

**WATERFALL APPLICATION**

**IN THE HIGH COURT OF JUSTICE**

**Nos 7942 and 7945 of 2008 and No. 429 of 2009**

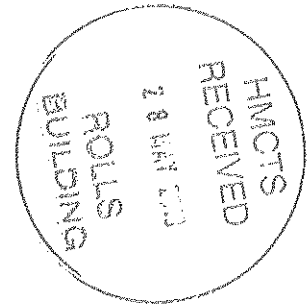
**CHANCERY DIVISION**

**COMPANIES COURT**

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

**(IN ADMINISTRATION) AND OTHERS**

**AND IN THE MATTER OF THE INSOLVENCY ACT 1986**



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**LBIE ADMINISTRATORS' POSITION PAPER**

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- 1. Are the members of LBIE (being LBHI2 and LBL) (together the "Members") entitled to prove in LBIE's administration in respect of sums owed by LBIE to the Members (other than in respect of sums owed to LBHI2 pursuant to three subordinated loan agreements entered into on 1 November 2006 between LBHI2 (as lender) and LBIE (as borrower) (the "LBHI2 Subordinated Debt") notwithstanding that LBIE is an unlimited company and, in the event of LBIE being wound up, one or both of the Members may be called upon to contribute, pursuant to Section 74 of the Act, to LBIE's assets an amount sufficient for payment of LBIE's debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories amongst themselves (hereinafter defined in respect of each member as the "Potential Liability as Contributory")? In particular, what (if any) is the effect of Section 74(2)(f) of the Act on each of the Members' Potential Liability as Contributory?*

- (a) There is an equitable rule that a person who owes an estate money cannot claim a share in that estate without first making the contribution which completes it (the “Equitable Rule”).
- (b) The Equitable Rule applies in the case of a liquidation so that a contributory who seeks to prove in the liquidation 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 in any distribution as a creditor.
- (c) The Equitable Rule, and its application in a liquidation, was recently confirmed by the Supreme Court in *Re Kaupthing Singer & Friedlander Ltd (in administration) (No. 2)* [2012] 1 AC 804 at [52].
- (d) The Equitable Rule applies equally in the case of a distributive administration.
- (e) In this case, it dictates that the Members are not entitled to prove in LBIE’s administration, alternatively, are not entitled to receive any dividends from the LBIE Administrators until they have discharged their liabilities (whether actual or contingent) under section 74 of the Act. The Potential Liability as Contributory is a contingent liability owed by the Members to LBIE, the contingencies being LBIE moving from administration into liquidation in circumstances where the Members will be liable to contribute to LBIE’s assets an amount sufficient for payment of LBIE’s debts and liabilities and the expense of its winding up.
- (f) Section 74(2)(f) of the Act is not relevant. First, it appears<sup>1</sup> that no sums are due from LBIE to the Members in their character as members. Secondly, because of the Equitable Rule, the Members are not entitled to prove in LBIE’s administration, alternatively, are not entitled to receive any dividends from the LBIE Administrators until they have paid everything that they owe to LBIE as

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<sup>1</sup> The LBIE Administrators reserve their right to review and amend their position in this regard following the completion of the disclosure exercise required by paragraph 3 of the Court’s order of 27 March 2013.

contributories, including on a contingent basis. Accordingly, there is no question of the Members proving in competition with LBIE's other creditors.

2. *If LBIE were wound-up, would the Members be entitled to prove in LBIE's liquidation in respect of sums owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt). In particular, to what extent would the Members' ability to prove in a winding-up of LBIE be affected by: (i) each of the Members' Potential Liability as Contributory; and (ii) Section 74(2)(f) of the Act?*
  - (a) The Equitable Rule dictates that the Members would not be entitled to prove in LBIE's liquidation, alternatively, would not be entitled to receive any dividends from the liquidators, until they had discharged their liability to LBIE as contributories under section 74(1) of the Act.
  - (b) Section 74(2)(f) of the Act is not relevant. First, it appears<sup>2</sup> that no sums are due from LBIE to the Members in their character as members. Secondly, because of the Equitable Rule, the Members would not be entitled to prove in LBIE's liquidation, alternatively, would not be entitled to receive any dividends from the liquidators until they have discharged their liability to LBIE as contributories under section 74(1) of the Act. Accordingly, there is no question of the Members proving in competition with LBIE's other creditors.
  
3. *Is LBHI2 entitled to prove in LBIE's administration, or would LBHI2 be entitled to prove in any subsequent liquidation of LBIE, in respect of the LBHI2 Subordinated Debt notwithstanding: (i) the terms of the LBHI2 Subordinated Debt; and (ii) LBHI2's Potential Liability as Contributory? What (if any) is the effect of Section 74(2)(f) of the Act?*

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<sup>2</sup> Footnote 1 is repeated.

- (a) LBHI2 is not entitled to prove in LBIE's administration or subsequent liquidation unless and until LBHI2 has discharged its actual or contingent liability to LBIE as a contributory under section 74(1) of the Act. The answers given by the LBIE Administrators to questions 1 and 2 above apply equally to any proof by LBHI2 in respect of the LBHI2 Subordinated Debt.
- (b) In addition, the LBIE Administrators refer to their answer to question 11 below. In accordance with the terms of the three subordinated loan agreements entered into on 1 November 2006 between LBHI2 (as lender) and LBIE (as borrower), LBHI2 is not entitled to prove in LBIE's administration or subsequent liquidation unless and until the principal of the provable debts owed to LBIE's general, unsecured creditors, interest payable under Rule 2.88(7) of the Rules and any non-provable liabilities have been paid or discharged in full.
- (c) Section 74(2)(f) has no bearing on the answer to question 3. In any event, it appears<sup>3</sup> that no sums are due from LBIE to the Members in their character as members.

4. *In the case of each of paragraphs 1 to 3 above, to the extent that there is an entitlement to prove, in so proving, is credit required to be given or is any deduction to be made in respect of each of the Members' Potential Liability as Contributory either: (i) by way of insolvency set-off (set out in rules 2.85 and 4.90 of the Insolvency Rules 1986 (the "Rules") as applicable); and/or (ii) pursuant to the rule in Cherry v Boulton 41 ER 171; and/or (iii) otherwise?*

Because of the operation of the Equitable Rule described above, this question does not arise.

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<sup>3</sup> Footnote 1 is repeated.

5. *Is LBIE entitled to prove in the administrations (or would LBIE be entitled to prove in any subsequent liquidations) of the Members in respect of each of the Members' Potential Liability as Contributory?*

(a) Yes. Contingent liabilities and liabilities to which the Members may become subject after going into administration by reason of any obligation incurred before that date are provable in the Members' administrations (or in any subsequent liquidations) in accordance with Rules 13.12(1)(a) and 13.12(1)(b) of the Rules respectively.

(a) When LBIE is wound up, the Members will be under an actual obligation under section 74(1) of the Act to contribute to LBIE's assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up.

(b) The obligation to contribute was incurred when the Members became members of LBIE.

(c) LBIE is, therefore, entitled to prove in the Members' administrations (or their subsequent liquidations) in respect of the Members' contingent liability to contribute, the contingencies being LBIE moving from administration into liquidation in circumstances where the Members will be liable to contribute to LBIE's assets an amount sufficient for payment of LBIE's debts and liabilities and the expense of its winding up.

6. *If LBIE is entitled to prove in the Members' administrations (or any subsequent liquidations) as described in paragraph 5 above, what effect (if any) does:*

6.1 *insolvency set-off have on the LBHI2 Subordinated Debt?*

6.2 *insolvency set-off have on the Members' respective non-subordinated debt claims?*

6.3 *the rule in Cherry v Boulton have on the LBHI2 Subordinated Debt?*

6.4 *the rule in Cherry v Boulton have on the Members' respective non-subordinated debt claims?*

6.5 *any other relevant form of set-off or deduction have on:*

i. *the LBHI2 Subordinated Debt; and/or*

ii. *the Members' respective non-subordinated debt claims?*

(a) As a result of the application of the Equitable Rule, no deduction or set-off is to be made from or applied in respect of LBIE's proof to take into account the Members' respective non-subordinated debt claims or the LBHI2 Subordinated Debt.

(b) Where a liquidator makes a call on a member to contribute to its assets any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up, the member has no right of set-off (*Re Kaupthing Singer & Friedlander Ltd (in administration) (No. 2)* [2012] 1 AC 804 at [52]).

(c) Just as a contributory who seeks to prove in the liquidation can receive nothing until he has paid everything that he owes as a contributory, a contributory cannot reduce the amount owed by it under section 74 of the Act until he has paid everything that he owes as a contributory.

7. *What (if any) is the effect of Section 149 of the Act on:*

7.1 *any proof submitted by either of the Members in LBIE's administration or (if LBIE were wound-up) liquidation?*

7.2 *any proof submitted by LBIE in either of the Member's respective administrations or (if either of the Members were wound-up) liquidations?*

- (a) Sections 149(1) and (2) of the Act provide a summary remedy for the recovery of money due from a contributory in its capacity as such, other than money payable by virtue of any call in pursuance of the Companies Act 2006 or the Act.
- (b) Where an order is made under section 149(1), in the case of an unlimited company, the court has a discretion under section 149(2) to allow to the contributory by way of set-off any money due to him or the estate which he represents from the company on any independent dealing or contract with the company. One of the factors which will be taken into account in the exercise of the discretion is the contributory's financial position.
- (c) The Members' Potential Liability as Contributories could not be the subject of an order made under section 149(1), however, because it is a liability to pay money by virtue of a call in pursuance of the Act and as matters stand the LBIE Administrators do not believe that the Members owe any other obligations to LBIE in their capacity as contributories<sup>4</sup>.
- (d) Accordingly, the sections have no effect either: (i) on a proof submitted by either of the Members in LBIE's administration or (if LBIE were wound-up) liquidation; or (ii) on any proof submitted by LBIE in either of the Member's respective administrations or (if either of the Members were wound-up) liquidations.
- (e) For the avoidance of doubt, it is to be noted that the Members would be contributories in the context of LBIE being wound up but LBIE would not be a contributory in the context of the winding up of either of the Members.
- (f) When all of LBIE's (non-Member) creditors have been paid in full, both as regards provable debts, interest payable under Rule 2.88(7) of the Rules and any non-provable liabilities owed to them by LBIE, section 149(3) of the Act

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<sup>4</sup> If, following disclosure or otherwise, the LBIE Administrators establish that either or both of the Members do owe further obligations to LBIE in their capacity as contributories, they reserve their right to amend this Position Paper.

provides that any money due to the Members may be allowed to them by way of set-off against any subsequent calls made for the adjustment of the rights of the Members among themselves.

8. *To the extent that LBIE is entitled to prove in respect of it, or it is required to be brought into the account on any proof which either of the Members is entitled to file in LBIE's administration or a subsequent liquidation, in circumstances in which each Member's Potential Liability as Contributory is contingent, is that Member's Potential Liability as Contributory capable of being ascertained and quantified and, if so, how should the quantum of that Member's Potential Liability as Contributory be quantified?*
- (a) The Members' Potential Liability as Contributories is capable of being ascertained and quantified. It would be quantified in accordance with Rule 2.81 of the Rules (in the Members' administrations) or Rule 4.86 of the Rules (in the Members' liquidations).
- (b) In estimating the value of the Members' Potential Liability as Contributories, the Members' administrators or liquidators (as the case may be) are required to take into account the probability of LBIE going into liquidation and, in light of LBIE's proof of debt and the supporting information produced to them by LBIE, estimate (to the extent that they are not at that time established) the amount of LBIE's debts and liabilities, which include provable debts, interest payable under Rule 2.88(7) of the Rules and any non-provable liabilities, and the expenses of its winding up.
9. *Whether, and in what circumstances each of the Member's Potential Liability as Contributory extends to contributing to LBIE's assets an amount sufficient for payment of:*



- i. *interest provable and/or payable pursuant to Rule 2.88 of the Rules on the principal of the debts and liabilities owed to LBIE's creditors by LBIE; and/or*
  - ii. *the LBHI2 Subordinated Debt; and*
  - iii. *Currency Conversion Claims (as defined at paragraph 12 below), to the extent that paragraph 12 is answered in the affirmative.*
- (a) Each of the items listed in question 9 falls within the broad scope of the term "debts and liabilities" within section 74 of the Act. The term is not confined to provable debts. There are a number of indications in the Act that this is so.
- i. First, section 74 of the Act refers to "*debts and liabilities*". The term "*liability*" is defined in Rule 13.12(4) and includes interest under Rule 2.88(7).
  - ii. Secondly, section 74 (as does section 150) confers a power to make calls "*for the adjustment of the rights of contributories among themselves*". Such an adjustment, pursuant to section 107 (voluntary winding up) or section 154 (compulsory winding up) of the Act, would occur only once all sums due to creditors, including interest under Rule 2.88(7) of the Rules) has been paid in full.
  - iii. Thirdly, section 89(1) of the Act provides that a statutory declaration of solvency for the purpose of a members' voluntary winding up must address the company's ability to pay "*its debts in full, together with interest at the official rate*".
  - iv. Fourthly, section 149(3) of the Act provides that it is only when "*all creditors are paid in full (together with interest at the official rate)*" that a contributory is able to exercise a right of set-off in respect of any subsequent call.

- (b) Accordingly, each of the Member's Potential Liability as Contributory extends to contributing to LBIE's assets an amount sufficient for payment of each of those items.
- (c) Interest provable and/or payable pursuant to Rule 2.88 of the Rules on the principal of the debts and liabilities owed to LBIE's creditors by LBIE includes interest payable on a debt pursuant to a contractual obligation to pay interest at a specified rate (see Rule 2.88(9) of the Rules). Notwithstanding Rule 2.88(1) of the Rules, which prevents such interest from being provable to the extent that it is not payable in respect of any period before LBIE went into administration, the contractual liability to pay interest in respect of the post-administration period survives and such interest is payable out of any surplus remaining after payment of the debts proved (see Rule 2.88(7)).
- (d) Similarly, LBIE is liable to pay "statutory interest" in accordance with Rule 2.88(7) of the Rules in the event of there being a surplus remaining after payment of the debts proved (see Rule 2.88(7) "*shall... be applied*").
- (e) The interest provable and/or payable pursuant to Rule 2.88(7) of the Rules on the principal of the debts and liabilities owed to LBIE's creditors by LBIE constitutes a liability of LBIE within the meaning of Rule 13.12(4) of the Rules and for the purpose of section 74 of the Act.
- (f) The LBHI2 Subordinated Debt is a debt of LBIE's. The fact that it has been subordinated does not alter its status as a debt. It forms part of LBIE's "debts and liabilities" for the purposes of section 74 of the Act.
- (g) To the extent that paragraph 12 is answered in the affirmative, Currency Conversion Claims likewise form part of LBIE's "debts and liabilities" for the purposes of section 74 of the Act. They are liabilities within the meaning of Rule 13.12(4) of the Rules and for the purpose of section 74 of the Act.

10. *In the event that the Members are obliged to contribute to the assets of LBIE pursuant to Section 74 of the Act, and in light of the fact that LBL owns one ordinary share of \$1 in LBIE, and LBHI2 owns 2 million 5% redeemable Class A preference shares of \$1000 each, 5.1 million 5% redeemable Class B shares of \$1000 each and 6,273,113,999 ordinary shares of \$1 each in LBIE:*

- i. whether their obligations are joint, several or otherwise as against LBIE;*
  - ii. whether they are entitled to seek a contribution or indemnity from one another in respect of any payments made pursuant to any such obligation and, if so, the nature and extent of such right of contribution or indemnity;*
  - iii. to what extent any right to contribution or indemnity as referred to in subparagraph (b) above is affected by any other claims which LBHI2 and LBL have against one another.*
- (a) The Members' obligation to contribute to the assets of LBIE pursuant to section 74(1) of the Act is joint and several. Both are members of an unlimited company.
  - (b) Save as aforesaid, the LBIE Administrators take no position as regards question 10.

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

- i. interest payable on such debts and liabilities in respect of the periods during which they have been outstanding since LBIE entered administration pursuant to Rule 2.88(7) of the Rules;*

- ii. *Currency Conversion Claims (as defined at paragraph 12 below), to the extent that paragraph 12 is answered in the affirmative;*
  - iii. *to the extent that the Members have been unable to prove in respect of them, debts owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt); and*
  - iv. *to the extent that LBHI2 has been unable to prove in respect of it, the LBHI2 Subordinated Debt.*
- (a) The LBIE Joint Administrators would be required to apply the surplus in the order in which the four items listed in the question appear.
  - (b) As a result of the application of the Equitable Rule, the Members can receive nothing until they have paid everything for which they are or may become liable in their capacity as contributories. For the reasons set out in relation to question 9(a) above, what the Members owe LBIE includes interest payable on LBIE's provable debts and liabilities in respect of the periods during which those debts and liabilities have been outstanding since LBIE entered administration pursuant to Rule 2.88(7) of the Rules. Accordingly, such interest ranks ahead of debts owed by LBIE to the Members, whether subordinated or otherwise.
  - (c) Even if that were not the case, the LBHI2 Subordinated Debt has been contractually subordinated to LBIE's debts and liabilities to its other creditors, including in respect of interest under Rule 2.88(7) of the Rules. The agreements pursuant to which the LBHI2 Subordinated Debt is owed provide, by Standard Term 5(1), that LBHI2's rights in respect of the Subordinated Debt "*are subordinated to the Senior Liabilities*" (being "*all Liabilities [of LBIE] except the Subordinated Liabilities [i.e. LBIE's liabilities to LBHI2 in respect of the Subordinated Debt] and Excluded Liabilities*"<sup>5</sup>) and that payment of any

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<sup>5</sup> The LBIE Administrators are not aware of the existence of any Excluded Liabilities (defined as "*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 [LBIE]*").

amount due to LBHI2 in respect of the Subordinated Debt is (in circumstances where LBIE is in administration or liquidation) conditional upon LBIE “*being ‘solvent’ at the time of, and immediately after, the payment by [LBIE] and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that [LBIE] could make such payment and still be ‘solvent’*”.

- (d) Standard Term 5(2) provides that for this purpose, LBIE will be “*solvent*” if it is “*able to pay its Liabilities (other than the Subordinated Liabilities) in full disregarding – (a) obligations which are not payable or capable of being established or determined in the Insolvency of [LBIE], and (b) the Excluded Liabilities.*”
- (e) The term “*Liabilities*” is defined as meaning “*all present and future sums, liabilities and obligations payable or owing by [LBIE] (whether actual or contingent, jointly or severally or otherwise howsoever)*”. Interest payable under Rule 2.88(7) of the Rules falls within this definition. It is payable contingently (the contingency being the payment in full of the debts proved) or “*otherwise howsoever*”.
- (f) The intention of the draftsman was to define “*Liabilities*” as broadly as possible. That reflected the fact that loans made on the terms of the FSA’s standard form Long-Term Subordinated Loan Agreement could be treated as regulatory capital on the basis that they are only repayable where the interests of other creditors are not thereby prejudiced.
- (g) Accordingly, LBIE will not be solvent for the purposes of Standard Term 5(2), and the Subordinated Debt will not be repayable under Standard Term 5(1)(b), unless and until LBIE has paid, or is in a position to pay, interest under Rule 2.88(7) of the Rules in full.
- (h) To the extent that question 12 is answered in the affirmative, the definition of “*Liabilities*” also covers Currency Conversion Claims such that they are payable in priority to the Subordinated Debt.

- (i) The same applies as regards debts owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt). Because, to the extent that question 12 is answered in the affirmative, Currency Conversion Claims fall within the scope of “debts and liabilities” within the meaning of section 74 of the Act, debts owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt) will only be repayable by LBIE if and to the extent that the Members have discharged their liability in their capacity as contributories. Accordingly, to the extent that question 12 is answered in the affirmative, Currency Conversion Claims are payable in advance of debts owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt).

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

- i. *all creditors’ proved debts; and*
- ii. *interest on such debts in respect of periods during which they have been outstanding since LBIE entered administration pursuant to Rule 2.88(7) of the Rules,*

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

- (a) Yes. Currency Conversion Claims are an example of a non-provable liability. The contractual obligation owed by LBIE is neither released nor discharged by the payment in full of the provable debt (as converted into Sterling) and interest payable under Rule 2.88(7) of the Rules.

- (b) An unsecured creditor is entitled to payment of its Currency Conversion Claim before any surplus is returned to the Members.

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24 May 2013

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