENPRU 2.2.245R to GENPRU 2.2.180R, and there is no other rule in similar terms which applies to Tier 3 capital. In particular, as with lower Tier 2 capital, there is no provision that appears to impose in relation to Tier 3 capital instruments the prohibition that applies to upper Tier 2 and Tier 1 capital instruments that the obligations to which they give rise do not constitute liabilities for the purposes of determining the firm's insolvency or, if they do, prohibiting the holder of the instrument from petitioning for the firm's winding up of administration on the grounds that it is or may become unable to pay any such

liability.

WATERFALL APPLICATION

Nos 7924 and 7945 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) and others

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

WRITTEN OPENING SUBMISSIONS

OF LEHMAN BROTHERS HOLDINGS, INC

BARRY ISAACS QC
MARK ARNOLD QC
South Square
Gray's Inn
London WC1R 5HP

24 October 2013

Weil, Gotshal & Manges
110 Fetter Lane
London EC4A 1AY