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

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

IN THE MATTER OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN

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

(2) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)

(3) THE JOINT ADMINISTRATORS OF LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)

Applicants

and

(1) LEHMAN BROTHERS HOLDINGS, INC (a company incorporated in the State of Delaware, USA)

(2) LYDIAN OVERSEAS PARTNERS MASTER FUND LIMITED

Respondents

OPENING SUBMISSIONS ON BEHALF OF THE JOINT ADMINISTRATORS OF LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION) ("LBHI2")

References are to the 11 volume agreed bundle in the form [bundle/page] or [bundle/tab/page].

(A) INTRODUCTION: SUMMARY OF THE FACTS[1] AND OF LBHI2'S CASE ON THE ISSUES

1. LBHI2 has been in administration since January 2009. It is one of the two shareholders in Lehman Brothers International (Europe) ("**LBIE**"), which was the principal trading company within the European Lehman Brothers group of companies. LBIE has been in administration since September 2008.

2. LBHI2 holds (a) 6,273,113,999 ordinary shares of $1 each, (b) 2 million 5% redeemable preference shares of $1,000 each, and (c) 5.1 million 5% redeemable Class B preference shares of $1,000 each in LBIE.

3. LBIE's only other shareholder is Lehman Brothers Limited ("**LBL**"), which holds a single ordinary share in LBIE, and was the service company for the Lehman Group's operations in the UK, Europe and the Middle East. LBL has been in administration since September 2008.

4. Lehman Brothers Holding Inc ("**LBHI**") is the ultimate parent for the Lehman Brothers group of companies worldwide. It is incorporated in the State of Delaware.

5. Pursuant to three Subordinated Loan Facility Agreements ("**the Sub-Debt Agreements**") [4/210-260], LBHI2 provided loans to LBIE. The loans provided under those agreements ("**the Sub-Debt**") formed part of LBIE's regulatory capital for the purposes of the FSA's capital adequacy requirements.

6. LBHI2 has lodged unsecured claims in LBIE's administration for £38,089,911.30 (in respect of the general intercompany unsecured balance) and £1,254,165,598.48 in respect of the outstanding Sub-Debt. Its proof of debt is at [4/196-209].

[1] Unless otherwise stated, the facts set out here are contained in the Statement of Agreed Facts [1/4/1-9].

7. LBL has lodged an unsecured claim in LBIE's administration for £363 million [4/177-194].

8. As set out at para.7 of the witness statement filed by Mr Howell, one of the Administrators of LBHI2 [3/4] –

"Whilst LBIE's administrators have not yet indicated whether liquidation [of LBIE] is likely, their various progress reports and evidence submitted to the court are illuminating. In short, the documents exhibited to this witness statement show –

(a) LBIE's administrators have envisaged that the realisation of assets and distribution to creditors should be undertaken in the administration.
(b) There are powerful arguments as to tax efficiency which support LBIE's realisation and distribution process being undertaken in administration.
(c) There is some evidence to suggest that LBIE's administrators have contemplated, as an exit strategy, either the approval of a scheme of arrangement or immediate dissolution of the company, the realisation process having been completed in the administration. In contrast, there is no evidence to support the proposition that LBIE's administrators have a settled intention to proceed to liquidation.
(d) If creditors are to be paid by way of distributions out of the administration, there are no obvious arguments supporting the proposition that LBIE's administrators would wish to convert the administration into liquidation."

9. In response, Mr Downs, one of the Administrators of LBIE, has filed evidence as follows (Downs 4, paras.64-65 [3/6/21-22]):-

"I understand that, depending upon the outcome of certain issues in the Joint Application, it may, at some stage, be in the interests of LBIE's creditors for LBIE to enter into liquidation.
The LBIE Administrators consider that all options are available with regard to whether LBIE might go into liquidation. The LBIE Administrators will consider whether, and if so when, to place LBIE into liquidation, including in light of the Court's determination of the issues in the Joint Application. The LBIE

Administrators' Proposals (as approved by creditors) expressly contemplate the possibility of a liquidation ... Further if it is in the interests of creditors to do so, the costs of moving into liquidation are (relative to the potential sums at stake) de minimis."

10. By way of introductory summary to LBHI2's case on the issues, LBHI2 respectfully submits that, for the reasons set out below, the Court should hold that:-

    (a) upon payment in full of all unsubordinated unsecured creditors of LBIE and before payment of (i) statutory interest and (ii) currency conversion claims (if any), LBHI2 is entitled to have its claim admitted to proof and to rank in LBIE's administration for payment of dividends in respect of its Sub-Debt claim;

    (b) unless and until LBIE goes into liquidation and its liquidators make a call on LBHI2 as a contributory, the Equitable Rule does not apply to LBHI2's entitlement to dividends in LBIE's administration;

    (c) instead, all LBHI2's claims and LBIE's potential contingent claim against LBHI2 as a contributory are subject to insolvency set-off (in LBIE's administration, and also in LBHI2's administration in due course) – although LBHI2 accepts that unless and until all LBIE's unsecured creditors have been paid in full, insolvency set-off cannot apply to its Sub-Debt claim because of the subordination provisions of the Sub-Debt Agreements.

11. LBHI2 addresses the issues set out in the Agreed List of Issues [1/4/1-9] below, in the order in which they fall most naturally for considering the position of LBHI2.

(B) THE SUB-DEBT

12. LBIE's administrators have provided evidence of what they estimate to be the impact on LBHI2 and LBIE's other creditors of the Court's decision on this issue. Downs 4, paras.58-59 [3/6/21], states that if statutory interest ranks ahead of LBHI2's Sub-

Debt, *"there will be no monies available to meet LBHI2's subordinated claim based on the estimated outcome in paragraph 56 above"*, whereas if LBHI2's Sub-Debt ranks ahead of the payment of statutory interest *"then LBHI2's subordinated debt claim would, in the high estimated outcome, be paid in full and the amount of funds available to pay statutory interest to ordinary unsecured creditors would be reduced by a corresponding amount"*.

13. It is agreed between the parties that the LBHI2 Sub-Debt Agreements were based on templates provided by the FSA and that there are only minimal differences between the terms of the subordination provision in the LBHI2 Sub-Debt Agreements and the subordination provision in the FSA standard form subordinated debt agreement: see para.41 of the Statement of Agreed Facts [1/4/7].

<u>*Contractual construction: the relevant considerations and the correct approach*</u>

14. The effect of the subordination provisions is primarily a question of contractual construction, which involves consideration of (a) the actual words used in the Sub-Debt Agreements; (b) how competing constructions of the words used fit into the scheme of those documents; and (c) the background reasonably available to both parties insofar as it would have affected the way in which the language of the document would have been understood by a reasonable man (see <u>ICS v West Bromwich</u> [1998] 1 WLR 896 per Lord Hoffmann at 912-913), which includes the legal, regulatory and commercial context.

15. As McMeel comments (in <u>The Construction of Contracts: Interpretation, Implication and Rectification</u> at §§5.70-5.71) –

> *"The extension of the context to include explicitly legal background was a major advance. Contracts are drafted against a legal and regulatory backdrop. In many cases it would be unrealistic to disregard that reality.*
> *"Lord Hoffmann's speech in the <u>Investors Compensation Scheme</u> case is a model example. The assignment document was clearly drafted by legal representatives of the statutory compensation body. His Lordship immediately contextualized the document*

in the wider context of the primary and secondary legislation governing investment advice and constituting the Investors Compensation Scheme ...".

16. The Court should not consider the "natural meaning" of the words used divorced from the contractual context, i.e. the scheme of the document as a whole. In Charter Reinsurance Co Ltd v Fagan [1997] AC 313, the House of Lords held that the meaning of "actually" paid was "payable" and not "paid". Lord Hoffmann said (at 391C):

"I think that in some cases the notion of words having a natural meaning is not a very helpful one. Because the meaning of words is so sensitive to syntax and context, the natural meaning of words in one sentence may be quite unnatural in another. Thus a statement that words have a particular natural meaning may mean no more than that in many contexts they will have that meaning. In other contexts their meaning will be different, but no less natural." [2]

17. Charter Re was cited with approval by the Supreme Court in Re Sigma Finance Corporation [2009] UKSC 2, [2010] 1 All ER 571. As Lord Mance explained (at [12]), the "natural meaning" approach had led the Chancery Division and Court of Appeal into error:

"In my opinion, the conclusion reached below attaches too much weight to what the courts perceived as the natural meaning of the words of the third sentence of cl.7.6, and too little weight to the context in which that sentence appears and to the scheme of the security trust deed as a whole."

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[2] In that case Lord Hoffmann gave the following memorable example (at 391D-E): *"Take, for example, the word 'pay'. In many contexts, it will mean that money has changed hands, usually in discharge of some liability. In other contexts, it will mean only that a liability was incurred, without necessarily having been discharged. A wife comes home with a new dress and her husband says 'What did you pay for it?' She would not be understanding his question in its natural meaning if she answered, 'Nothing, because the shop gave me 30 days' credit.' It is perfectly clear from the context that the husband wanted to know the amount of the liability which she incurred, whether or not that liability had been discharged."*

18. Where there are two possible constructions, the court is entitled to prefer the construction that is consistent with business common sense. See Rainy Sky v Kookmin Bank [2011] UKSC 50, [2011] 1 WLR 2900 at [29-30] per Lord Clarke, quoting Longmore LJ in Barclays Bank plc v HHY Luxembourg SARL [2011] 1 BCLC 336, at [25-26].

19. In this case, the relevant regulatory background is that the FSA enabled entities such as LBIE to meet part of its regulatory capital requirements by means of subordinated debt on the terms of the agreements used in this case (rather than by requiring equity investment).

20. The central provision of the legislation forming the backdrop to these agreements for the purposes of the issue before the Court is the order of priority for payments out of the company's assets in an administration (and in a liquidation), set out as follows by Lord Neuberger in Re Nortel GmbH [2013] 3 WLR 504 at §39:-

"(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; and
(8) Shareholders."

Construction of the Sub-Debt Agreements

21. The central provisions of the Sub-Debt Agreements for the purposes of the statutory interest issue are as follows:-

Clause 1 (*"Interpretation"*) includes the following:

"'Excluded Liabilities' means Liabilities which are expressed to be and, in the opinion of the Insolvency Officer of the Borrower do, rank junior to the Subordinated Liabilities in any Insolvency of the Borrower"

"'Liabilities' means all present and future sums, liabilities and obligations payable or owing by the Borrower (whether actual or contingent, jointly or severally or otherwise howsoever);"

"'Senior Liabilities' means all Liabilities except the Subordinated Liabilities and Excluded Liabilities"

"'Subordinated Liabilities' means all Liabilities to the Lender in respect of each Advance made under this Agreement and all interest payable thereon"

<u>Clause 5</u> *"Subordination"*

(1) Notwithstanding the provisions of paragraph 4, the rights of the Lender 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 the Borrower ...)...

(b) the Borrower being 'solvent' at the time of, and immediately after, the payment by the Borrower and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that the Borrower could make such payment and still be 'solvent'.

(2) For the purposes of sub-paragraph (1)(b) above, the Borrower 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 the Borrower, and

(b) the Excluded Liabilities.

(3) Interest will continue to accrue at the rate specified pursuant to paragraph 3 on any payment which does not become payable under this paragraph 5.

(4) For the purposes of sub-paragraph (1)(b) above, a report given at any relevant time as to the solvency of the Borrower by its Insolvency Officer, in form and substance acceptable to the FSA, shall in the absence of proven error be treated and accepted by the FSA, the Lender and the Borrower as correct and sufficient evidence of the Borrower's solvency or Insolvency.

(5) Subject to the provisions of sub-paragraphs (6), (7) and (8) below, if the Lender shall receive from the Borrower payment of any sum in respect of the Subordinated Liabilities –

(a) when any of the terms and conditions referred to in sub-paragraph (1) above is not satisfied, or

(b) where such payment is prohibited under paragraph 4(3),

(6) Any sum referred to in sub-paragraph (5) above shall be received by the Lender upon trust to return it to the Borrower.

(7) Any sum so returned shall then be treated for the purposes of the Borrower's obligations hereunder as it if had not been paid by the Borrower and its original payment shall be deemed not to have discharged any of the obligations of the Borrower hereunder.

(8) *A request to the Lender for return of any sum referred to in sub-paragraph (5) shall be in writing and shall be made by or on behalf of the Borrower or, as the case may be, its Insolvency Officer."*

22. LBHI2 submits that these provisions should be analysed as follows:-

(a) The insolvency legislation (against the backdrop of which the Sub-Debt Agreements were drafted) recognises two different payment stages in an administration (as in a liquidation): (i) a stage involving payment of all proved debts and (ii) the stage where, pursuant to IR2.88(7), an administrator applies any surplus remaining after the stage (i) payments *"in paying interest on those debts in respect of the periods during which they have been outstanding since the relevant date"* (the *"relevant date"* in this case being the date of administration of LBIE, pursuant to r.2.88(A1)).

(b) If, as part of the payment stage (i) identified above, all debts proved by the unsecured creditors (other than the LBHI2 Sub-Debt) can be paid, then LBIE is "solvent" (under the terms of clause 5(1)(b)) and, accordingly, the Sub-Debt due to LBHI2 is (in accordance with the terms of clause 5(2)) "payable" and is therefore, at that stage at the latest[3], provable in the administration (and a dividend payable thereon). Further, at that stage, any insolvency set-off otherwise available in LBIE's administration in respect of LBHI2's Sub-Debt is also available.

(c) There is therefore no reason for the LBIE administrators not to accept LBHI2's proof for its Sub-Debt and to use the assets remaining (after payment in full of all other unsecured creditors' proved debts, as required by clauses 5(1) and (2)) first to pay LBHI2 what is then payable to it in respect of its proof.

[3] It therefore probably does not matter in this case that the clause is expressed in terms of whether the debt is "payable" rather than restricting the creditor from proving for its debt. By either method, the debt is payable and provable at the same point in this administration.

(d) It is after that stage (and not before) that stage (ii) payment (under IR 2.88(7)) becomes relevant; if there is anything left after payment stage (i) (i.e. all debts proved in LBIE's administration, including the Sub-Debt) have been completed, then that is a "surplus" and the LBIE administrators should then apply it to pay statutory interest. No such obligation arises other than in respect of the surplus that arises after payment of all proved debts: if the Administrators had not by then paid the debt for which LBHI2 was entitled to prove after payment of all the other unsecured creditors, there would be no power (let alone an obligation) for the administrator to apply the assets in his hands in the payment of statutory interest.

23. In other words, the primary concern of the subordination provisions is in relation to the ranking of the Sub-Debt within the general class of unsecured creditors, and their purpose and effect is to rank the subordinated unsecured debt (for the purpose of receiving a dividend from LBIE's administration) behind the un-subordinated unsecured liabilities falling within the definition of "Senior Liabilities", not to create a different class of liability which LBIE's administrators are obliged to discharge only after having paid interest under IR 2.88(7).

24. Indeed, it is far from clear that contracting parties could validly agree to move a debt which is by statute put in a particular class of liability (eg here, the "unsecured creditors" class) into a different class. That would be a different exercise to an agreement for a particular creditor agreeing to rank behind other creditors within that same class for the purpose of proof and/or dividend payment.

25. This construction is consistent with the statutory order of priorities. The Insolvency Act and the Insolvency Rules provide that statutory interest is payable only after payment of the debts proved. The relevant provision for companies in administration[4] is IR 2.88:

[4] The provision applicable to companies in winding up is in the same terms at s.189 IA 1986.

"(7) 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 relevant date.
"(8) All interest payable under paragraph (7) ranks equally whether or not the debts on which it is payable rank equally."

Thus, the construction advanced by LBIE and Lydian requires the Court to hold that LBHI2 is not entitled to prove and receive a distribution in respect of the Sub-Debt even after the other unsecured creditors have been paid in full. There is no such provision in the loan agreements.

26. The LBIE/Lydian analysis involves two particular flaws: (i) a misconception as to the nature of the power or obligation to pay statutory interest provided by IR 2.88(7) and (ii) it places too much emphasis on particular words in the definition of "Liabilities" in the Sub-Debt Agreements without regard to the legislative and contractual context in which those words are used. The legislative and contractual context includes a wide definition of "Excluded Liabilities", which definition is clearly intended to be understood by reference to the statutory order of priorities for payments in insolvency.

27. There is no provision for the payment of interest in the course of winding up or administration except in accordance with the statutory provisions (at s.189 and IR 2.88(7) respectively), which apply only if there is a surplus remaining after the payment in full of all proved debts (including interest accrued up to the date of liquidation or administration, which is provable, under IR 4.93 (liquidation) and IR 2.88(1) (administration)): see Sealy & Milman, 16th Edn, Vol.1, p.191[5]. The entitlement of the unsecured creditors to enforce a claim to interest on any other basis

[5] See also eg Palmer's Company Law, Vol.4, §15.470 which states, *"Under the Insolvency Act 1986 a complete change was made to the law concerning the payment of interest on debts proved in a winding up. Section 189 introduced new provisions in line with the recommendations of the Cork Report, and provides for the payment of interest, at the rate prescribed in subsection (4), in respect of the period the debts have been outstanding since the company went into liquidation. Payment of post-insolvency interest under this provision can only occur if there is a surplus after all creditors' claims proved in the winding up have been met in full, including claims for pre-insolvency interest which can be properly incorporated into the amount for which proof is lodged."*

(e.g. pursuant to contract) is therefore, on the date of liquidation or administration, brought to an end: its place is taken by the power given to the liquidator/administrator to distribute any "surplus" (as defined in s.189 and IR 2.88(7)) remaining in his hands in the payment of statutory interest. As set out above, that power is only triggered once all unsecured proved debts are paid.

28. Further, once statutory interest is payable under IR 2.88(7), it then *"ranks equally whether or not the debts on which it is payable rank equally"* (IR 2.88(8)). The fact that interest payable under IR 2.88(7) applies equally to preferential and non-preferential debts (which are, by statute, different classes of debt for the purpose of ranking for divided payment, with preferential debts ranking above non-preferential debts: s. 386 and schedule 6 to the Act), further indicates that the statutory ranking scheme is concerned primarily with placing all unsecured provable debts (comprising principal and pre-insolvency interest) for which the creditor is entitled to prove ahead of the payment of statutory interest, only once payment to all unsecured creditors has been made in full. As the statutory scheme is to the effect that preferential creditors are not paid statutory interest before the ordinary unsecured creditors are paid their proved debts, it is hard to see why here the senior unsecured creditors should be paid statutory interest before LBHI2 is paid its proved subordinated unsecured debt.

29. Statutory interest, clearly, forms no part of an unsecured creditor's provable debt: otherwise, (i) the wording of IR 2.88 (7) would fail for circularity and (ii) statutory interest would undermine the 'freeze' which is effectively put in place when a company goes into liquidation or administration so that all claims can be determined as at that date. (See also Lord Neuberger's priority of payments in Nortel at §39 (set out above) and *In re a debtor* [1947] 1 Ch 313 at 328 *per* Romer J where it is said that statutory interest on a debt (under s. 33(8) of the Bankruptcy Act 1914[6]) is not something for which a creditor can prove.)

[6] S. 33(7) and (8): "*(7) Subject to the provisions of this Act, all debts proved in the bankruptcy shall be paid pari passu. (8) If there is any 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 4l. per cent per annum on all debts proved in the bankruptcy*"

30. Thus the true construction of the contractual subordination provisions in the Sub-Debt Agreements are to be understood in the light of a statutory scheme which ranks unsecured creditors for payment of their provable debts (including principal and provable interest) before there can be said to be any "surplus" which the administrator can then apply (and, indeed, is obliged by the insolvency legislation to apply) in paying statutory interest on those proved debts which have been paid in full.

31. In these circumstances, the true construction of the Sub-Debt Agreements involves recognising statutory interest either as not falling within their definition of "Liabilities" at all, or, if that is wrong, as falling within their definition of "Excluded Liabilities".

32. As set out above, the provision requiring an administrator to apply the "surplus" in paying statutory interest is triggered only when all proved debts have been paid, and is a power or obligation imposed on the administrator in dealing with that surplus, rather than an obligation or liability of the company. The language of IR 2.88 (and of s.189 containing the equivalent power for a liquidator) sets out a mechanism which directs the office holder as to how he is to apply the surplus in his hands, and does not impose any obligation or liability on the company. The potential power of the LBIE Administrators to pay statutory interest is therefore not within the definition of Liabilities contained in the Sub-Debt Agreements: that power is not a "liability" or "obligation" "payable or owing by LBIE (whether actual or contingent, jointly or severally or otherwise howsoever)". The requirement is instead simply on the administrator in the way in which he applies the surplus of assets in his hands.

33. Alternatively, if the "obligation" on the administrator to pay statutory interest is a "Liability" within the meaning of the loan agreements, then it is an "Excluded Liability" rather than a "Senior Liability":

    (a) The starting point is that any "Excluded Liability" is also one of the "Liabilities" as defined in the Sub-Debt Agreements.

(b) The reference in the contract's definition of "Excluded Liabilities" to "Liabilities which are expressed to be … junior to the Subordinated Liabilities in any Insolvency of the Borrower" (emphasis added) is a reference to something "expressed" in the Insolvency Act or Rules to rank junior to the subordinated debt. That is clear from (i) the fact that the Sub-Debt Agreements themselves contain nothing expressing any specific liability to be junior to the subordinated liabilities, (ii) the reference to something expressing a liability to be junior to the Subordinated Liabilities "in any Insolvency of the Borrower", and (iii) the reference to the "opinion of the Insolvency Officer of the Borrower", which can only be relevant where someone has been appointed to administer assets of the Borrower in the course of its insolvency (within the definition of "Insolvency Officer").

(c) In this context, the liabilities "expressed to be and [which do] rank junior to the Subordinated Liabilities in any Insolvency of the Borrower" are the liabilities which rank below payment of unsecured provable debts in the statutory priority of payments i.e. (using Lord Neuberger's list from Nortel set out above) statutory interest, non-provable liabilities and sums due to shareholders in their capacity as such.

34. By contrast, on the analysis advanced by LBIE and Lydian, then LBHI2's subordinated debt claim is pushed down the list of priorities, not just below statutory interest, but right down to the very bottom of the list (i.e. below non-provable liabilities such as contractual interest claims (to the extent they can be made out) and currency conversion claims (to the extent they can be made out) so that there is no room for the operation of the "Excluded Liabilities" provision contained in the Sub-Debt Agreements. This appears most clearly from the position paper of Lydian, which sets out its position at §3.2 as being that, "the Terms [the terms of the Sub-Debt Agreements] in any event preclude LBHI2 from receiving any distribution in respect of the LBHI2 Subordinated Debt until such time as all other liabilities of LBIE, including statutory interest on all proved debts and the Currency Conversion Claim, have been paid in full" (emphasis added).

35. It is of course the case that the claim for the Sub-Debt does not fall within the definition of "postponed claims" given by IR 12.3(2A)(c). There are several examples of 'statutory subordination' of certain sums due out of an insolvent estate such that they cannot be proved until other classes of creditor have been paid in full (such as s. 74(2)(f) of the Act (see Derham on the Law of Set-Off[7] at para. 6.116)). But it is common ground on this application that there are no such sums due from LBIE to LBHI2.

36. Further, and without prejudice to the point made above that moving a contractual debt from one class of liabilities to another may not be possible in any event, given the consideration of the insolvency scheme which the draftsman of the Sub-Debt Agreements had in mind (as set out above), it is surprising that, if the parties' intention was to prioritise statutory interest and other possible lower ranking payments (contractual interest, currency claims etc) above the Sub-Debt, this was not stated in terms.

(C) THE EQUITABLE RULE (AND THE CONTRIBUTORY RULE)

The "Equitable Rule"

37. The "Equitable Rule" for which LBIE contends is set out as follows at §1(a) of LBIE's position paper:

> *"a person who owes an estate money cannot claim a share in that estate without first making the contribution which completes it".*

38. LBIE contends that the Equitable Rule *"applies in the case of a liquidation so that a contributory who seeks to prove can receive nothing until he has paid everything that he is liable to pay as a contributory pursuant to section 74 of the Act. Payment by the contributory of the call is a condition precedent to his participation as a creditor".*

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[7] 4th ed., November 2010 ("Derham").

These contentions are said to have been recently confirmed by the Supreme Court in Re Kaupthing Singer & Friedlander Ltd (No.2) [2012] 1 AC 804 at [52].

39. LBHI2's position is that the "Equitable Rule" discussed in Kaupthing (No.2) has no application in this case because LBIE is not in liquidation and no call has been made on LBHI2. Set-off will operate in favour of LBHI2 in relation to the Sub-Debt and its unsecured claim, such that (if LBIE is permitted to prove for the Potential Liability as Contributory) LBHI2's liability to LBIE will be satisfied and LBHI2 will be entitled to prove for the balance and receive a dividend in respect thereof in LBIE's administration.

Kaupthing (No.2)

40. The decision in Kaupthing (No.2) was concerned with the relationship between (i) the rule against double proof (held to be implicit in the insolvency legislation, including in respect of a distributing administration[8]) and (ii) the "rule in Cherry v Boultbee" (which is what LBIE has termed the "Equitable Rule").

41. At first instance, Morritt C, being bound by Court of Appeal authority, directed the administrators that the "rule in Cherry v Boultbee" was not excluded by the rule against double proof and that the administrators of the relevant estate (KSF) could rely on it to refuse to admit to proof the claim of a particular creditor (F) until it (F) had satisfied its contingent liability to KSF (since KSF was the guarantor of F's debt to another entity, "the trustee", and, accordingly, entitled to an indemnity from F in the event that it had to pay out under the guarantee to the trustee) in full.[9]

42. The Supreme Court considered what function, if any, the "rule in Cherry v Boultbee" had to perform in the operation of the rule against double proof as it applies in suretyship situations.[10] It held (allowing the appeal) that the rule against double proof took priority over and excluded the "rule in Cherry v Boultbee", with the result that

[8] See Kaupthing at 811G
[9] See Kaupthing at 813B-C
[10] See question posed in Kaupthing at 813E-F

KSF had to satisfy its liability to the trustee in full before KSF could prove in the administration of F for the indemnity to which it was entitled as the guarantor of F's debts to the trustee.[11]

43. As part of the analysis of whether the "rule in Cherry v Boultbee" had any application in that case, Lord Walker considered the reasoning in Re SSSL [2006] Ch 610 (CA), which was also a case about the interaction between the rule against double proof and the "rule in Cherry v Boultbee" (albeit that it concerned proofs between two companies in liquidation, rather than distributing administrations). Lord Walker disapproved the reasoning of the Court of Appeal in Re SSSL, in particular, the conclusion (at [96] of Re SSSL) that both the rule against double proof and the "rule in Cherry v Boultbee" should apply in situations of double insolvency. Lord Walker considered that such an approach *"would lead to many doubts and difficulties, and whether the end result would strike a fair balance would depend very much on the facts of the particular case"*.[12] His conclusion was that the "rule in Cherry v Boultbee" applies where insolvency set-off under the Rules does not; and that the "rule in Cherry v Boultbee" produces a *"similar netting-off effect except where some cogent principle of law requires one claim to be given strict priority to another"*. He gives two examples of such "principles of law" which require a particular claim to be given priority over another, one being the rule against double proof (i.e. the subject of the actual decision in Kaupthing (No.2)). It is against that background that [52] and [53] of his speech must be read. At [52] he analysed a line of cases which he described as *"dealing with the special case of shareholders liable for calls on shares which are not fully paid up"* as the second example of a principle which can, in appropriate circumstances, result in "the rule in Cherry v Boultbee" working other than so as to produce a similar netting-off effect to set-off as follows:-

"The situation in this line of authority is that a shareholder is a creditor of an insolvent company, but his shares are not fully paid up, so that he is liable as a contributory. Suppose he has 10,000 £1 shares, 10p paid, and is owed £15,000, but the dividend prospectively payable is only 30p in the pound. If the liquidator calls on

[11] See Kaupthing at 826D-E (*per* Lord Walker) and 826F (*per* Lord Hope)
[12] See Kaupthing at 825D-E

him for £9,000 to make his shares fully paid up, he has no right of set-off, and to that extent he is disadvantaged (that is In re Auriferous Properties Ltd *[1898] 1 Ch 691). If he seeks to prove in the liquidation, the liquidator can rely on the equitable rule as it applies in a case of this sort – that is, that he can receive nothing until he has paid everything that he owes as a contributory. That is* In re Auriferous Properties Ltd (No.2) *[1898] 2 Ch 428 The rule is also very clearly stated by Buckley J in* In re West Coast Gold Fields Ltd *[1905] 1 Ch 597, 602 (affirmed [1906] 1 Ch 1, and cited in para 20 above). Payment of the call is a condition precedent to the shareholder's participation in any distribution, and again the shareholder is to that extent disadvantaged.*

53 So the equitable rule may be said to fill the gap left by disapplication of set-off, but it does not work in opposition to set-off. It produces a similar netting-off effect except where some cogent principle of law requires one claim to be given strict priority to another. The principle that a company's contributories must stand in the queue behind its creditors is one such principle. The rule against double proof is another. I would accept Mr Moss's submission that it would be technical, artificial and wrong to treat the rule against double proof as trumping set-off (as it undoubtedly does) but as not trumping the equitable rule."

44. There is, however, no authority for LBIE's contention that, *"The Equitable Rule applies equally in the case of a distributive administration"* (§1(d) of LBIE's position paper).

45. LBIE's contention confuses the issues being considered in Lord Walker's speech. The whole of [52] describes the situation when a company is in liquidation and its liquidator makes a call. "The equitable rule" which Lord Walker addresses (and on which LBIE seeks to rely) is the second of two stages, which must be considered; it is only engaged if the first stage is fulfilled.

46. As is clear from Lord Walker's speech (particularly at [53]), the rule that set-off is not available to a shareholder who is also a creditor to reduce the sum payable by him on a call made in the liquidation is the background to the application of "the equitable

rule" in the situation he describes. The two rules involved in the situation set out in [52] are –

(i) If the company's liquidator calls on the shareholder for £9,000 to make his shares fully paid up, the shareholder has no right of set-off against that call, and to that extent he is disadvantaged (that is In re Auriferous Properties Ltd [1898] 1 Ch 691). LBHI2 will refer to this rule as the "Contributory Rule"[13].

(ii) If the shareholder then seeks to prove in the company's liquidation, the liquidator can rely on "the equitable rule" as it applies in a case of this sort – that is, that the shareholder can receive nothing from the liquidation until he has paid everything that he owes as a contributory (that is In re Auriferous Properties Ltd (No.2) [1898] 2 Ch 428). LBHI2 will refer to this rule as the "Equitable Rule"[14].

47. The first rule is a necessary precursor to discussion of the Equitable Rule because, if the Contributory Rule does not apply, then the Equitable Rule does not apply. Indeed, in that case, the normal rules of set-off would apply and there would be no room for the operation of the Equitable Rule: hence Lord Walker's reference at [53] to the Equitable Rule being said to *"fill the gap left by disapplication of set-off"*; see also MK Airlines Ltd v Katz [2013] Bus LR 243 at [69][15]. Accordingly, LBIE has sought to extract and rely on a principle, without considering the circumstances which must be fulfilled before that principle is engaged.

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[13] Without accepting the formulation of that rule set out in Lydian's position paper.

[14] Without accepting the formulation of that rule set out in LBIE's position paper.

[15] "… one of the conditions for the application of the rule in Cherry v Boultbee is precisely that there should be no right of set-off. The rule is stated in Wood on English and International Set-Off (1989), p.396, para 8-1 as follows:
'(1) 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 …'(My emphasis.)
"At para 8-4, it is stated that, where there is a right of set-off, there is no room for the rule in Cherry v Boultbee to apply. It operates most often where the claim is on a trust fund, which has no legal personality, so that set-off is unavailable."

The Contributory Rule

48. Lydian at §1.1 of its position paper describes the Contributory Rule as a *"principle that a contributory is not entitled to recover anything in respect of any amount due to it from the company unless and until it has paid everything which it owes to the company"*. LBHI2 submits that this is an incorrect statement of the rule; LBHI2's case is that the rule applies only in liquidation and only where the liquidator makes a call, or seeks to enforce a call that has already been made (which, of course, has not occurred in this case) and is then to the effect that the shareholder has no right to set-off a debt owed to him as a creditor against that call.

49. There is no authority for Lydian's contention that the Contributory Rule *"applies equally whether the company is in liquidation or in a distributive administration"* (at §1.2 of its position paper).

50. The Contributory Rule is derived from the true construction of the legislation now contained in the Insolvency Act itself, in particular in the light of the legislative history:-

    (a) s.17 of the Joint Stock Companies Amendment Act 1858 provided that –

    "In fixing the Amount payable by any Contributory, in pursuance of the Joint Stock Companies Acts or any of them, he shall be debited with the Amount of all Debts due from him to the Company, including the Amount of the Call, and shall be credited with all Sums due to him from the Company on any independent Contract or Dealing between him and the Company, and the Balance, after making such Debit and Credit as aforesaid, shall be deemed to be the Sum due."

    In other words, the contributory could set-off, against the amount of the call made upon him, any sum due to him on an independent contract or dealing with the company (whether the company was limited or unlimited).

(b) By contrast s.101 of the Companies Act 1862 provided that –

101. "The court may, at any Time after making an Order for winding up the Company, make an Order on any Contributory ... directing Payment to be made ... of any Monies due from him or from the Estate of the Person whom he represents to the Company, exclusive of any Monies which he or the Estate of the person whom he represents may be liable to contribute by virtue of any Call made or to be made by the Court in pursuance of this Part of this Act and it may, in making such Order, when the Company is not limited, allow to such Contributory by way of Set-off any Monies due to him or the Estate which he represents from the Company on any independent Dealing or Contract with the Company, but not any Monies due to him as a Member of the Company in respect of any Dividend or Profit".

102. "The Court may, at any Time after making an Order for winding up a Company, and either before or after it has ascertained the Sufficiency of the Assets of the Company, make Calls on and order Payment thereof by all or any of the Contributories for the Time being settled on the List of Contributories, to the Extent of their Liability, for Payment of all or any Sums it deems necessary to satisfy the Debts and Liabilities of the Company, and the Costs, Charges and Expenses of winding it up, and for the Adjustment of the Rights of the Contributories among themselves, and it may, in making a Call, take into consideration the Probability that some of the Contributories upon whom the same is made may partly or wholly fail to pay their respective Portions of the same."

51. Thus, the 1862 Act was drafted so as to provide a right of set-off only to shareholders of an unlimited company and only against sums due from them as shareholders to the unlimited company <u>other than</u> sums due from them pursuant to a call made under the Act. (The wording of s.101 of the 1862 Act is almost identical to that of s.149(1) and (2)(a) of the 1986 Act, which similarly provide (i) a summary process for recovering sums due from contributories other than sums due from them pursuant to a call and

(ii) for set-off for contributories of unlimited companies in respect of such sums, ie not in respect of sums due pursuant to a call.)

52. It was held in Overend, Gurney & Co; Grissell's Case, Re (1866) 1 Ch App 528 that a shareholder of a limited liability company could not set-off a debt owed by the company to him against his liability for an unpaid call. Mr Grissell was a holder of shares in the company, which shares were not fully paid up. He was also a creditor for sums lent to the company. The company was put initially into voluntary liquidation, and subsequently into winding up under the supervision of the Court. The liquidators having made a call of £10 per share and being expected to pay a dividend, Mr Grissell took out two summons, asking –

(i) that the liquidators might be ordered, upon any dividend being paid by them to creditors, to pay to Mr Grissell a dividend at the same rate on the balance due to him after setting off from the debt due to him the amount of any call that should have been made on the shares held by him; and

(ii) (after the first summons was dismissed) that the liquidators might be ordered, upon any dividend being paid by them to the creditors, to pay to him a dividend at the same rate on the amount of his debt, deducting from that dividend the amount of any call that should have been made on the shares held by him and which had not been paid.

53. Lord Chelmsford LC described the case as *"depend[ing] entirely upon the construction of the Companies Act 1862"* (at 534), and held as follows (at 535-536):-

"It appears to me to be quite clear that the amount of the call not paid cannot be set-off against the debt. The [Companies Act 1862] creates a scheme for the payment of the debts of a company in lieu of the old course of issuing execution against individual members. It removes the rights and liabilities of parties out of the sphere of the ordinary relation of debtor and creditor to which the law of set-off applies. Taking the Act as a whole, the call is to come into the assets of the company, to be applied with the other assets in payment of debts. To allow a set-off against the call would be

contrary to the whole scope of the Act. In support of this view it will be sufficient to refer again to the 133rd section as to the satisfaction of the liabilities of the company pari passu. And the argument against the allowance of a set-off, addressed to the Court on behalf of the official liquidators, is extremely strong – that if a debt due from the company to one of its members should happen to be exactly equal to the call made upon him, he would in this way be paid twenty shillings in the pound upon his debt, while the other creditors might, perhaps, receive a small dividend, or even nothing at all.

"The case of a member of a limited company is different from that of a member of a company of unlimited liability as to set-off. This is exemplified in the 101st section, where a set-off upon an independent contract is allowed to the member of an unlimited company against a call[16]*, although the creditors have not been paid—evidently because he is liable to contribute to any amount until all the liabilities of the company are satisfied, and, therefore, it signifies nothing to the creditors whether a set-off is allowed or not. But with respect to a member of a company with limited liability, if a set-off were allowed against a call, it would have the effect of withdrawing altogether from the creditors part of the funds applicable to the payment of their debts. But if the amount of an unpaid call cannot be satisfied by a set-off of an equivalent portion of a debt due to the member of a company upon whom it is made, it necessarily follows in the last place, that the amount of such call must be paid before there can be any right to receive a dividend with the other creditors. The amount of the call being paid, the member of the company stands exactly on the footing of the other creditors with respect to a dividend upon the debt due to him from the company. The dividend will be of course upon the whole debt, and the member of the company will from time to time, when dividends are declared, receive them in like manner when either no call has been made, or, having been made, when he has paid the amount of it."*

[16] Lord Chelmsford LC may here have been commenting by reference to the situation where a call was made before the company went into liquidation, as that situation was not excluded from the scope of s.101 (because s.101 excluded only calls made or to be made under the relevant part of that Act). If he was in fact commenting by reference to the situation where a call was made in the liquidation, then he was mistaken to suggest that s.101 applied to calls made under the winding-up (which were excluded from s.101) – as counsel submitted (fruitlessly) in Gibbs and West's Case (see 326).

54. This analysis was applied by Lord Romilly MR in In re Breech-Loading Armoury Company (1868) LR 5 Eq 214. That was an application by the liquidator of the limited company (being wound up by the Court) for an order for payment by Mr Calisher of £300 as the amount of a call made against him before the date of the winding up order in respect of 100 shares which were not fully paid up. Lord Romilly referred to s.101 and continued:-

"It is clear that the section applies to the present case; an order has been made for winding up the company, Calisher is a contributory, the call is money due from him to the company, and it is not money which he is liable to contribute by virtue of any call made by the Court in the winding-up. The Court may, therefore, under the first part of the section make the order now asked, directing him to pay the call. The section then proceeds to empower the Court, in making such an order, when the company is not limited, to allow the contributory, by way of set-off, any moneys due to him from the company on an independent dealing or contract with the company, but not any moneys due to him as a member of the company in respect of any dividend or profit. The Legislature, therefore, has given the express power to allow a set-off in the case of an unlimited company, and by so doing it must be taken to have implied that without such express provision there would be no right of set-off, and upon the principle of the maxim expressio unius exclusio alterius, to have excluded, for the reason stated by the Lord Chancellor in Grissell's Case, that right in the case of the contributories of a limited company. The case of the Garnett and Moseley Gold Mining Company v Sutton, in which a contributory of a joint stock company registered under the Act of 1856 was allowed to plead a debt from the company as a set-off against a call, solely on the ground of the express statutory right created by the 17th section of the 21&22 Vict. c60, which section was repealed and not renewed by the Companies Act, 1862, raises a strong inference that under the latter Act the right does not exist, and it is clear from Grissell's Case that in the opinion of the Lord Chancellor and Lord Justice Knight Bruce, and probably of Lord Justice Turner also, the 101st section of the Act of 1862 excludes the right of set-off, except in the case of unlimited companies. Upon the ground, therefore, of the general law I am of opinion that the Respondent is not entitled to the right which he claims."

55. Malins VC appears to have misunderstood s.101 in Re International Life Assurance Society (Gibbs and West's Case) (1870) LR 10 Eq 312, in that he seems to have thought that s. 101 extended to the situation where a call was made after the winding-up against a contributory by the liquidator of an unlimited company. LBHI2 accepts that the correct decision on the point in Gibbs and West's Case was reached by Fry J in Ex p Branwhite, re The West of England and South Wales District Bank (1879) 40 LT 652, in which it was held that set-off was not available to a shareholder in respect of calls made after the winding-up of an unlimited company (although LBHI2 accepts Fry J's decision insofar as based on statutory construction, but not insofar as it was based on analysing the money payable in respect of the call as not being money due to the company). (See also Derham §8.77.)

56. In General Works Co, Gill's Case, Re (1879) 12 Ch D 755, Bacon VC held that the introduction of the bankruptcy set-off rules into winding up effected by the Judicature Act 1875, had not affected the rule preventing set-off against calls.

57. All the cases referred to by Lord Walker in Kaupthing (No.2) as relating to the Contributory Rule were cases where a call had already been made on the contributory (in circumstances where set-off was not permitted by s.101 of the 1862 Act). It was because the law was that set-off was not available other than as permitted by s.101 (i.e. because of the Contributory Rule), that the Equitable Rule was applied in these cases: see Grissell's Case, Re Auriferous (No.1), and Re West Coast Gold Fields.

58. In this case, not only has (of course) no call been made, but no call could have been made and no call will be able to be made unless and until LBIE goes into liquidation. An administrator's power in relation to calls is set out in paragraph 19 of Schedule 1 to the Act, i.e. an administrator has power "*to call up any uncalled capital of the company*". However, there is no equivalent to s. 80 of the Act in the Act or the Rules which applies to an administration (be it distributive or not). By ss. 150, 160(1) and 165(4) of the Act and IR 4.195 and 4.202ff., it is only the Court which has the power (then delegated to a liquidator under s. 160(1)(d) in compulsory liquidation and under s. 165(4)(b) in voluntary liquidation) to make a call on contributories to contribute to

the debts and liabilities of an insolvent company in a winding-up (with no reference to administration).

59. As the Contributory Rule does not apply here – because no call has been made (and because LBIE is in administration and not in liquidation) – there is no question of the Equitable Rule being engaged.

60. That this is the correct position here is further supported by the fact that, in Kaupthing (No.2), Lord Walker approved the following statement of the rule by Warrington J in In re Abrahams [1908] 2 Ch 69. There Warrington J held –

"the debt due to the testator is one which is not immediately payable, whereas the right of the debtor to receive the residuary share is an immediate right. I think, therefore, that the debtor is entitled to receive that share …".

61. Lord Walker approved that passage in Kaupthing (No.2) at [45] as stating "the correct rule" and specifically disapproving Chadwick LJ's identification in Re SSSL of a principle that the Equitable Rule *"extends to cases where the fund has a right to be indemnified against a liability which the fund may be required to meet in the future"*.

62. This point goes fundamentally to the justification for the Equitable Rule. The underlying principle was identified by Sargant J as being that, *"where a person entitled to participate in a fund is also bound to make a contribution in aid of that fund, he cannot be allowed so to participate unless and until he has fulfilled his duty to contribute"* (Re Peruvian Railway Construction Co Ltd [1915] 2 Ch 144 at 150). Derham analyses the rule as *"an illustration of a more fundamental principle of equity, that he who seeks equity must do equity"* (Derham, §14.01, citing, among other cases, Courtenay v Williams (1844) 67 ER 494 at 500).

63. There is no meaning to any suggestion that LBHI2 should, or can, at present *"do equity"* for the purposes of the underlying principle, or *"complete the estate"* for the purposes of the rule as contended for by LBIE. LBHI2's Administrators cannot satisfy the Potential Liability as Contributory because LBIE's Administrators have not made

(and cannot, for the reasons set out above, make) a call for a payment to which LBIE is entitled and which would *"complete the estate"*.

64. The words *"complete the estate"* further emphasise that the rule for which LBIE contends has no application on the current facts. The estate is not currently *"incomplete"* by reason of any failure of LBHI2 to satisfy a call: as set out above, by contrast to the cases referred to by Lord Walker, no call has to date been made. Further, the estate of LBIE <u>in administration</u> is never going to be completed by a payment by LBHI2 in respect of its liability as a contributory because any such payment would be made to the liquidation estate. The estate available to the LBIE Administrators for distribution will never include a contribution from LBHI2 in that regard, and so there is no question of that administration estate currently being *"incomplete"*.

65. If the position were as LBIE contends, then the commercial position in which a creditor like LBHI2 is left is unfair. In any case in which the Equitable Rule is being applied, the creditor in the position of LBHI2 ought to be able to make a commercial judgment about whether it is in its interests to make the necessary payment to *"complete the estate"* in order that it can participate in dividends, or whether it is in its interests not to pay and accordingly forgo any right to distributions.

66. The true position is that the only liability to which LBHI2 is currently subject is a potential contingent liability for a call. That can, in accordance with the current rules for the valuation of future and contingent claims in an administration, be valued (albeit that, as set out below, the current value of that liability would appear to be very low) and should, in the usual way, be the subject of mandatory automatic insolvency set-off, just as set-off is available under the Statutes of Set-Off in respect of a call when the company is solvent.

<u>*The Application of the Equitable Rule*</u>

67. It is LBHI2's position that the Equitable Rule does not fall to be applied at all in this case (and cannot be applied because there is no current obligation to pay a call).

Accordingly, it does not set out here any case as to the mechanics of how the Equitable Rule should be applied. LBHI2 will, however, respond to any case made by another party as to how the Equitable Rule should be applied in these circumstances in its supplemental written submissions and orally at the hearing.

(D) SET-OFF

68. As set out above, LBHI2's case is that the Contributory Rule does not apply here. If LBHI2's Potential Liability as Contributory is a provable debt by LBIE in LBHI2's administration (as well as being a "sum regarded as due" from LBHI2 to LBIE for the purpose of IR 2.85(3)), then the mandatory insolvency set-off rules apply in both the administrations of LBIE (at the date its administrators gave the IR 2.95 notice[17]) and of LBHI2 (at the date its administrators give a IR 2.95 notice, if/when they do) and would apply in any liquidation of LBIE (at the date it went into administration – IR 4.75(1)(b)).

69. Insolvency set-off is *"mandatory and self-executing"* (per Lord Hoffmann in Stein v Blake [1996] AC 243 at 255B) and there is no reason why it should not apply here. LBHI2 submits that there is nothing in the Insolvency Act or Rules (properly construed, as LBHI2 submits above) to disapply or prohibit the application of insolvency set-off in respect of the contingent liability of a contributory which exists before a call has been made by a liquidator. Thus, LBIE's administrators should value LBHI2's Potential Liability as Contributory as at the date of its IR 2.95 notice and employ that (very low) sum in set-off against LBIE's liability to LBHI2 for the unsecured claims and the Sub-Debt.

70. As the Insolvency Rules now permit the valuation of provable future and contingent debts owed both by and to the company (see76 below), then assuming that LBIE's claim against LBHI2 as contributory is a provable debt and there were no relevant dealings between those entities after the date of LBIE's IR 2.95 notice, the result of

[17] (that being the date by operation of IR2.85(3) at which an account is to be taken of mutual dealings for set-off in administration)

applying those rules should be that the sum calculated as being due to LBHI2 from LBIE (if, as LBHI2 contends, this is the result of the account) is the same in both the administration of LBIE and in the administration of LBHI2.

71. Alternatively, the same position is reached if the analysis is that, whatever balance is reached after the set-off exercise carried out by the administrators who carry out the exercise first in time (assuming it is not successfully challenged by the other company), that balance is then the only outstanding debt due between the parties (see Stein v Blake), with the consequence that that is the only *"dealing"* between the parties which remains to be admitted to proof, or accepted as a liability, by the other company in administration.

72. The above analysis assumes that LBHI2's Potential Liability as Contributory is a claim provable by LBIE in LBHI2's administration (as well as being a "sum regarded as due" from LBHI2 to LBIE for the purpose of IR 2.85(3)).

(E) QUANTIFYING CONTINGENT CLAIMS

Rules 2.81 and 4.86

73. If LBHI2's Potential Liability as Contributory is provable by LBIE in LBHI2's administration (or a subsequent liquidation), then (as set out at 68 above) insolvency set-off applies as between LBHI2's provable debts (including the LBHI2 Sub-Debt) and LBIE's contingent claim to produce a balance. Although LBHI2 has submitted a proof of debt in respect of its unsecured claims, including the Sub-Debt, in LBIE's administration, LBIE's administrators are yet to place a value on its contingent claim in LBHI2's administration for the Potential Liability as Contributory (if the same is provable, as to which see 72 above). LBHI2 has not yet received proofs (and not given a notice under IR 2.95) and, therefore, its administrators have not yet been in a position where they have been required to value any proof by LBIE for the Potential Liability as Contributory.

74. The rationale behind IR 2.81(1) and 4.86(1) on the valuation of claims and liabilities subject to contingencies (and behind IR 2.105 and 11.13 on the valuation of future claims and liabilities) in insolvency is that, as at the relevant date, there should be an account taken of all matters coming within the rules on insolvency set-off (IR 2.85 and 4.90), such that there is, as at that date, a balance due either to or from the insolvent company.

75. The position in relation to contingent claims (and future claims) owing by or to a company in administration or liquidation was amended by the Insolvency (Amendment) Rules 2005. Prior to the enactment of those Rules, the position was that a contingent debt owed <u>by</u> the company in administration or liquidation was capable of valuation pursuant to IR 2.81 or 4.86 (and so was required to be included in the account for set-off purposes), but that there was no similar process for the valuation of a contingent claim owed <u>to</u> the company in administration or liquidation, with the result that such a claim was not available for insolvency set-off. If the contingency occurred during the course of the winding up, the quantified claim could then be set-off against what the company owed to the creditor, but not otherwise. The principle behind this rule appears to have been that it would be unfair for a solvent party who owed a contingent claim to be compelled to discharge that contingent liability through the operation of mandatory insolvency set-off when (depending on the subsequent events) that claim might never crystallise.

76. However, a different policy provides the explanation for the new (i.e. post 1 April 2005) IR 2.85 and 4.90, which make contingent (and future) debts owing <u>to</u> and <u>by</u> the insolvent company fall within the sums that should be set-off against each other for the purposes of insolvency set-off (provided that those debts arise out of obligations incurred prior to the relevant date, which, in administration, is the date on which the administrator gives its IR 2.95 notice of an intention to distribute). Therefore, the valuation rules apply on both sides of the account taken to produce a balance one way or the other (in favour either of the creditor or the insolvent

company): see Re Kaupthing Singer & Friedlander No. 2 [2010] 1 BCLC 222 at [20] *per* Norris J.[18]

77. Insolvency set-off (as applied in administration and liquidation) is intended to allow an insolvency process (be it administration or liquidation) to proceed with due expedition, whilst seeking to do justice between different creditors with different relationships to the insolvency company: see Re Kaupthing Singer & Friedlander No. 2 [2011] BCC 555 (CA) at [32] *per* Etherton LJ:

"*The provisions for insolvency set-off are intended to promote speedy and efficient administration of the assets so as to enable a distribution to be made to creditors as soon as possible and in a manner which achieves substantial justice between the parties to the set-off and, so far as practicable, equality in the treatment of creditors*".

78. The Rules which require office holders to make estimates of the value of contingent debts and claims (and the rules on discounting future debts as a quid pro quo for accelerated payment) so that an account can be taken as between the creditor and the company in administration as at the date on which the IR 2.95 notice is given, exist in order to facilitate that process. Under previous legislation, there were no such rules and, if a claim was not capable of a fair valuation, then it was simply removed from the scope of being a 'provable debt' and, effectively, ignored. However, the Rules now mean that any provable debt has to be valued (even if contingent or future) so that there is some certainty as to the position between the creditor and the insolvent company at the relevant date: see Re Danka Business Systems plc (in liquidation) [2013] 2 WLR 1398 (CA), which concerned IR 4.86 and contingent claims proved in the liquidation, at [36] per Patten LJ:

"*It is clear from the wording of rule 4.86 itself that there must be a valuation of contingent claims in order for them to be admitted to proof. Rule 4.86 of the 1986 Rules is drafted on the basis that "any" contingent claim is capable of valuation. This*

[18] The decision covered four points; one point (relating to IR 2.105) was appealed and the Court of Appeal overturned Norris J's decision, but the remaining three points in Norris J's decision stand.

is to be contrasted with the previous statutory regime contained in the Bankruptcy Acts under which: "An estimate shall be made … of the value of any debt or liability provable as aforesaid, which by reason of its being subject to any contingency or contingencies, or for any other reason, does not bear a certain value. Any person aggrieved by any estimate made by the trustee as aforesaid may appeal to the court, and the court may, if it think the value of the debt or liability incapable of being fairly estimated, make an order to that effect, and upon such order being made such debt or liability shall, for the purposes of this Act, be deemed to be a debt not provable in bankruptcy, but if the court thinks that the value of the debt or liability is capable of being fairly estimated it may direct such value to be assessed with the consent of all the parties interested before the court itself without the intervention of a jury, or if such parties do not consent by a jury, either before the court itself or some other competent court, and may give all necessary directions for such purpose, and the amount of such value when assessed shall be provable as a debt under the bankruptcy." (See Bankruptcy Act 1869 (32 & 33 Vict c 71), section 31, re-enacted in section 37(7) of the Bankruptcy Act 1883 (46 & 47 Vict c 52) and section 30(7) of the Bankruptcy Act 1914.)"

79. At [38] he continues:

"*The effect of the 1986 Rules is to allow the liquidator (after the disposal of any appeal against valuation) to distribute the assets of the company free from any further claims by creditors. Mr Arden was, I think, minded to accept that the liquidator could properly stay his hand if (post-valuation but pre-distribution) the contingency was about to occur. I am by no means certain about that, although if the contingency does occur pre-distribution to members and so creates an actual liability of the company which the liquidator has not provided for then it would obviously be open to the creditor (absent agreement) to lodge an additional proof out of time which in a solvent liquidation the liquidator would have to deal with. But where (as in this case) the contingency remains a year away I cannot see the basis on which the liquidator comes under a legal duty to make the retention sought in the section 112 application. And absent such a legal duty, that part of the application must fail. The liquidator is*

entitled to proceed to a distribution to members on the basis of the debts admitted to proof."

80. In putting a value on the Potential Liability as Contributory, such that an account is taken and a balance reached as between LBHI2 and LBIE, LBIE's administrators will be required to (a) ascertain what sums fall within the Potential Liability as Contributory as a matter of principle and (b) value the Potential Liability as Contributory by taking into account all the circumstances of the case in order to take account of the fact that the LBHI2 Potential Liability as Contributory is contingent on a number of matters.

81. LBHI2's position is that the only sums that should be included within the Potential Liability as Contributory are those which are provable debts within the meaning of IR 12.3 and 13.12. That is because:

    (a) that is what the insolvency legislation requires (on a proper construction of the relevant sections of the Act and the Rules); and

    (b) the purpose of the valuation rules (in IR 2.81 and 4.86) is to enable an account to be taken (as per IR 2.85 and 4.90), as at the relevant date, so that distributions can be made and the administration of the insolvent estate can proceed, despite the existence of contingencies which may, or may never, occur.

82. That submission requires consideration of ss. 74(1) and 80 of the Act and IR 13.12.

    (a) Section 74(1) provides that a contributory, when a company is in liquidation, 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"* (emphasis added).

    (b) "*Debts and liabilities*" are defined (in relation to liquidation) in IR 13.12 as follows:

*"**13.12 'Debt', 'liability' (winding up)***

(1) 'Debt', in relation to the winding up of a company, means (subject to the next paragraph) any of the following— (a) any debt or liability to which the company is subject at the date on which it goes into liquidation; (b) any debt or liability to which the company may become subject after that date by reason of any obligation incurred before that date; and (c) any interest provable as mentioned in rule 4.93(1).

...

(3) For the purposes of references in any provision of the Act or the Rules about winding up to a debt or liability, it is immaterial whether the debt or liability is present or future, whether it is certain or contingent, or whether its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion; and references in any such provision to owing a debt are to be read accordingly."

(c) Such "debts and liabilities" are then rendered provable (by IR 12.3) so that the office holder in an insolvent company knows what assets and liabilities of the company s/he is dealing with.

(d) As set out above, the purpose of the valuation provisions in the Rules is so that an account can be taken and there can be certainty as to the balance provable in the company's insolvency or due to the company from a creditor as at the relevant date. The Potential Liability as Contributory can, according to the Act and the Rules, only take into account pre-insolvency debts and liabilities and so any valuation of the Potential Liability as Contributory (which must be carried out by the office holders so that an account is taken by the operation of insolvency set-off) must exclude debts and liabilities incurred after insolvency.

(e) A claim to statutory interest under IR 2.88(7) is plainly not a provable debt (which is obvious from the wording of IR 2.88(7) itself); it only arises once all the "debts proved" have been paid in full.

83. The submission is supported by the decision at first instance of Norris J in Kaupthing No. 2. The Court of Appeal in Kaupthing No. 2 (per Etherton LJ) stated:

"Under IR 2.88(1) pre-administration contractual interest is provable as part of any debt owed by the company, but not post-administration interest. The Administrators contended that, by contrast, post-administration contractual interest payable by creditors on loans by KSF should be taken into account for the purpose of set-off under IR 2.85 in respect of mutual dealings. The Judge rejected that submission, holding in paragraph [24] of his judgment that, for the purpose of striking the balance of mutual dealings, IR 2.88(1), as applied by IR 2.85(7), means that post-administration interest is left out of consideration on both sides of the account. Turning to the balance remaining after the account is taken, the Judge held in paragraph [25] of his judgment that, if the balance is due to the creditor, it will already include any pre-administration interest, and under the general rule applicable in the administration the creditor is not permitted to prove for post-administration interest (save in the event of a surplus in the administration). On the other hand, if the balance is due to the company, he held in paragraph [26] of his judgment, rejecting the arguments for the depositors to the contrary, that the balance bears interest in accordance with the terms of the loan."

84. Norris J also stated at [20] of his judgment in Kaupthing (No.2), in dealing with the question of how the valuation principles (in IR 2.86) applied in set-off (under IR 2.85) where the proof was from a creditor whose debt was incurred/payable in a non-sterling currency (which is why IR 2.86 applies and not IR 2.81):

"*In my judgment, although rule 2.85(6) does not expressly apply to sums "due to or from the company" the effect of the Rules read as a whole is to make the same valuation principles apply on each side of the account. In order for the provisions of rule 2.85 to be brought into play at all there must be "[a] creditor of the company proving or claiming to prove for a debt in the administration" (rule 2.85(2)), and in that event an account is taken of mutual credits, mutual debts or other mutual dealings between himself and the company. But a creditor proving for a debt incurred or payable in a currency other than sterling can only prove in accordance with rule*

2.86 or 2.87: he cannot seek to recover anything else from the company. The company, however, is not "proving" anything in the administration and absent rule 2.85(6) would be able to value its debt for the purposes of set-off at any advantageous date it chose. The purpose of rule 2.85(6) is to subject the company to the same valuation rules as those to which the creditor is already subject. That is why it is confined to sums due to the company."

85. As set out above, a claim to statutory interest under IR 2.88(7) falls outside the scope of s. 80 of the Act and therefore cannot form part of the Potential Liability as Contributory. Further, by the same reasoning, the Currency Conversion claim falls outside the scope of s. 80 (correctly, no one has ever suggested that it is a "provable debt"). Therefore, as a matter of principle, when valuing the Potential Liability as Contributory, the administrators should not take into account (1) the Currency Conversion claim or (2) any post-insolvency interest (under IR 2.88(7)) or (3) any other non-provable debt.

86. In carrying out the valuation, the office holders should bear in mind the following:

(a) Danka at [47] at first instance *per* HHJ Pelling QC (upheld by the Court of Appeal): *"I am not able to agree that the liquidators were wrong to proceed with the liquidation by valuing on the contingent claims. Had they not done so they would have been vulnerable to criticism by the members that the liquidation was not being conducted in accordance with the statutory scheme. Once (a) the members' voluntary liquidation process had been embarked upon by the company's members, (b) notice of intention to make a distribution had been given and (c) Ricoh had proved in accordance with that notice, the only choice the liquidators had was either to apply for directions under Insolvency Act, section 112 or proceed to value the claims in accordance with rule 4.86. Had an application been made to the court in those circumstances, in my judgment the court could only have either directed the liquidators to arrive at a valuation in accordance with rule 4.86 or undertaken such a valuation itself or, possibly, given directions to the liquidators as to how to arrive at an appropriate valuation".*

(b) Danka at [43] *per* Patten LJ: "… *any valuation of a contingent liability must be based on a genuine and fair assessment of the chances of the liability occurring. The very concept of valuing a contingency implies the need to make an assessment of how likely are the chances of the event occurring. The liquidator must therefore use his own expertise and that of any relevant advisers to make a realistic estimate…Where some material change in the relevant factual position occurs it must be taken into account. But the liquidator is not, in my opinion, required simply to wait and see. That is the opposite of valuation…There is nothing in rule 4.86 which requires the liquidator to guarantee a 100% return on the indemnity by assuming a worst-case scenario in favour of the creditors".*

(c) *"In valuing contingent claims, account is taken of those subsequent events which can bring greater certainty to the process of estimation. This is referred to as the hindsight principle. As the process of estimation is designed to put a figure on a contingent claim by reference to what may happen in the future, it would be "pure conceptualism" not to take account of subsequent events which have occurred before the estimation is made":* Federal-Mogul Aftermarket UK Ltd [2008] EWHC 1099 (Ch) at [20] per David Richards J, citing (at [21]) Lord Hoffmann in Wight v Eckhardt Marine GmbH [2004] 1 AC 147 (PC) - *"These cases on the use of hindsight to value debts which were contingent at the date of the winding up order show that the scene does not freeze at the date of the winding up order. Adjustments are made to give effect to the underlying principle of pari passu distribution between creditors. Hindsight is used because it is not considered fair to a creditor to value a contingent debt at what it might have been worth at the date of the winding up order when one now knows that prescience would have shown it to be worth more. The same must be true of a contingent debt which prescience would have shown to be worth less"* which is a point made by Lord Hoffmann in the bankruptcy context in Stein v Blake [1996] AC 243 at [252].

(d) Office holders are obliged to proceed with the liquidation and are not obliged to provide for the contingency in full by keeping a reserve to cover the situation where that contingent liability crystallises. There might be cases where the contingency was so imminent that the office holder could sensibly wait for the event to occur rather than expending time in a valuation of the chances of the claim ultimately materialising. But there were real difficulties in seeing how an office holder who had already gone through the process of valuing the contingent liability should then have to provide for it in full by means of a reserve. The office holder is entitled to proceed to a distribution to members on the basis of the debts admitted to proof: see Danka (CA) at [32], [37] and [38] *per* Patten LJ.

87. Issue 13(b) in the List of Issues asks whether IR 2.105 is relevant to the calculation of the quantum of LBHI2's Potential Liability as Contributory. LBHI2's position is that the precise formula in IR 2.105 does not apply when LBIE's administrators (or LBHI2's administrators) place a value on the Potential Liability as Contributory because IR 2.105 applies specifically to future debts, which are different from contingent debts. That is not to suggest that, in the valuation of the Potential Liability as Contributory, the relevant administrator should not take into account the fact that there is, at present, nothing due and payable from LBHI2 to LBIE for the call liability, but the actual valuation exercise in relation to a contingent debt/claim is not the same as the straight application of a formula, as is the case for future debts.

(F) THE CURRENCY CONVERSION CLAIM

88. There is no binding authority for the proposition that an unsecured creditor is entitled to payment of its Currency Conversion Claim before any surplus is returned to the members of a company.

89. Lydian's contention for, and LBIE's recognition of, such a claim is based simply on a dictum of Brightman LJ in Re Lines Bros [1983] 1 Ch 1 at 21F. In addition to the fact that, as dicta, those comments are of relatively little weight, Brightman LJ in Re Lines Bros:-

(a) expressly stated that the issue did not arise for decision in the case before him;

(b) specifically recognised that he wished "to guard against expressing any concluded view upon it" (at 21C); and

(c) acknowledged that, "I do not say that this is necessarily the solution to the problem, but I have not heard any convincing objection to that solution" (at 21G).

Re Lines Bros therefore leaves open the question of whether in a solvent liquidation a residual entitlement to a Currency Conversion Claim remains, where "solvent" means that all proved debts are paid in full with statutory interest thereon.

90. There are convincing reasons why no such claim should be available. Lydian advance its argument on the basis that the legislative scheme for converting claims into sterling will leave it out of pocket on the date of payment, compared to the situation where it received payment in the contractual currency on the date of payment. The suggestion seems to be that creditors in a foreign currency have an "upside only" option in this respect. Lydian do not suggest that any adjustment process should work both ways (i.e. adjusting payments if a foreign currency creditor received a greater return through the statutory scheme than he would have done if the same dividend had been calculated on its debt in the contractual currency). The proposed Currency Conversion Claim thus involves an uneven treatment of foreign-currency creditors which undermines the existing statutory scheme in respect of foreign-currency claims. IR 2.86(7) makes it clear that a line is drawn as at the relevant date so that there is a certain figure for which a foreign-currency creditor can prove. The rationale behind that is the same as the reason why the Rules were altered in 2005 to ensure that contingent and future claims/liabilities could be valued (for the purposes of insolvency set-off and, then, proof) on both sides of the account as at a particular date.

91. Further and in any event, there is nothing in what was said by Brightman LJ to support the broader contention advanced by Lydian that a Currency Conversion Claim

is available here <u>before</u> LBHI2's claim for Sub-Debt has been admitted to proof and paid in full.

92. LBHI2's position on the Currency Conversion Claim largely mirrors its submissions on the interrelationship between statutory interest and LBHI2's Sub-Debt claim (as set out at Section A above). It is not suggested by anyone that the Currency Conversion Claim is anything other than a non-provable debt. Therefore, as accepted by Lydian in its position paper at §12.1, the Currency Conversion Claim should rank in the list of priority of payments below the payment of (a) all proved debts and (b) statutory interest (which is also in accordance with Lord Neuberger's list at [39] of <u>Nortel</u>).

93. LBHI2's position is that the Sub-Debt is a provable debt and that the true effect of the subordination provisions in the Sub-Debt Agreements is that LBHI2 ranks below other 'unsubordinated' unsecured creditors for dividend purposes on its Sub-Debt claim in LBIE's administration, but that the Sub-Debt is still a provable unsecured debt, which must be discharged in full (a) before statutory interest and (b) before any non-provable claims (such as the Currency Conversion Claim).

94. LBIE's position paper at §12 does not engage with the ranking in any detail. Although it accepts Lydian's contention that the contractual liability of LBIE to Lydian is not extinguished by reason of the currency conversion process (which occurs as at the date of liquidation), all it says is that the Currency Conversion Claim should be paid before any sums are returned to members.

95. Lydian's position paper (§12) indicates that it will argue that LBHI2's claims in LBIE's administration rank below the Currency Conversion Claim because LBHI2 should not receive anything from LBIE's administration because either the terms of the Sub-Debt preclude it or because LBHI2 should not receive anything in the administration until it has paid/discharged its Potential Liability as Contributory. These arguments are incorrect for the reasons set out above.

96. The only sums that can rank below the 'class' of non-provable debts are sums to be returned to shareholders *qua* shareholders. There are no such sums due to LBHI2 (or

LBL) in this case. Accordingly, the Currency Conversion Claim (if – as to which see paragraphs 88 to 91 above – it is a sum that LBIE would have to pay to Lydian in certain circumstances, i.e. LBIE having a surplus after discharged all proved debts and statutory interest thereon) ranks lowest out of the various sums that are the subject matter of this application for payment out of LBIE's administration.

(G) POSITION BETWEEN LBHI2 AND LBL

93. LBL's position (see position paper at Question 10) is that, in the event of LBIE going into liquidation and its liquidators making a call, the call liability as between LBL and LBHI2 ought to be rateable in proportion to their respective shareholdings. LBL also contends that it can seek a contribution or indemnity against LBHI2 if LBL were to pay more than its rateable proportion of the total call liability. The 'call liability' of LBHI2 and LBL is said to be joint and several (by LBL, LBIE and Lydian).

94. LBHI2's position is that LBL's submission misses the point of s. 74(1) and 74(2) of the Act and the purpose behind the making of calls on contributories.

95. Section 74(1) of the Act renders all contributories liable (in an uncapped amount in the case of being a contributory to an unlimited company such as LBIE) for a sum sufficient for LBIE to make payment of its debts and liabilities together with the costs and expenses of winding up and for the adjustment of the rights of the contributories among themselves (emphasis added). In making a call, the liquidator is entitled to take into account the likelihood of any one of the contributories being unable partly or wholly to pay the call made (s. 150(2) of the Act).

96. The statutory scheme puts in place a mechanism by which the liquidator of the company in liquidation (i.e. LBIE, hypothetically, in this case) collects in from its contributories (whatever their individual financial situations and whatever the relationship between them) so much as to enable there to be sufficient in the estate to cover debts, liabilities, costs and expenses of the winding up, primarily, and then to enable the liquidator to adjust the position (to do justice between the contributories) in the event that, for whatever reason, one contributory has contributed significantly

more than another. Under the legislation, it is possible for a call to be made on individual contributories in different amounts by the liquidator, once the liquidator has taken into account what he may do under s. 150(2) of the Act. Each individual call liability is an individual liability (subject to the amount being challenged by the contributory against whom enforcement is sought) and, although it is fair to say that, overall, the liability of contributories as a group to the liquidator of a company in liquidation who has made a call is 'joint and several' in the sense that payment by one contributory reduces the amount that would be needed from any other contributory, it is not 'joint and several' in the sense that it gives a right, as between the contributories, for the contributories to claim contributions and/or indemnities from each other. Indeed, if contributories could do so, it would upset the statutory mechanism which is in place for the orderly collection of assets and their distribution in the circumstances of a liquidation.

97. Therefore, if LBIE went into liquidation and there were a shortfall for the purposes of paying the debts and liabilities and defraying the costs and expenses of LBIE's winding up, then the liquidator's primary purpose in making any call on LBHI2 and/or LBL would be to ensure that he received sufficient funds to cover those sums. Once he had the maximum he could achieve from making calls, he would make the relevant adjustments as between the contributories (and can make further calls – although plainly there would be a question mark over whether any further recoveries could, in practice, be made – to make those adjustments).

98. Whether, if LBIE goes into liquidation and makes a call on LBL and/or LBHI2, either contributory would have sufficient funds to cover that call is unknown at present, given the lack of clarity as to the sums to be included in any call liability and the fact that the existence of such a shortfall in liquidation is something that, on the present evidence, is a long way off. For present purposes, the value of LBHI2's Potential Liability as Contributory (and that of LBL's) is a matter for LBIE's administrators to estimate, taking into account all circumstances and the various contingencies (including the level of sums that would, hypothetically, be called on by LBIE's liquidator were it to go into liquidation).

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