IN THE COURT OF APPEAL (CIVIL DIVISION)

Appeal Court Ref. No. 2014/1833

ON APPEAL FROM THE HIGH COURT OF JUSTICE, CHANCERY DIVISION, COMPANIES COURT (MR JUSTICE DAVID RICHARDS)

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) AND OTHERS

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR

(in their capacity of Joint Administrators of Lehman Brothers International (Europe) (in administration))

Appellants

-and-

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

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

(3) LEHMAN BROTHERS HOLDINGS, INC

Respondents

LBIE'S SKELETON ARGUMENT

Introduction

1. The Joint Administrators of Lehman Brothers (International) Europe (in administration) ("LBIE") appeal with the permission of the Judge against two of the ten declarations made in the Order made by Mr Justice David Richards on 19 May 2014 (the "**Order**"). App/C/6

2. The context in which the issues arise is as follows:

3. LBIE is an unlimited liability company. Lehman Brothers Limited ("**LBL**") and LB Holdings Intermediate 2 Limited ("**LBHI2**") (together the "**Members**") are its only shareholders.

   (1) LBL holds only one ordinary share in LBIE.

   (2) LBHI2 holds the entirety of the remainder of LBIE's ordinary shares and the entirety of LBIE's Class A preference shares and Class B preference shares.

4. The Members (which are also creditors of LBIE) are liable to contribute to LBIE's assets to meet any deficiency in its winding-up. Section 74(1) of the Insolvency Act 1986 provides that: Auth/3/20

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

5. As matters stand, LBIE is not being wound up but is in administration; however, winding up is an "exit route" available to LBIE's administrators. Whether that course is adopted will depend upon what is in the creditors' best interests as a whole, taking into account, amongst other matters, the outcome of this appeal.

6. The liabilities of a company in administration or winding-up were exhaustively listed, in their order of priority, by Lord Neuberger P. in *Re the Nortel Companies*[1]. They include, in the order that follows: (i) debts owed to secured creditors; (ii) expenses; (iii) preferential liabilities; (iv) unsecured provable debts; (v) statutory interest; and (vi) non-provable liabilities. It is only after payment of those liabilities that a return can be made to the members. Auth/1C/96

7. This reflects the principle of company law that the members of a company "*must stand in the queue behind its creditors*"[2]. Auth/1C/89

8. LBIE's skeleton argument is structured as follows:

   (1) The first ground of appeal: declaration (iv) (Section (1)); and

   (2) The second ground of appeal: declaration (vii) (Section (2)).

(1) The first ground of appeal: declaration (iv)

9. In paragraph (iv) of the Order, the Judge declared that: App/C/6/103

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

10. The Judge's reasoning in support of this declaration was set out at paragraphs [112] to [127] of the judgment handed down on 14 March 2014 (the "**Judgment**"). App/C/4/61-65

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1 [2013] 3 WLR 504 at [39] Auth/1C/96

2 *Re Kaupthing, Singer and Friedlander Ltd (No. 2)* [2012] 1 AC 804 ("*Kaupthing*") at [53] Auth/1C/89

11. The issue arises in the context of the extent to which post-insolvency interest is a liability of LBIE's within the meaning of section 74(1). Its importance is twofold: Auth/3/20

(1) The Judge's conclusion dictates that the statutory interest which has accrued to the benefit of LBIE's creditors since the commencement of the administration *but which has not been paid* would, if LBIE were to move into liquidation prior to payment: (i) no longer be payable under rule 2.88(7); and (ii) not be payable under section 189. It would therefore be lost to the creditors entirely. Auth/3/21 Auth/3/20

(2) As a consequence, there will be unprincipled commercial disadvantages to LBIE's unsecured creditors if it moves into liquidation (which, unless LBIE is successful on its second ground of appeal, is a necessary step to trigger the application of the contributory rule) before the surplus has been used to pay statutory interest in full. Given that there are numerous complex issues which will need to be resolved prior to the Administrators being in a position to pay statutory interest (other than potentially on an interim payment basis), the bar which the Judge's conclusions impose is one which will take quite some time for the Administrators to lift. Until that time, (unless LBIE is successful on its second ground of appeal) the Members (other than LBHI2 in relation to its subordinated debt claim) will not be prevented from proving in LBIE's administration in competition with its other creditors.

12. In making the declaration in paragraph (iv) of the Order, LBIE contends that the Judge erred in law. He should have concluded that, on the proper construction of rule 2.88(7) of the Insolvency Rules 1986 and section 189 of the Insolvency Act 1986[3], where: (a) an administrator of a company has given App/C/6/103 Auth/3/21 Auth/3/20

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[3] References to "rules" refer to the Insolvency Rules 1986 (the "Rules"); references to "sections" refer to the Insolvency Act 1986 (the "Act").

notice of an intention to make a distribution to creditors, (b) that company subsequently goes into liquidation before statutory interest has been paid by the administrator out of the surplus remaining after payment of the debts proved, and (c) the administrator or liquidator has in his hands a balance after the payment of all debts proved, then either:

(1) statutory interest will be payable pursuant to Rule 2.88(7), to all creditors who proved or prove (whether during or after the conclusion of the administration, there being no temporal limit as regards proving within the sub-rule) and section 189 is, in that context, simply inapplicable; or Auth/3/21 Auth/3/20

(2) statutory interest will be payable pursuant to Rule 2.88(7) to those creditors who proved during the administration, while statutory interest will be payable pursuant to section 189(2) to those creditors who prove during the winding-up. Auth/3/21 Auth/3/20

13. In each case, such statutory interest will be payable in respect of the periods during which the debts proved have been outstanding since the relevant date. It is plain that the Judge reached the conclusion that he did with considerable reluctance. In expressing that reluctance, he was correct to conclude that there exists no convincing policy justification for an interpretation of the relevant statutory provisions which entails that, where an administration is followed by a liquidation, statutory interest is payable out of a surplus only for the period which starts with the commencement of the liquidation (Judgment [120]). App/C/4/64

14. Further, the Judge was correct to suggest that his interpretation is apt to give rise to injustice (Judgment [119]). In particular: App/C/4/63

(1) It has always been clear that, in the case of either a distributing administration or a liquidation, where there is no preceding liquidation or administration (as the case may be), interest is provable on interest-bearing debts for the period up to the commencement of the relevant insolvency proceeding, while statutory interest is payable out of the

surplus on all debts for the period from the commencement of the relevant insolvency proceeding.

(2) No public policy is served (and substantial injustice is caused) by denying the accrual of interest during the period of an immediately preceding administration or liquidation.

(3) That there is no policy justifying such denial appears to be demonstrated by the amendments made to rule 2.88, with effect from 6 April 2010, which ensure that, in an administration which has been immediately preceded by a liquidation, statutory interest is payable in respect of the period since the commencement of the earlier liquidation. Auth/3/21

15. Furthermore, the Judge was correct to hold that creditors whose debts carried interest (whether by contract, judgment interest or otherwise) prior to the commencement of the preceding administration could claim interest in the liquidation for the period of the administration as a non-provable liability (Judgment [127])[4]. App/C/4/65

16. That holding does not help those creditors whose debts do not carry interest other than under the statutory scheme but who nevertheless are kept out of their money as a result of the process of administration and who the legislation intends should be compensated in the event that there is a surplus after the payment of debts proved.

17. Further, it highlights an illogical inconsistency between the treatment of the two categories of creditor in circumstances in which (putting the rate of payment to one side) rule 2.88(7) and section 189(2) appear to contemplate that, as a matter of principle, they should both be equally entitled to payment of interest out of any surplus. Auth/3/21 Auth/3/20

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[4] See *In re Humber Ironworks & Shipbuilding Co* (1869) LR 4 Ch App 643. Auth/1A/12

18. The legislature clearly intended that creditors: (i) should be entitled to interest accruing during an administration before any return is made to members; and (ii) should be entitled to interest accruing during a winding-up before any return is made to members. There is no logical or policy reason to permit assets of the insolvent company to be returned to members in priority to the creditors' rights to interest accruing during the period of administration, simply because the company moves from administration into liquidation before statutory interest can be paid.

19. Crucially, the Judge was incorrect to find that he was compelled, on a proper interpretation of the relevant statutory provisions, to reach such an unattractive conclusion (Judgment [126]). Rather, there are two other interpretations of the relevant statutory provisions, both of which - since each of them accords with public policy and does not give rise to injustice - are preferable to the one he adopted. App/C/4/65

(a) Rule 2.88(7) continues to be applicable and Section 189(2) is inapplicable

20. The first interpretation is that, in the circumstances contemplated by declaration (iv), the creditors' right to interest out of any surplus continues to be governed by rule 2.88(7), and section 189 is inapplicable, notwithstanding that the administration has ended. App/C/6/103 Auth/3/21 Auth/3/20

21. Rule 2.88 provides a complete code for the payment of statutory interest in the context of an administration. In particular (and so far as material): Auth/3/21

(1) Rule 2.88(1)[5] provides: Auth/3/21

> "*Where a debt in the administration bears interest, that interest is provable as part of the debt except insofar as it is payable in respect of*

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[5] References to rules 2.88 and 4.93 are to the forms of those rules in force between 1 April 2005 and 5 April 2010 which are, by virtue of the transitional arrangements, applicable to the administration of LBIE (which commenced during that period). Auth/3/21

any period after the company entered administration or, if the administration was immediately preceded by a winding up, any period after the date that the company went into liquidation."

(2) Rule 2.88(7) provides: Auth/3/21

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

22. The corresponding code for the payment of statutory interest in the context of liquidation is found partly in the Rules and partly in the Act:

(1) Rule 4.93(1) provides: Auth/3/21

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

(2) Section 189(2) provides: Auth/3/20

"*Any surplus remaining after the payment of the debts proved in a winding up shall, before being applied for any other purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the company went into liquidation.*"

23. Section 189 only addresses what occurs in a liquidation. Section 189 does not contemplate a preceding administration. Accordingly, its application is limited to interest accruing on debts for the period after the company went into liquidation. Auth/3/20

24. Rule 2.88(7) applies once the administration has become distributive because notice has been given under rule 2.95(1)[6]. It addresses interest on debts proved Auth/3/21 Auth/3/21

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[6] Rule 2.68(1). Auth/3/21

thereafter, and provides for the payment of interest accruing since the commencement of the administration.

25. Crucially, rule 2.88(7) does not cease to apply merely because the distributing administration is succeeded by a winding-up. There is nothing in the wording of rule 2.88(7) which requires it to cease to apply in these circumstances or which limits the "*surplus remaining*" to a surplus remaining in the hands of the administrator. Auth/3/21 Auth/3/21

26. The Judge set out various objections to this reading of rule 2.88(7) (Judgment [125]). The answers to these objections are set out in the following paragraphs. Auth/3/21 App/C/4/65

27. The Judge's first objection was that, on a natural reading of rule 2.88(7), it applies to a surplus in the hands of the administrator rather than in the hands of a subsequent liquidator. The Judge was wrong to read the rule in this way: Auth/3/21

    (1) Contrary to the Judge's view, on a natural reading of rule 2.88(7) the "*surplus remaining*" refers simply to what remains after payment of the debts proved. While the "*surplus remaining*" will normally (at least initially) be the surplus remaining in the hands of the administrators there is nothing in the language which expressly limits it in that way. Auth/3/21

    (2) In particular, rule 2.88(7) is not expressly limited to the surplus remaining after the debts proved have been paid in the administration. As a matter of language the words are equally capable of extending to the surplus remaining after the debts proved have been paid whenever that may be, whether in the administration or in a subsequent liquidation. Auth/3/21

    (3) This is reinforced by rule 4.73(8), which deems a creditor proving in the administration to have proved in a subsequent winding-up. This deeming provision shows that the "*debts proved*" referred to in rule 2.88(7) may be paid in a subsequent liquidation, and that therefore the Auth/3/21 Auth/3/21

word "*payment*" in rule 2.88(7) is not necessarily limited to payment in the administration. It would be an odd position if the debts were deemed proved in the liquidation, could be paid in the liquidation, but that interest accruing on those debts after the date of the administration was not payable. Auth/3/21

28. The Judge's second objection was that LBIE's construction of rule 2.88(7) cannot be reconciled with section 189(2), on the basis that section 189(2) requires the surplus remaining in the hands of the liquidator to be applied in paying interest on proved debts in respect of the periods during which they have been outstanding since the company went into liquidation "*before being applied for any other purpose*". However, the provisions are capable of being reconciled: Auth/3/21 Auth/3/20

(1) The requirements of section 189(2) relate to how "*the surplus remaining*" is to be applied but does not make specific provision for what constitutes the surplus. Auth/3/20

(2) The reference in section 189(2) to the surplus "*remaining after the debts proved in a winding up*" does no more than identify that the debts proved in the winding-up must first be paid before any interest is paid on those debts. Auth/3/20

(3) It follows that, everything that is (or is treated by rule 4.73(8) as being) a debt proved in a winding-up must first be paid before the liquidator can take steps to apply the surplus in payment of interest. Auth/3/21

(4) Contrary to the Judge's view, this does not mean that the rule defines the concept of what is the "*surplus*" so as to exclude that which has to be paid by operation of rule 2.88(7). Auth/3/21

29. It is true that the consequence of rule 4.73(8) is that debts proved in the administration can be treated as debts proved in the subsequent winding-up for the purposes of section 189(2). However, rule 4.73(8) is only a deeming Auth/3/21 Auth/3/20 Auth/3/21

provision and should not be read so as to deprive a creditor who had *actually* proved in the administration (and so fell within rule 2.88(7)) from the benefit of receiving interest on any surplus arising before any return is made to members. Auth/3/21

30. The Judge was incorrect to hold that the application of rule 2.88(7) was limited to those creditors who have actually lodged a proof in the administration. There is no temporal limit contained in rule 2.88(7) that necessitates such a conclusion. Auth/3/21 Auth/3/21

31. Finally, it is no objection to LBIE's construction of the relevant statutory provisions that it provides no assistance in the case of an administration which has not become distributive. It is correct that Chapter 10 of the Rules (in which rule 2.88 appears) only applies where an administrator makes or proposes to make a distribution (rule 2.68(1)). All that means, however, is that LBIE's construction only addresses the injustice which would otherwise be caused in the context of a distributing administration. It achieves that benefit, while the construction favoured by the Judge permits injustice in both distributing and non-distributing administrations. Auth/3/21 Auth/3/21

32. Accordingly, rule 2.88 provides a complete code for the payment of statutory interest relating to the period of an administration and section 189 is, in this context, inapplicable and unnecessary to the analysis. Auth/3/21 Auth/3/20

(b) Section 189(2) only applies to creditors proving in a subsequent winding-up

33. Alternatively, if the Judge was correct to hold that the effect of rule 2.88(7) is limited to those creditors who have actually lodged a proof in the administration (Judgment [125]), then rule 2.88(7) applies to such creditors and section 189(2) applies to those creditors who actually proved during the winding-up. Auth/3/21 Auth/C/4/65 Auth/3/21 Auth/3/20

34. On this basis, if a creditor proves during the administration then his right to interest during the period of administration arises under rule 2.88(7) and is not Auth/3/21

lost upon the conversion of the administration to a winding-up, whereas if a creditor does not prove until the subsequent winding-up then he will not accrue a right to interest under rule 2.88(7). Auth/3/21

(2) The second ground of appeal: declaration (vii)

35. In paragraph (vii) of his order the Judge declared that: App/C/6/104

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

36. The Judge's reasoning in support of this declaration was set out at paragraphs [179] to [194] of the Judgment. App/C/4/ 78 - 83

37. In making the declaration in paragraph (vii) of the Order, the Judge erred in law. He should have concluded that, as a matter of law, the contributory rule (and the rule in *Cherry v Boultbee*) does apply in an administration (including the administration of LBIE). He should have held that the effect of the contributory rule is to prevent the Members from proving in competition with LBIE's other creditors at a time when they have a contingent liability as contributories of LBIE to contribute to its assets to any amount sufficient for payment of LBIE's debts and liabilities, and the expenses of LBIE's winding-up. App/C/6/104 Auth/1A/1

38. Subject to the submissions developed below, no point is taken as to the Judge's broad summary of the key authorities at paragraphs [179] to [183] of the Judgment. App/C/4/ 78-79

(a) The contributory rule

39. It is well established in the context of winding-up that a member "*can receive nothing until he has paid everything he owes as a contributory*"[7]. He must discharge his obligation to the company before he can participate in any distributions. This rule, referred to below as "the contributory rule", arises out of the rule in *Cherry v Boultbee*. Auth/1A/1

40. The rule in *Cherry v Boultbee* may be summarised as follows[8]: Auth/1A/1

> *"A person who owes an estate money, that is to say, who is bound to increase the general mass of the estate by a contribution of his own, cannot claim an aliquot share given to him out of that mass without first making the contribution which completes it. Nothing is in truth retained by the representative of the estate; nothing is in strict language set off; but the contributor is paid by holding in his own hand a part of the mass, which, if the mass were completed, he would receive back. That is expanding what the Lord Chancellor calls in Cherry v Boultbee 'a right to pay out of the fund in hand,' rather than a set-off..."*

41. The contributory rule differs from the rule in *Cherry v Boultbee* in that it precludes any set-off between the member's obligation to contribute and the company's liability to the member. Auth/1A/1

42. Wright J explained, in *Re Auriferous Properties (No. 1)* [1898] 1 Ch 691 at 696, that the "*ground*" of the contributory rule is the *pari passu* principle, that is: Auth/1A/29

> *"...that all contributions from shareholders enforceable in the liquidation are by the Companies Acts made applicable for the payment of the company's creditors pari passu..., and that a person who is a creditor and also a contributory cannot be allowed to do what*

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7 *Kaupthing* at [52] Auth/1C/89

8 By Kekewich J in Re Akerman [1891] 3 Ch 212 at 219, cited with approval by Lord Walker in *Kaupthing* at [13]. Auth/1A/26 Auth/1C/89

might amount to paying his own claim in full out of a fund which ought to be distributed rateably..."

43. The contributory rule is, therefore, a firmly established rule to protect the position of those entitled as creditors to a distribution out of a company's assets. It prevents a contributory from claiming or proving in competition with them, until such time as it has discharged its obligations to contribute to the full extent of his liability.

(b) Application of the contributory rule in a distributing administration

44. LBIE submits that, contrary to the Judge's finding, the contributory rule does apply once the administration has become distributive, i.e. where the administrator gives notice under rule 2.95(1) that he or she is proposing to make a distribution to creditors. From this moment, that part of the process of winding up which is relevant to the policy underpinning the contributory rule (i.e. the distribution of assets in discharge of the liabilities) becomes the principal objective of the administration. The consequence of this is that, from that moment, the contributory rule should apply to any member who might be required to contribute under section 74 if the company were wound up. Auth/3/21 Auth/3/20

45. It is accepted that no call can be made on its Members while LBIE remains in administration because the administrator has no power equivalent to the liquidator's power under section 74 in a winding-up to make a call on contributories. It is also accepted that previous cases applying the contributory rule all involved a company in liquidation, in which a call obviously could be, and had been, made (Judgment [190]). Auth/3/20 App/C/4/ 81-82

46. The absence of any provision for calls in an administration should not, however, prevent the courts from developing the contributory rule so as to apply in an administration, in order to protect the very interests which it exists to protect in a liquidation.

47. In a passage referred to in more detail below, the Judge concluded that there is a "*fundamental difficulty*" in applying the contributory rule in an

administration arising from the absence of a statutory mechanism for making calls on contributories in an administration (Judgment [188]). It is not accepted that this is the case and it is not surprising that there is no previous authority on the application of the contributory rule to a distributing administration, given the relatively recent introduction of that procedure[9]. App/C/4/ 80-81

48. Further, it is no bar to the conclusion that the application of the contributory rule in the context of a distributing administration would be novel. As with all principles of equity, the contributory rule is capable of moulding itself to new circumstances as they arise[10].

49. The rule should be developed to meet the changes in insolvency procedures made by the introduction of administrations, and in particular the power to wind up the affairs of the company and to distribute the realised proceeds of a company's assets among creditors in an administration. Therefore, the Court should look to the principles underpinning the contributory rule in order to determine whether it applies in the context of a distributing administration.

50. A distributing administration, as much as a liquidation, involves a *pari passu* distribution among creditors[11] and involves the protection of the interests of all creditors, including those whose debts may not be provable. A distributing administration, like a liquidation, may end with the dissolution of the company. In these circumstances, it is entirely adventitious from the perspective of the Members that it happens to be in administration, rather than liquidation. It is in administration, rather than liquidation, because the Joint

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9 i.e. with the coming into force of the relevant parts of the Enterprise Act 2002 on 15 September 2003.

10 See, for example, Snell's Equity, 32nd edition, at paragraph 1-004. See also *Re Hallett's Estate* (1879-80) L.R. 13 Ch. D. 696, 710, *per* Jessel MR: "*... the rules of Courts of Equity are not, like the rules of the Common Law, supposed to have been established from time immemorial. It is perfectly well known that they have been established from time to time – altered, improved, and refined from time to time.*" Auth/2/6 Auth/1A/20

11 The *pari passu* principle operates from the point in time at which notice is given by the administrator under rule 2.95(1) that he or she proposes to make a distribution to creditors: *HMRC v The Football League Limited* [2012] Bus LR 1539, at [84] to [90]. Auth/3/21 Auth/1C/93

Administrators consider that it continues to be in the best interests of the estate as a whole that it should remain in administration, and the court has endorsed that view.

51. In these circumstances, there is no sensible policy reason why the contributory should be able to prove in an administration where it is clear that it would not be able to do so in a liquidation. The mischief which the contributory rule prevents, that of removing from the creditors all or part of the fund which should be available to pay their debts, is present equally in an administration and a liquidation.

52. The Judge concluded (Judgment [188]) that: App/C/4/ 80-81

> *"The fundamental difficulty in applying the contributory rule in an administration is precisely because there is no statutory mechanism for making calls on contributories in an administration. While LBIE remains in administration, there can be no calls and therefore nothing that LBHI2 and LBL as members could do to put themselves in a position where they could prove as creditors in respect of their subordinated and unsubordinated claims. ... If the affairs of LBIE are fully wound up in the course of its distributing administration, culminating in the dissolution of the company without a liquidation, LBHI2 and LBL, even if they were fully solvent, would have no opportunity of participating as creditors in any distribution."*

53. This "*fundamental difficulty*" is illusory for two reasons.

54. The first reason is that administrators have wide powers of compromise (see paragraph 60 of Schedule B1 and paragraph 18 of Schedule 1, to the Act). If Auth/3/20 appropriate, LBIE's Administrators could enter into an arrangement or compromise with Members which enabled them to put themselves in a position where they could prove as creditors in respect of their subordinated and unsubordinated claims. In principle there is no reason why they could not agree to contribute to the extent of their contingent liability, which would then justify the Administrators in agreeing to admit those claims.

55. The second reason that the Judge's "*fundamental difficulty*" is illusory is that, subject only to the proper interpretation of the authorities considered below,

even if LBIE were to be in liquidation, LBHI2 and LBL would only have an opportunity to participate if they were to contribute the full amount for which they are liable. As they are members of an unlimited company, this would involve making LBIE whole, including in respect of any claims which they themselves may have against LBIE, and in respect of which they would otherwise be entitled to a distribution.

56. Such an outcome would be the consequence of the Members having to wait at the back of the queue whilst the other creditors are paid. The lack of opportunity which the Judge describes as a "*fundamental difficulty*" arises by reason of the fact that LBHI2 and LBL undertook liability as members of an unlimited company – it does not arise from the application of the contributory rule where the liability to calls has not yet fallen due and payable. LBIE does not accept that the possibility countenanced by the Judge should have led him to reach the conclusion he reached and it appears that he did not appreciate that the same situation could occur in a liquidation.

57. All the cases on the contributory rule concern liquidations in which a call has been made on contributories, so that the liability is due and immediately payable. This has led to the rule being characterised infelicitously (or incompletely) in some of the authorities. For example:

(1) Lord Walker, in *In re Kaupthing Singer & Friedlander Ltd (No 2)* [2012] 1 AC 804, paragraph [52], observed, in relation to the effect of the contributory rule, that "*[p]ayment of the call is a condition precedent to the shareholder's participation in any distribution*" (emphasis added)[12]. Auth/1C/89

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[12] See also the view of Lord Chelmsford in *In re Overend Gurney & Co (Grissell's case)* (1866) LR 1 Ch App 528, 536: "*the amount of such call must be paid before there can be any right to receive a dividend with the other creditors*". Auth/1A/6

(2) It is accepted that Lord Walker's dictum is correct but it is submitted that it is incomplete. The complete position is that payment of a call is a condition precedent to the shareholder's participation in any distribution in circumstances where a call has in fact been made, but not necessarily where a call has not been made.

(3) Thus, if a company pays all of its liabilities without having to make a call on its contributories, then the *pari passu* principle ceases to apply. In these circumstances there would remain no basis on which the contributory rule would apply and therefore no basis on which the company's members could be denied the opportunity to participate in a distribution.

58. Similarly, upon closer analysis there is no force in the Judge's objection, at paragraph [190] of the Judgment, that, if LBIE's position were well-founded, "*it would follow that the rule could be relied upon between the commencement of the liquidation and the making of any call*". In fact, the contributory rule can legitimately be relied upon in such circumstances, and there is nothing in the authorities on the contributory rule (as opposed to the rule in *Cherry v Boultbee*), which holds to the contrary. App/C/4/81-82 Auth/1A/1

59. It is submitted that the correct position is as follows:

(1) From the commencement of a winding-up, the assets of the company are subject to a statutory regime for the payment of all creditors *pari passu*.

(2) The valuation of claims in a winding-up proceeds on the basis of the fiction that "*the liquidation and the distribution are to be treated as notionally simultaneous*", i.e. that all assets are realised and all liabilities paid as at the date on which the company goes into winding-up: see *In re Dynamics Corporation of America (in Liquidation)*

[1976] 1 WLR 757, 762, *per* Oliver J[13]. This is, in Selwyn LJ's words[14], so that "*no person should be prejudiced by the accidental delay which, in consequence of necessary forms and proceedings of the court, actually takes place in realizing the assets*". Auth/1B/55

(3) Accordingly, although the contributory's liability to the company is not actually payable until a call is subsequently made (section 80), the circumstances which give rise to the need for a call have crystallised as at the date of the winding-up. Auth/3/20

(4) In the case of a liquidation where there is certain to be a shortfall, and thus certain to be a need to make a call on members, but the extent of the shortfall is currently unknown, the underlying principle (that a member with a liability to contribute to the assets should stand in the queue behind creditors[15]) would be wholly undermined if the member could share in interim distributions until such time as the liquidator makes a call.

(5) In principle, the position should be no different where there is as yet no certainty of a call being made, but a likelihood, or a possibility. Any other conclusion would mean that creditors were prejudiced by the "*accidental delay*"[16] which actually takes place in the realisation of assets.

(6) In all such circumstances, the contributory rule, which is a substantive rule of equity intended to protect the rights of independent creditors

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13 Citing Selwyn LJ in *In re Humber Ironworks and Shipbuilding Co* (1869) L.R. 4 Ch. App. 643, 646. Auth/1A/12

14 *In re Humber Ironworks and Shipbuilding Co* (1869) L.R. 4 Ch. App. 643, 646. Auth/1A/12

15 *In re Kaupthing Singer & Friedlander Ltd (No 2)* [2012] 1 AC 804, at [53]. Auth/1C/89

16 *In re Humber Ironworks and Shipbuilding Co* (1869) L.R. 4 Ch. App. 643, 646. Auth/1A/12

over the rights of members where there remains a liability to contribute, should apply once the company is in winding-up, whether or not the members' liability has become immediately payable by operation of section 80. Auth/3/20

60. If it is accepted that the contributory rule applies to prevent a member from receiving interim distributions in a liquidation, prior to any call being made, then the same result should apply in a distributing administration:

(1) There are substantial similarities between the two proceedings: in both, there is a statutorily imposed scheme for distribution of all the assets of the company in accordance with a waterfall which includes payment to all proved unsecured creditors *pari passu*.

(2) While the comments of Selwyn LJ in *Humber Ironworks* were made in the context of liquidation, they logically apply with equal force to a distributing administration. The only material difference is that it is within the liquidator's power to turn the member's liability into a presently payable debt by making a call, whereas the administrator has no such power. Until the liquidator makes such a call, however, the status of the member's liability is identical, whether the company is in liquidation or a distributing administration, and equally subject to the contributory rule. Auth/1A/12

61. Accordingly, and contrary to the Judge's finding, the contributory rule applies once an administration has become distributive.

(c) *Cherry v Boultbee*

62. It is accepted that, in the normal case, the "right of retainer", arising from the rule in *Cherry v Boultbee*, does not entitle a fund, which owes a present debt to another person, to retain an amount equal to a future liability of that person Auth/1A/1

to the fund[17]. This is not invariably the case, however: see *In re Rhodesia Goldfields Ltd* [1901] 1 Ch 239. Auth/1B/36

63. The Judge was incorrect to distinguish a member's position in a distributing administration from the beneficiary's position in *In re Rhodesia Goldfields* (Judgment [193]). The Judge considered that this case was inapplicable on the basis that, although the amount of the debt due from the beneficiary to the fund had not been established or ascertained, there was no dispute that, if an amount was due, it was presently payable. Auth/1B/36 App/C/4/83

64. The valuation of claims in a winding-up proceeds on the basis of the fiction that "*the liquidation and the distribution are to be treated as notionally simultaneous*", i.e. that all assets are realised and all liabilities paid as at the date on which the company goes into winding-up: see *In re Dynamics Corporation of America (in Liquidation)* [1976] 1 WLR 757, 762, *per* Oliver J[18]. The same point may be made, *mutatis mutandis*[19], in the context of a distributing administration. Accordingly, it is clear that a debt owed by the member to the company accrues as at the date on which the administration becomes distributive, notwithstanding that the quantum of that debt is unascertained as at that date. Auth/1B/55

65. The fact that the debt is owed as at this date (notwithstanding doubt as to its quantum) is shown by the fact that the member's liability in such circumstances is one for which the company may prove in the member's

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[17] See Judgment, [193]. App/C/4/83

[18] Citing Selwyn LJ in *In re Humber Ironworks and Shipbuilding Co* (1869) L.R. 4 Ch. App. 643, 646. Auth/1A/12

[19] Noting in particular that the relevant date, in the context of a distributing administration, is the point at which notice is given by the administrator under rule 2.95(1) that he proposes to make a distribution to creditors: *HMRC v The Football League Limited* [2012] Bus LR 1539, at [84] to [90]. Auth/3/21 Auth/1C/93

insolvency, irrespective of whether a call has yet been made by the company, or indeed whether the company is yet in liquidation[20].

66. For these reasons it is submitted that a principled approach to the elements of the contributory rule demonstrates that it applies in a distributing administration as much as a liquidation and the Judge was wrong to conclude to the contrary.

William Trower QC
Daniel Bayfield
Alexander Riddiford

South Square

20 June 2014

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[20] See *Re McMahon* [1900] 1 Ch 173, *per* Stirling J.

Appeal Court Ref. No. 2014/1833

IN THE COURT OF APPEAL (CIVIL DIVISION)

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) AND OTHERS

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR

(In their capacity of Joint Administrators of Lehman Brothers International (Europe) (in administration))

Appellants

-and-

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

Respondents

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