Appeal Court Ref.Nos.A2/2014/ 1833

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM
THE HIGH COURT OF JUSTICE **Nos.7924 & 7945 of 2008 & No.429 of 2009**
CHANCERY DIVISION
COMPANIES COURT
Mr Justice David Richards

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION) and others
AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

Appellants

and

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

Respondents

RESPONDENT'S REPLACEMENT SKELETON ARGUMENT ON BEHALF OF THE JOINT ADMINISTRATORS OF LBHI2

Introduction

1. This skeleton argument sets out LBHI2’s submissions in response to the Grounds of Appeal and Appellant’s Skeleton Argument of LBIE dated 9 June and 20 June 2014 respectively **[A/5/42-44]** and **~~[A/9/63-85]~~**. It also addresses the issues raised in LBHI2’s Respondent’s Notice dated 30 June 2014 **[B/1/12-15]** (by which LBHI2 seeks to uphold paragraphs (iv)[1] and (vii)[2] of the Judge’s Order of 19 May 2014 **[C/6/101-8]**). **E/1/1-23**

2. References to “IA” and “IR” are to the Insolvency Act 1986 and the Insolvency Rules 1986 respectively.

Declaration (iv): statutory interest is not payable in a liquidation in respect of the period of an administration which preceded the commencement of that liquidation

3. LBHI2 relies on the reasons given by the Learned Judge in paragraph 125 of the Judgment **[C/4/65]** as to why statutory interest is not payable in a liquidation in respect of the period of an administration which preceded the commencement of that liquidation. It also makes the following further submissions.

4. LBIE makes two alternative submissions in paragraph 12 of its Skeleton Argument **~~[A/9/66-7]~~** in support of its contrary argument: **E/1/4-5**

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[1] “*If the administration of LBIE is immediately followed by a liquidation, any interest in respect of the period of the administration which has not been paid before the commencement of the liquidation will not be provable as a debt in the liquidation, nor will it be payable as statutory interest under either r. 2.88 of the Insolvency Rules 1986 (“the “**Rules**”) or section 189 of the Insolvency Act 1986 (the “**Act**”)”*

[2] “*Neither the contributory rule (that is, the rule that a contributory of a company in liquidation cannot recover anything in respect of the claims he may have as a creditor until he has fully discharged his obligations as a contributory) nor the equitable rule in Cherry v Boultbee has any application in an administration (including the administration of LBIE) so as to permit the administrator to refuse to admit a proof of debt by a member ro to refuse to pay dividends on such proof on the grounds that, if the company went into liquidation, the member would or might become liable to calls under section 74(1)”*

(a) *"statutory interest will be payable pursuant to Rule 2.88(7) to all creditors who proved or prove (whether during or after the conclusion of the administration…) and section 189 is, in that context, simply inapplicable"*; or

(b) *"statutory interest will be payable pursuant to Rule 2.88(7) to those creditors who proved during the administration, while statutory interest will be payable pursuant to section 189(2) to those creditors who prove during the winding up"*.

Neither contention has the slightest support from, and both are inconsistent with, the statutory scheme.

5. Both of LBIE's suggestions ignore the fundamental point this issue relates to, namely what is to occur **after** the administration has ended and the winding up has begun. At that stage (at the risk of stating the obvious) the only insolvency process in existence will be the winding up, and in a winding up, the sole and governing provision as regards payment of statutory interest is s.189 IA **[Auths 3/20/p34]**. That provides (in material part),

> *(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 such 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 in respect of the periods during which they have been outstanding since the company went into liquidation.*
>
> *(3) All interest under this section ranks equally, whether or not the debts on which it is payable rank equally.*

6. This provision makes express provision for the application of a surplus to the payment of interest on debts proved in the winding up in respect of the period **after** the company went into liquidation. It is incapable of being interpreted, consistently with

the remainder of the statutory scheme, so as to provide for the payment of statutory interest in respect of any period which **preceded** the winding up.

7. The wording of IR2.1(1)(d) **[Auths 3/21/p2]** and IR 2.68(1) **[Auths 3/21/p8]** make it equally clear that the provisions to be found in Chapter 10 of Part 2 of the IR - of which IR 2.88(7) **[Auths 3/21/p19]** is one – only apply in an administration. They do **not** apply in a winding up or any other insolvency process under the IA. Accordingly, LBIE's *"crucial"* assertion in paragraph 25 of its Skeleton Argument ~~**[A/9/71]**~~ **E/1/9** that IR 2.88(7) *"does not cease to apply merely because the distributing administration is succeeded by a winding up"* is plainly incorrect; as is its implied assertion that the *"surplus remaining"* referred to in IR 2.88(7) can be interpreted to apply to the same *"surplus remaining"* identified in s.189 IA.

8. For the same reason, it is notable that LBIE's skeleton is studiously silent as to the identity of the person to whom, on its case, the direction as to how to apply the "surplus remaining" in IR 2.88(7) is addressed after the conclusion of the administration. *Ex hypothesi* the instruction in IR 2.88(7) cannot any longer be directed at the administrator; but because of IR 2.1(1)(d) and IR 2.68(1) it cannot be directed at the liquidator.

9. Still less does LBIE explain (on its first alternative) how or why section 189 IA is in some way "inapplicable" to creditors who prove their debts "after the conclusion of the administration". *Ex hypothesi* the **only** process for proving a debt available after the conclusion of the administration is by way of the submission of a proof in the winding up under Chapter 9 of Part 4 of the IR. S.189 IA **[Auths 3/20/p34]** expressly applies to such debts and LBIE gives no reason why the plain words of the statute do not mean what they say. Similarly, IR 2.88(7) **[Auths 3/21/p19]** cannot apply to persons who did not prove their debts in the administration: the reference therein to *"debts proved"* can **only** be to debts proved in the administration.

10. LBIE's second alternative is equally misconceived. It is based upon a premise that in some way IR 2.88(7) can have a life after the conclusion of the administration, and

that in a subsequent winding up there will be two separate and distinct regimes for the payment of interest: (i) for those who proved their debts during the administration, and (ii) for those who proved their debts during the winding up. Quite apart from the fact that there is not the slightest hint that such a bifurcated regime exists in a winding up (and indeed s.189(3) IA makes it quite clear that all debts rank equally for payment of interest in a winding up) this suggestion is flatly contradicted by IR4.73(8) **[Auths 3/21/p39]**, which provides that,

> *"Where a winding up is immediately preceded by an administration, a creditor proving in the administration shall be deemed to have proved in the winding up."*

11. Accordingly, in a winding-up, all debts will either actually have been proved in that winding-up or, if they were proved during the period of prior administration, they will be deemed to have been proved in that winding-up. There is therefore no basis in principle or in the legislation for drawing a distinction in a winding up between debts depending upon when they were proved.

12. Finally, to adopt either of the approaches contended for by LBIE would not be a permissible exercise of the court's interpretive function: see Bloom v The Pensions Regulator [2011] Bus LR 766 at [111]-[123] per Briggs J **[Auths 1C/88]** referring to Inco Europe Ltd v First Choice Distribution [2000] 1 WLR 586, 592 per Lord Nicholls **[Auths 1B/70]**; Re Nortel GmbH [2014] AC 209 at [116], [125-126] per Lord Neuberger **[Auths 1C/96]**; Re Portsmouth City FC [2014] 1 All ER 12 at [35] per Mummery LJ **[Auths 1C/95]**. Lord Nicholls set down in Inco Europe the relevant test which the Court should apply before construing a legislative provision other than in accordance with the natural meaning of its wording in order to correct an obvious drafting error:

> "*It has long been established that the role of the courts in construing legislation is not confined to resolving ambiguities in statutory language. The court must be able to correct obvious drafting errors. In suitable cases, in discharging its interpretative function the court will add words, or omit words or substitute words. ... This power is*

confined to plain cases of drafting mistakes. The courts are ever mindful that their constitutional role in this field is interpretative. They must abstain from any course which might have the appearance of judicial legislation. A statute is expressed in language approved and enacted by the legislature. So the courts exercise considerable caution before adding or omitting or substituting words. Before interpreting a statute in this way the court must be abundantly sure of three matters: (1) the intended purpose of the statute or provision in question; (2) that by inadvertence the draftsman and Parliament failed to give effect to that purpose in the provision in question; and (3) the substance of the provision Parliament would have made, although not necessarily the precise words Parliament would have used, had the error in the Bill been noticed.".

13. Given that no change was made to s.189 IA **[Auths 3/20/p34]** when the IR were amended in 2005 or 2010 it is impossible to say that the current regime that exists is the result of a *"plain case of drafting mistake"* so as to bring this principle into play. Moreover, neither of the interpretative suggestions offered by LBIE comply with this test, not least because, for the reasons set out above, they are inconsistent with the remainder of the scheme of the IA and IR.

Declaration (vii): the Contributory Rule does not apply in an administration at all and the Equitable Rule does not apply in an administration where insolvency set-off applies

14. Declaration (vii) **[C/6/104]** should be upheld for the reasons given by the Learned Judge in paragraphs 179-192 of the Judgment **[C/4/78-83]** and for the further reasons set out in this section of this Skeleton Argument.

The Contributory Rule does not apply in an administration

15. As the Judge correctly observed in paragraph 179 of the Judgment **[C/4/78]**, the so-called Contributory Rule is simply a statement of the principle that in a liquidation a person who is liable to pay money to the company following a call upon him as a contributory must discharge such liability before he can recover any money from a company in respect of a debt owed to him.

16. The early authorities which describe such principle make clear that it is derived from, and is entirely dependent on, the true construction of the relevant provisions of the companies legislation (which is now contained in the Insolvency Act). In the first of such cases, <u>Overend, Gurney & Co; Grissell's Case, Re</u> (1866) 1 Ch App 528 Lord Chelmsford LC described the case as *"depend[ing] entirely upon the construction of the Companies Act 1862"* (at 534) **[Auths 1A/6]**. His reasoning focused on the scheme of the 1862 Act as a whole and in particular the provisions of s.101 by which a contributory's liability for a call in a liquidation was excluded from the possibility of the set-off which was permitted in respect of other debts and liabilities.[3] From this Lord Chelmsford LC derived the proposition that the contributory had to pay the amount of a call made upon him in the liquidation before he was entitled to receive any dividend with the other creditors.

17. As such, the core of LBIE's submission (in paragraphs 48, 49 and 59(6) of its Appellant's Skeleton Argument **~~[A/9/77 and 81-2]~~**) that the Contributory Rule is a *"rule of equity"* which *"is capable of moulding itself to new circumstances"* is fundamentally wrong. There is no free-standing equitable principle at all: the Contributory Rule derives from the true construction of the statutory scheme in liquidations, and in particular from the fact that the statutory scheme excludes money payable to the company by virtue of a call from the set-offs that might be made as between a contributory and the company under what is now s.149(2) IA **[Auths 3/20/p21]**.

E/1/15 & 19-20

18. Accordingly, and as the Judge correctly recognised in paragraph 188 of the Judgment **[C/4/80-1]**, since the statutory scheme for administrations contains no provision under which a call can be made whilst LBIE is in administration, there is simply no basis for the court inventing a rule for administrations which is similar to the Contributory Rule which has been derived from the statutory provisions applicable to liquidations.

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[3] The exclusion of liabilities for calls from the scope of set-off in section 101 of the 1862 Act **[Auths 3/9]** is now contained in section 149(1) IA 1986 **[Auths 3/20/p21]**. The power to make a call (previously s.102 of the 1862 Act **[Auths 3/9]**) is now contained in section 150 IA 1986 **[Auths 3/20/p22]** and is not subject to any set-off.

19. LBIE's Skeleton Argument further suggests (in paragraph 51 **~~[A/9/78]~~**) that, *"The mischief which the contributory rule prevents, that of removing from the creditors **all or part of the fund which should be available to pay their debts**, is present equally in an administration and a liquidation"*. That is not so. The *"part of the fund"* there referred to is the sum which the contributories could potentially be called upon to contribute if the company goes into liquidation. The reason why that "*part of the fund*" is not available to pay creditors in the administration of LBIE is because the Administrators have chosen not to take steps to put LBIE into liquidation, in full knowledge of the fact that no call for any monies from contributories can be made during an administration. Accordingly, it is the consequence of the statutory scheme itself - and not any act or omission of LBHI2 - that that *"part of the fund"* will not be available in LBIE's administration. **E/1/16**

20. LBIE's attempt by this appeal to expand the Contributory Rule to have much wider scope and to apply where no call has been made but where there is potential liability to a call is also patently unjust. As the Judge held, it would be wrong in principle, and there is no justification in the IA or IR, for keeping members out of distributions in an administration in circumstances in which they are unable to take any steps to pay a call, because no such call can be made or quantified whilst the company is in administration (Judgment paragraph 188 **[C/4/80-1]**).

21. LBIE suggests two reason why this difficulty identified by the Judge is *"illusory"*. The first (in paragraph 54 of its Skeleton **~~[A/9/78]~~**) is to suggest that the administrators could *"if appropriate"* agree a compromise with the contributories under which the contributories would make a payment in respect of their contingent liability. It is no answer to the injustice which the invention of a rule would create to say that the parties could always agree to follow another course. **E/1/16**

22. The second point (in paragraphs 55-56 of LBIE's Skeleton **~~[A/9/78-9]~~**) is based upon an assertion that even if LBIE were to be in liquidation, LBHI2 would have to contribute the full amount for which they would be liable, including in respect of their **E/1/16-17**

own claims against LBIE, before they could participate in any distribution. Hence – so it is said – there is nothing inappropriate in a regime which excludes a contributory from either proving for its debt or participating in a distribution in an administration by reason of the fact that he cannot take steps to pay a call.

23. But that analysis of a liquidation is incorrect for (at least) two reasons. First because the Contributory Rule does not prohibit a contributory from **proving** its debt; and secondly because in a liquidation, even though a contributory could not rely upon set-off in respect of its unpaid call, it could rely upon the rule in Cherry v Boultbee to pay the call through the liquidator's exercise of the right of retainer of an appropriate proportion of the distribution otherwise due to the contributory.

(i) The Contributory Rule does not prohibit proof

24. LBIE submits at paragraph 37 of its Skeleton Argument ~~**[A/9/74]**~~ **E/1/12** that *"the effect of the contributory rule is to prevent the Members from proving in competition with LBIE's other creditors at a time when they have a contingent liability as contributories of LBIE*". A similar point is made in paragraph 51 ~~**[A/9/78]**~~ **E/1/16** where it is suggested that this would be the position in a liquidation. This characterisation of the Contributory Rule is incorrect:

(a) There is no authority for the proposition that the effect of the Contributory Rule is to prevent a member from (i) submitting a proof of debt or (ii) having its proof of debt admitted in a liquidation. The effect of the Contributory Rule is merely to prevent the contributory from **receiving** any distribution of the company's assets in competition with the company's other creditors at a time when it is subject to an outstanding unpaid call: see e.g. per Buckley J in West Coast Gold Fields Limited [1905] Ch 597 at 602 **[Auths 1A/33]** ("*the person liable as contributory must discharge himself in that character before he can set up that, as a creditor, he is entitled to **receive** anything*...") as cited with approval by Lord Walker in Re Kaupthing [2012] 1 AC 804 at [20] **[Auths 1C/89]**.

(b) There is nothing in the statutory basis or underlying rationale of the Contributory Rule (set out above) which requires or justifies the Contributory Rule being understood as prohibiting proof rather than prohibiting sharing in distributions while a statutory call is unpaid.

(ii) The rule in Cherry v Boultbee in a liquidation

25. The rule in Cherry v Boultbee is, as Lord Walker explained in Kaupthing at [8][4] **[Auths 1C/89]**, a simple netting-off process originally developed in the courts of Chancery and the administration of estates. As applied to a liquidation in which set-off is not available to a contributory, it produces the same net results for the purposes of making a distribution as if the contributory had satisfied his obligations to the company under the call in full.

26. The process was described in Re Leeds & Hanley Theatre of Varieties (No.2) [1904] 2 Ch 45, [1906] 1 Ch 1 **[Auths 1A/31]**.[5] The liquidator notionally treats the contributory as having paid the call (£A) in full and then, using the notional aggregate amount of assets of the company, calculates the dividend payable. When applied to the amount due to the contributory (in its capacity as creditor) that produces an amount (£B). If £B is larger than £A, then the contributory will be entitled to receive the difference. If £A is larger than £B, the contributory will get nothing (and will be liable for the balance).

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[4] *"The expression 'the rule in Cherry v Boultbee' suggests a technical rule of some complexity. Any such impression would be misleading. It is basically a simple technique of netting-off reciprocal monetary obligations, even where there is no room for legal set-off, developed and used by masters in the Court of Chancery in giving directions for the administration of the estates of deceased persons. Complication arises only in a situation of insolvency, where the equitable rule produces a different outcome from that produced by statutory set-off..."*

[5] See also Lightman & Moss, The Law of Administrators and Receivers of Companies, 5th Edn at [22-017]: **[Auths 2/7]**.

27. To similar effect see <u>Wood on English and International Set-Off</u> (1989), p.396, paragraph 8-1 **[Auths 2/3]**, (as adopted in In <u>MK Airlines Ltd v Katz</u> [2013] Bus LR 243 at [69] **[Auths 1C/92]**),:

> *"Where the contributor's share is a pro rata participation in the fund, his share is generally calculated by ascertaining what it would have been if he had paid his contribution to the fund and then deducting his contribution from that notional share."*

28. The operation of the rule in the case of an unlimited company can be illustrated by the following example. Assume that an unlimited company has assets of £70; its member is owed £50 by the company; and the company has liabilities to other creditors totalling £50. In a liquidation, the member's liability under s.74 would be £50 + £50 - £70 = £30. The application of the rule in <u>Cherry v Boultbee</u> would mean that the member is assumed to have contributed to the fund for the purposes of calculating his entitlement to a distribution from it, and he is entitled to receive any net positive balance between his entitlement to a dividend and his liability to contribute. In this case, the effect of the notional contribution of £30 is that the company would pay a 100% dividend on the member's £50 debt (i.e. he would receive £50), and so he will be entitled to participate in the distribution of the company's assets by receiving £50 - £30 = £20. The member does not actually have to pay £30 to the company as a condition of then receiving back £50.

29. Standing back, in spite of the fact that a contributory would be entitled to receive a distribution if LBIE were to go into liquidation, LBIE's argument appears to be that in an administration the Contributory Rule should exclude the member from any participation in a distribution because he *"would or might"* be liable to a call in the future if the company were to go into liquidation. LBIE appears to argue that the company's assets should be distributed in the administration and applied to the payment of non-provable claims without regard to the member's debt, and that the company should then be dissolved (see paragraph 50 of LBIE's Appellant's Skeleton Argument **[A~~/9/77~~]**). That would be a perverse result. There can be no justification for members being put into a worse position in an administration on account of the

mere possibility that a call might be made in a subsequent liquidation than they would be in if the postulated liquidation actually took place.

<u>The rule in Cherry v Boultbee does not apply in a distributing administration</u>

30. As the Judge held in paragraph 193 of the Judgment **[C/4/83]**, the rule in <u>Cherry v Boultbee</u> does not apply where the debt due to the estate is not presently payable: in such a case the estate must pay its present debt in full: see <u>Re Abrahams</u> [1908] 2 Ch 69 **[Auths 1A/35]** as affirmed in <u>Re Kaupthing</u> at [45] **[Auths 1C/89]**. The Judge was also correct in his analysis of <u>Re Rhodesia Goldfields</u> [1910] 1 Ch 239 **[Auths 1A/36]**.

31. LBIE's submissions to the contrary in paragraphs 63-66 of its Skeleton Argument **[~~A/9/83-4~~]** **E/1/21-22** seek to rely upon the fact that the same valuation date is taken for the purposes of valuation of all liabilities in a winding-up as in some way transforming LBHI2's contingent liability under a possible future call into a present liability. That is misconceived and wrong. The fact that a value is placed upon a contingent liability by reference to the same date as present debts are assessed does not transform the nature of the liability. The potential liability of LBHI2 in respect of a future call remains entirely contingent and it does not, as LBIE would have it in paragraph 64 of its Skeleton Argument **[~~A/9/83~~]** **E/1/21**, *"accrue as at the date on which the administration becomes distributive"*.

32. The rule in <u>Cherry v Boultbee</u> cannot apply, therefore, to LBHI2's contingent liability (if any).

33. Moreover, irrespective of whether the rule in <u>Cherry v Boultbee</u> could apply to any contingent liability LBHI2 might be said to have, there is a more general reason why the rule cannot apply in LBIE's distributing administration. That is because, as Lord Walker explained in <u>Kaupthing</u> at [53] **[Auths 1C/89]**, *"the equitable rule may be said to fill the gap left by disapplication of set-off"*. In <u>MK Airlines Ltd v Katz</u> [2013] Bus LR 243 at [69] **[Auths 1C/92]**, Nicholas Strauss QC held that the rule in <u>Cherry v</u>

Boultbee could not apply because one of the conditions for the application of that rule is *"precisely that there should be no right of set-off"*, referring to Wood on English and International Set-Off (1989), p.396, paragraph 8-1 **[Auths 2/3]** (Nicholas Strauss QC's emphasis):

> *"Where a person is liable to contribute to a fund which is not a legal entity, such as an insolvent's estate, a deceased's estate or a trust fund, and is entitled to a share of the fund as beneficiary or creditor in circumstances* ***where there is no set-off of the face amounts of the contribution and the share****, then in certain cases the administrator of the fund may retain the contributor's share to cover the unpaid contribution."*

The giving of a notice of a proposal to distribute in administration pursuant to IR2.95 triggers the operation of insolvency set-off between qualifying claims (by reason of IR2.85 **[Auths 3/21/p14]**). Accordingly the rule in Cherry v Boultbee cannot thereafter apply[6].

34. For these reasons, therefore, neither the Contributory Rule nor the rule in Cherry v Boultbee apply in LBIE's distributing administration.

25 July 2014

Replacement dated 13 March 2015

RICHARD SNOWDEN QC

LOUISE HUTTON

ROSANNA FOSKETT

rsnowden@erskinechambers.com; lhutton@maitlandchambers.com;

rfoskett@maitlandchambers.com

[6] The only reason why the rule can apply to the liabilities of a contributory in a liquidation is that in a liquidation the Contributory Rule operates, pursuant to s.149 and the statutory scheme, to disapply insolvency set-off where the liquidator makes a call on the contributories.