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

B E T W E E N :

THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration) AND OTHERS

Applicants

-and-

LEHMAN BROTHERS HOLDINGS, INC AND ANOTHER

Respondents

LBIE'S SUPPLEMENTAL WRITTEN SUBMISSIONS (for hearing on 11-20 November 2013)

Introduction

1. These supplemental written submissions are filed on behalf of LBIE pursuant to paragraph 19 of the Order of 27 March 2013.

2. Capitalised terms which appear in these supplemental written submissions bear the meanings they are given in LBIE's written opening submissions.

3. In these supplemental written submissions, LBIE neither:

   (1) repeats the points made in its written opening submissions; nor

   (2) seeks to address every argument made by LBL, LBHI2 and LBHI in their respective written opening submissions[1].

4. LBIE does, however, address below certain of the key arguments made by LBL, LBHI2 and LBHI in relation to which it might be helpful to the Court to know LBIE's position prior to the commencement of the trial of the Application.

5. The issues addressed below can be summarised as follows:

   (1) Whether LBIE can prove in the Members' administrations in respect of the Members' contingent liability to contribute under section 74.

   (2) Whether the contributory rule applies prior to the making of a call by the liquidator on the member.

   (3) What falls within the scope of the Members' contingent liability to contribute under section 74.

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[1] The fact that many of the arguments raised by LBL, LBHI2 and LBHI are not addressed in these supplemental written submissions should not be read as an admission that those arguments are correct. The limited time available between the service of the other parties' written opening submissions and the production of these supplemental written submissions and the volume of the other parties' written opening submissions together dictate that these supplemental written submissions focus on the key issues.

(4) Whether, if the contributory rule does not apply whilst LBIE is in administration, the Members' claims against LBIE and LBIE's claims against the Members are set off against each other as part of the taking of the account under IR 2.85(3) in: (i) LBIE's administration; and (ii) the administrations of the Members.

(5) The extent of the contractual subordination of LBHI2's Subordinated Debt.

(6) The existence of currency conversion claims.

LBIE's right to prove in respect of the Members' contingent liability to contribute

6. At [166] to [177] of its written opening submissions, LBIE explained that the Members' contingent liability to contribute under section 74 arises out of an obligation incurred before the date on which the Members went into administration (or go into liquidation) such that LBIE will be entitled to prove its debt under IR 13.12(1)(b).

7. LBHI2 does not contend otherwise (LBHI2 at [66] and [72]) and LBHI does not address the issue. LBL, however, argues that the Members' contingent liability to contribute under section 74 does not give rise to a provable claim.

8. LBL contends (at [72]) that the two reasons why LBIE cannot prove in the Members' administrations or subsequent liquidations in respect of their liability to contribute are because:

(1) in the case of a corporate contributory, there is no express statutory provision to the effect of section 82(4), which provides that a bankrupt's liability to calls, whether made or future, can be proved in the bankruptcy; this is said to lead to the conclusion that a corporate member is not susceptible to proofs in respect of its liability to future calls; and

(2) administrators have no power to prove in an insolvent member's insolvency process because there is no express power to that effect and, until a call is actually made, the member is not indebted to the company.

9. LBL is wrong in both respects. Neither contention undermines the submissions made at [166] to [177] of LBIE's written opening submissions.

10. As to the first reason, whilst the legislature might have included a provision in the Act in terms similar to section 82(4), making it clear that a corporate contributory's liability to calls, whether made or future, can be proved in its administration or liquidation, there is no policy or other reason to infer from the absence of such a provision that no such liability exists and LBL has not identified one.

11. Moreover, the inclusion of section 82(4) simply flows from the provisions of section 82(1) and (2), which apply on the bankruptcy of a contributory who is an individual and the latter of which provides that "*His trustee in bankruptcy represents him for all purposes of the winding up, and is a contributory accordingly*". Presumably it was felt necessary to provide that, notwithstanding the terms of the other sub-sections transferring the status of contributory to the trustee (which, of course, have no application in the context of an insolvent corporate contributory), both an existing liability and the liability in respect of future calls were provable against the bankrupt's estate.

12. That is particularly so in circumstances such as the present, where the Members' contingent *liability* to contribute pursuant to section 74 arises out of their pre-insolvency *obligation* to do so and is indistinguishable, as a matter of principle, from the situation in *Re the Nortel Companies*[2], where the target companies' contingent *liability* to pay the debt due under a contribution notice (which has not yet been issued) was held to arise out of their pre-administration *obligation* to do so by virtue of being part of a group of companies which included a service company. It was therefore held to be provable under IR 13.12(1)(b).

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[2] [2013] 3 WLR 504 at [39]

13. LBL's second reason is the lack of any reference in Schedule B1 of the Act to a specific power to seek redress in respect of sums due from the contributory to the insolvent estate; this submission is back-to-front and flawed. The proper focus should be on whether LBIE has a provable claim within the meaning of IR 13.12(1)(b), not on whether its administrators have a specific power to prove for that specific type of claim. For the reasons given in LBIE's written opening submissions, LBIE does have such a claim.

14. Further and in any event, whilst Schedule 1 to the Act (which sets out a non-exclusive list of an administrator's powers) does not contain provisions in the terms of paragraphs 8 and 11 of Schedule 4:

    (1) paragraph 20 of Schedule 1 provides the administrator with power to "*rank and claim in the… insolvency… or liquidation of any person indebted to the company and to receive dividends…*";

    (2) LBL is wrong (in footnote [19]) to say that, before the company is wound up, the contributories are not indebted to the company. They are contingently indebted to it (within the meaning of IR 13.12(1)(b)) for the reasons explained in LBIE's written opening submissions; and

    (3) paragraph 59(1) of Schedule B1 to the Act confers on an administrator the power to do "*anything necessary or expedient for the management of the affairs, business and property of the company*"[3]. The powers specified in Schedule 1 of the Act are conferred on the administrator without prejudice to the generality of the power referred to in paragraph 59(1)[4]. Proving in the Members' administrations or liquidations would plainly be (at least) expedient for the management of the property of LBIE, which property includes its contingent claims against the Members.

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[3] See, in this context, the definition of "property" in section 436(1).

[4] See paragraphs 59(2) and 60 of Schedule B1 to the Act.

15. Accordingly, LBL's argument that the Members' contingent liability to contribute under section 74 does not give rise to a provable claim is to be rejected.

The application of the contributory rule pre-call

16. Each of LBL, LBHI2 and LBHI:

    (1) accepts that, if LBIE were to be in liquidation and a call were to be made under section 74, the contributory rule would apply such that the Members would not be entitled to receive dividends from the liquidators unless and until they had discharged their liability under that call; but

    (2) contends that the contributory rule only applies once a call has been made, post-liquidation ([LBL at [48]; LBHI2 at [59]; LBHI at [16]-[17]).

17. In this section, various of the points made in support of the argument that the contributory rule applies only after a call has been made are dealt with.

18. LBL contends[5], in reliance on section 74(2)(f) and Lord Browne-Wilkinson in *Soden v British & Commonwealth Holdings plc*[6], that the underlying principle is not "members come last" but that the rights of members *qua members* come last. Lord Browne-Wilkinson's comment was, however, not addressing the contributory rule at all. Although section 74, generally, is dealing with the liability of members to contribute, subsection 74(2)(f) is a free-standing provision concerned with members' ability to prove at all, in competition with outside creditors. It has nothing to do with the situation where the member is also, whether actually or contingently, liable to contribute to the assets of the company for the purposes of enabling the company to satisfy its debts and liabilities.

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[5] LBL's written opening submissions at [32].

[6] [1998] AC 298

19. Accordingly, it is wrong to say (*per* LBL at [42], footnote 12) that Lord Walker's reference, in the context of the contributory rule, to the principle that members stand in the queue behind creditors must be read subject to Lord Browne-Wilkinson's comments in *Soden*[7].

20. It is true, as LBL points out in its written opening submissions, that:

    (1) previous cases applying the contributory rule all involved a company in liquidation, in which a call obviously could be, and had been, made[8]; and

    (2) 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 to the fund[9].

21. However, neither of these factors leads to the conclusion that the contributory rule is not applicable where a contributory liable pursuant to section 74 of the Act seeks to prove in the administration of the company in relation to which he is a contributory.

22. As to the first point, it is unsurprising that there is no previous authority on the application of the contributory rule to a distributive administration, given the relatively recent introduction of that procedure (i.e. with the coming into force of the relevant parts of the Enterprise Act 2002 on 15 September 2003). LBIE does not shy away from the fact that there is no previous authority directly in point. That simply means that it is necessary to understand the principles that underlie the contributory rule and to apply it in that light.

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[7] Similarly, the comment of Lord Chelmsford in *Grissell's Case* quoted by LBL at [49] of its written opening submissions (to the effect that members can prove for debt claims *pari passu* with independent creditors) must be read in context. Lord Chelmsford was, at this point in his judgment, addressing solely the right of a member to prove in respect of a debt claim, without any regard to the possibility that the member might be liable to contribute to the assets of the company.

[8] LBL's written opening submissions at [43].

[9] LBL's written opening submissions at [48].

23. LBIE contends (as set out in its written opening submissions and developed below) that, in light of those principles, the rule must apply to prevent a member from receiving a distribution in an administration, in circumstances where there is an actual or possible shortfall in assets compared with the liabilities covered by section 74.

24. As to the second point, it does not follow, from the fact that there is a limitation on the application of the rule in *Cherry v Boultbee*, that the same limitation applies in the case of the contributory rule. On the contrary, the special position of members of a company, which provides the rationale for the contributory rule, means that any such limitations upon the right of retainer under *Cherry v Boultbee* should not apply to the contributory rule.

25. The special position of members of a company is, in summary, that they have undertaken to contribute to the assets of the company for the very purpose of enabling a distribution of those assets among creditors in accordance with the statutory scheme: see, for example, the passage quoted from *Re Auriferous Properties Ltd (No. 1)*[10] at [141] of LBIE's written opening submissions. The independent creditors have a correlative right to maximise the value of the assets available for distribution by ensuring that members comply with their obligation to contribute to those assets.

26. LBIE contends that the contributory rule therefore applies, so as to prevent members from receiving distributions from the company, from the commencement of the winding-up of the company or, in the case of a distributive administration, from the giving of notice by the administrator under IR 2.95(1) that he proposes to make a distribution to creditors[11].

27. It is helpful to consider, first, the application of the rule in the context of winding-up, and then consider its extension to a distributive administration.

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[10] [1898] 1 Ch 691 at 696, per Wright J

[11] This is the time from which the *pari passu* principle operates, see: *HMRC v The Football League Limited* [2012] Bus LR 1539 at [84] to [90].

28. So far as winding-up is concerned:

(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)*[12]. As Selwyn LJ put it in *Humber Ironworks*, "*no person should be prejudiced by the accidental delay which, in consequence of the necessary forms and proceedings of the court, actually takes place in realizing the assets*"[13].

(3) The corollary of this is that, although the contributory's liability to the company is not actually payable until a call is subsequently made (section 80 of the Act), the circumstances which give rise to the need for a call have crystallised as at the date of the winding up, even if (due to the complexity of the company's affairs) the actual value of the company's liabilities and assets is not then known.

(4) Take the case of a liquidation where there is certain to be a shortfall, and thus certain to be a need to 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 (*per* Lord Walker in *Kaupthing*[14]), would be wholly undermined if the member could share in interim distributions until such time as the liquidator makes a call.

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[12] [1976] 1 WLR 757, per Oliver J, at 762, citing Selwyn L.J. in *In re Humber Ironworks and Shipbuilding Co*. (1869) L.R. 4 Ch.App. 643, 646.

[13] *In re Humber Ironworks and Shipbuilding Co*. (1869) L.R. 4 Ch.App. 643, 646.

[14] [2012] 1 AC 804 at [53]

(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 even a possibility. Any other conclusion would mean that creditors were prejudiced by the "accidental delay" (per Selwyn LJ in *Humber Ironworks*) which actually takes place in the realisation of assets.

(6) The position is exacerbated where the member is itself insolvent and thus able only to pay a dividend in respect of its liability to contribute, particularly where the size of dividends payable by the company and its member were widely different (e.g. the company pays a 90% dividend, while the member pays only a 10% dividend). The consequence would be that the member received 90% of its debt from the company, notwithstanding it was at that time prospectively liable to contribute to the assets of the company to enable further debts, liabilities and expenses to be paid, and the company would subsequently receive only 10% of the amount of the member's obligation to contribute.

(7) In these circumstances, the contributory rule, a substantive rule of equity intended to protect the rights of independent creditors 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 payable by operation of section 80.

29. 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 distributive 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 distributive

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, but the administrator has no such power. Until the liquidator makes a call, however, the status of the member's liability is identical, whether the company is in liquidation or a distributive administration.

(3) It is no bar to this conclusion that the application of the contributory rule in the context of a distributive administration would be novel. As with all principles of equity, the contributory rule is capable of moulding itself to new circumstances as they arise[15]. As Jessel MR explained in *Re Hallett's Estate*[16]:

> "*…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*."

(4) No real prejudice is thereby caused to the members. If the company turns out to be able to pay all debts and liabilities and expenses of the winding-up from its own resources, then the members will turn out not to have any liability to contribute and can thus share in the distribution of the assets. If, however, the company turns out not to have sufficient assets to pay all debts, liabilities and expenses of the winding up without making a call on members, then it would flout the objective of the contributory rule if members had, before that position was clear, been paid out of the assets of the company, certainly if such payment was irreversible as a result of the members' own insolvency.

30. Alternatively, even if the contributory rule does not apply to prevent a member from participating in a distribution prior to the making of a call by a liquidator, in the case of an unlimited company, a member could not in practice share in the distribution of the assets of the company in administration, by virtue of the operation of set-off. LBL

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[15] See, for example, Snell's Equity, 32nd edition, at paragraph 1-004.

[16] (1879–80) L.R. 13 Ch. D. 696 at 710

objects to the operation of set-off as between the members' contingent liability to contribute and a debt owed to the member by the company. Those objections should be rejected, for the reasons dealt with further below. For present purposes, however, the availability of set-off, in conjunction with the unlimited nature of the member's liability, means that any claim which the member has against the company will always be "paid" by way of set-off against a part of its own liability to contribute, meaning that there will never be any extant claim by the member against the company, against which a distribution could be paid out of the assets of the company.

31. A simple illustration, taking the example at [31] and [32] of Lydian's skeleton argument, shows why this must always be the case:

    (1) A company has assets of £1 billion, and the aggregate value of its debts to independent creditors (including both actual values and estimated values where appropriate) is £2 billion.

    (2) A member, with an unlimited liability to contribute, has a claim against the company for £1 billion.

    (3) The member's liability to contribute is equal to the total liabilities of the company, less its available assets, i.e. £2 billion (i.e. £3 billion of liabilities to independent creditors and the member itself, less £1 billion of available assets).

    (4) Set-off between the member and the company results in £1 billion owed to the company, the member thus being prevented from sharing in any distribution of the company's assets among its creditors.

32. Whatever sum is owed by the company to the member by way of debt, the outcome is the same, whenever the member's liability is unlimited. In each case, the result of set-off where the company has any liabilities to outside creditors will always be a net balance owing to the company from the member.

The scope of the liability to contribute

33. LBHI, at [48ff] of its written opening submissions, contends that the "debts and liabilities" in respect of which a member is liable to contribute under section 74 does not extend beyond the company's debts which are provable in its liquidation. Accordingly, LBHI submits that statutory interest and non-provable liabilities (including currency conversion claims and subordinated debts which are not provable) do not fall within section 74.

34. LBIE does not repeat the argument already made by it in its written opening submissions, including at [107] as regards interest payable under IR 2.88(7) (meeting the point made by LBHI at [50] to [55] of LBHI's written opening submissions). LBIE does, however, in this section of its supplemental submissions, address the arguments raised by LBHI at [56] to [77] and [81] to [88] of its written opening submissions.

35. LBHI contends that the phrase "debts and liabilities" which appears in section 74 and which defines the scope of the liability to contribute "*cannot be read literally*" and, in fact, refers only to provable debts. In support of that construction of the section, LBHI relies upon various other provisions of the Act.

36. The first provision relied on by LBHI is section 107, where it is said that the word "liabilities" simply means "provable debts" because those are the liabilities that are paid *pari passu*. This submission cannot be correct in the terms in which it is made because section 189 provides for non-provable statutory interest to be paid before any distribution to members, which cannot stand with LBHI's construction of section 107. It follows that the only way of reading section 107 in a manner which is consistent with section 189 is by construing the word "liabilities" in section 107 as meaning all liabilities whether or not provable, but the obligation to pay *pari passu* is not across the entirety of the liabilities collectively. As Lord Neuberger's "insolvency

waterfall"[17] makes clear, statutory interest and non-provable liabilities rank higher than the members' rights.

37. The second set of provisions relied on by LBHI are those sections of the Act which refer to "debts and [other] liabilities" in connection with statements of affairs (sections 2(3)(b), 47(2)(a), 66(2)(a), 95(4)(a), 99(2)(a), 131(2)(a)). It is submitted that these references are to liabilities which go beyond provable debts in an appropriate case. A statement of affairs is required to show the full state of a company's affairs, including the extent of its liabilities, whether or not they are provable; it is not intended merely to identify that which is provable.

38. The third set of provisions relied on by LBHI (sections 123(2), 214(6), 216(7), 272(2)(a) and 421(4)) are those dealing with circumstances in which insolvency is required to be established. LBIE submits that in each of those cases, the draftsman deliberately requires the "balance sheet" insolvency test to be applied with reference to all of the company's liabilities, not merely those which would be provable in an administration or liquidation. In each instance, apart from section 123, this is clear from the fact that the word "other" appears before the word "liabilities". It is also consistent with the policy which underpins the relevant provision. The mere fact that a liability is not provable should not mean that it is to be left out of account:

    (1) In section 214(6), the test for whether a company has gone into insolvent liquidation for wrongful trading purposes is a test which requires to be brought into account all of the company's liabilities, whether they are provable or not. This is because a director of a company which has gone into insolvent liquidation at a time after the director knew or ought to have concluded that there was no reasonable prospect that it would avoid so doing, should be held responsible for his actions whether or not the company's liabilities are provable. The same applies to section 216(7) and the restriction on the re-use of the name of a company which has gone into insolvent liquidation.

[17] *Re the Nortel Companies* [2013] 3 WLR 504 at [39]

(2) Where a debtor is unable to pay his debts, he is entitled to present a debtor's bankruptcy petition. In demonstrating that he is unable to pay his debts, section 272(2)(a) requires the debtor to give particulars of his debts and other liabilities. This is because if he is unable to pay a particular liability, the fact that it is not provable does not affect the debtor's inability to pay it. Again, the draftsman has deliberately required non-provable liabilities to be taken into account.

(3) For the same reason as balance sheet insolvency and a debtor's inability to pay his debts is tested with reference to non-provable liabilities, the estate of a deceased person is insolvent if the estate will be unable to meet all of the deceased's debts and other liabilities (section 421(4)).

39. On each occasion identified by LBHI on which the draftsman has referred to liabilities instead of, or in addition to, provable debts, the draftsman has done so deliberately because testing the relevant matter with reference only to provable debts would not in any of those situations be appropriate. Accordingly, rather than support LBHI's argument that the reference in section 74 to "debts and liabilities" should be read as referring only to provable debts, the examples of the use of that (or a materially similar) term in the Act supports LBIE's contention that the scope of the section 74 liability to contribute includes both provable debts and non-provable liabilities.

40. This is unsurprising. Where, as in this case, the contributories' liability to contribute is unlimited, one would expect it to extend to all of the liabilities of the company, not just the liabilities which are provable. Further, it reflects the fact that the insolvency waterfall requires statutory interest and non-provable liabilities to be discharged before the members have any entitlement to the surplus.

41. At [58] and [59] of its written opening submissions, LBHI also contends that the fact that statutory interest is not referred to in terms in section 74 indicates that it is excluded from the scope of the contributory's liability to contribute. LBHI then contrasts this with those sections where interest is specifically referred to and submits that this shows that, where interest is intended to be taken into account, it is

specifically referred to. However, LBHI has not pointed to any provision in which the draftsman has referred to statutory interest in the context of a reference to "debts and liabilities" so that the contrast with those other provisions does not advance the argument.

42. Furthermore, no policy reason is given to support LBHI's submission and, as stated above, the structure of the insolvency legislation taken as a whole points firmly in the opposite direction.

43. LBHI's attempt (at [66]) to restrict the role of the definition of "liability" in IR 13.12(4) to the context of determining whether it is a provable debt is misconceived. Any such construction is inconsistent both with the opening words of the sub-rule ("*In any provision of the act or the Rules about winding up*") and with the fact that the definition appears in Part 13 of the Rules dealing with general definitions, not rule 12.3 which deals with provable debts. In any event it is clearly established at the highest level that there is a category of non-provable liabilities which must be paid before the members are entitled to any surplus and the many references to "debts and liabilities" in the Act would all be otiose if the term liability was only a reference to a sub-set of provable debts.

44. Returning to the example of section 123(2), when the Court assesses whether a company is balance sheet insolvent, say, for the purpose of deciding whether it should be wound up, there is no good reason why it should limit its assessment of the company's liabilities to the liabilities which would be provable in the company's liquidation. If the company is unable to pay its debts and liabilities, then it will often be appropriate for it to be placed into a formal insolvency proceeding, whether or not each and every one of its liabilities will rank as a provable debt. To the extent that any do not, they will still be payable before the members are entitled to anything. Moreover, it is well established that a creditor has standing to petition for the winding up of a company notwithstanding that the liability owed to it would not be provable[18].

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[18] See *Re T&N Limited* [2006] 1 WLR 1728 at [44]

45. LBHI also submits (at [68]) that including statutory interest within the phrase "debts and liabilities" is circular because, unless and until there is a surplus after payment of the debts proved, there is no liability to pay statutory interest; and any such liability is limited to the extent of the surplus. It is said that the result of imposing a liability on the member to contribute in relation to statutory interest would therefore be that his contribution actually creates the very liability to which the contribution itself is intended to relate.

46. This submission is wrong because the premise on which it is based is flawed. The liability exists independently of the surplus.

47. Furthermore, if there is a right to make a call in respect of any liability ranking below statutory interest in Lord Neuberger's waterfall *(Re the Nortel Companies*[19]*)*, including making a call to adjust the rights of contributories, receipt of the proceeds of that call will inevitably comprise the surplus and therefore have to be applied in payment of interest before being applied for any other purpose (section 189(2)), i.e. towards the amount for which the call was made.

48. Contrary to the submission made by LBHI at [69] of its written opening submissions, the fact that there is a reference additionally to the expenses of the winding up is because not all expenses are liabilities of the company. For a number of examples, see IR 4.218(3)(a) to (e).

49. In LBHI's written opening submissions, at [70] to [76], it is submitted that there are a number of categories of non-provable debts and liabilities which cannot be caught by section 74 for various reasons, which (so it is said) supports the proposition that the liabilities referred to in section 74 are only provable debts. This submission is wrong, either because the so-called liabilities are not in truth liabilities at all, or because they are wholly unenforceable:

[19] [2013] 3 WLR 504 at [39]

(1) As to the discounted element of a future liability the whole debt has been discharged by payment of the discounted amount. Accordingly, no claim survives. This example does not help on the issue under consideration.

(2) As to any amount in excess of the estimated amount of a contingent liability, subject to any revaluation (when the re-valued amount will be provable), the same analysis applies.

(3) As to statute barred and non-EU foreign tax "liabilities", they are wholly unenforceable and for that reason not payable by the company whether in the course of the insolvency or at all.

(4) As to secured liabilities, they fall outside the scope of the Act altogether. To the extent of any shortfall in the security those liabilities will be provable in the normal way.

(5) As to the *shareholder's* rights to the surplus, it is plain that that is not a debt or liability of the company within the meaning of section 74 (although section 74(1) is of course concerned with the adjustment of the rights of contributories *inter se*). This has no bearing on the wholly separate question of whether or not a *creditor's* right to interest, or any other non-provable debt, is a liability within the contemplation of that section.

50. It follows that, contrary to LBHI's submissions, there is no difficulty, and every sense, in reading "debts and liabilities" literally.

The application of insolvency set-off

51. LBIE's primary case, as fully set out in its written opening submissions, is that there is no scope for the operation of insolvency set-off as between the Members' contingent liability to contribute and their claims against LBIE because of the operation of the contributory rule.

52. If, however, the Court concludes that the contributory rule does not apply, whether because no call has yet been made or otherwise, LBIE will contend that, on 4 December 2009, when the administrators of LBIE gave notice that they were proposing to make a distribution to LBIE's unsecured creditors, an account was taken (under IR 2.85(3)) of what was actually or contingently due from each party to the other in respect of their mutual dealings and the sums due from one party set off against the sums due from the other.

53. LBIE will contend further that, on this hypothesis:

(1) the Members' contingent liability to contribute would have been included in the taking of the account and that the estimation provisions of IR 2.81 would have applied for the purposes of valuing the contingent liability (see IR 2.85(5)); but

(2) LBHI2's claim in respect of the Subordinated Debt would not have been included in the taking of the account because of the subordination[20].

54. LBHI2 appears broadly to agree with the proposition that set-off applies (at [68]-[72]), although no distinction is made by them as between their subordinated and unsubordinated claims, and LBHI does not address the issue.

55. LBL, however, argues that insolvency set-off would not operate as regards the Members' contingent liability to contribute because:

(1) it would not be fair on LBIE's other creditors for it do so in circumstances in which its effect would be to "*provide the contributories with £ for £ payment in respect of their debts owed by [LBIE]*" (at [61]); and

(2) the Members' contingent liability to contribute does not give rise to a provable debt such that there is no mutuality between the cross claims (at [62]).

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[20] As to which see *Derham on The Law of Set-Off* (4th edition) at [6.114] to [6.115].

56. What LBL appears to be seeking to achieve by making this argument is a situation in which:

(1) LBL is entitled to prove against LBIE and recover 100p in the £; but

(2) LBIE is prevented from proving against LBL until LBIE has gone into liquidation and made a call – by which time LBL will have distributed its assets amongst its other creditors or at which time LBL will be paying out considerably less than 100p in the £.

Accordingly, whilst LBL's argument at [61] is said to be based on avoiding LBIE's creditors being treated unfairly, what would flow from LBL's arguments being accepted is that LBIE's creditors are put in an even worse position.

57. It follows that the effect of LBL's argument is to subvert the *pari passu* rule in a manner favourable to LBL but deeply unfavourable to those whose interests the rule is there to protect.

58. In fact, LBL's arguments demonstrate clearly why the right result is for the contributory rule to apply such that, as a member of an unlimited liability company, contingently liable to contribute under section 74, LBL (and LBHI2) should be required to wait at the back of the queue, rather than to compete with LBIE's other creditors.

59. Taking LBL's arguments in turn:

(1) LBIE agrees that for the Members' contingent liability to contribute to fall into the set-off account would be inconsistent with the scheme of the insolvency legislation and afford the Members, in effect, £ for £ payment when that cannot be what the legislature contemplated. That is the very reason why LBIE's primary case, that the contributory rule is engaged, is correct.

(2) Nevertheless, LBL's argument turns on its head the principle underlying the contributory rule, as explained in *Grissell's Case* and *Black & Co's Case*. LBL (at [61]) quotes the comments of Lord Selborne LC in the latter case to

the effect that to allow a member to retain his own calls against debts due to him from the company would be to grant him a preference. This echoes the words of Lord Chelmsford LC in *Grissell's Case*[21] that "*to allow a set-off against a call would be contrary to the whole scope of the Act.*" These statements were made in support of the rule that the member should receive nothing until it has paid its call (i.e. the contributory rule): that rule was sufficiently strong that it could not be circumvented by set-off. If, as LBL contends, the member is *already* entitled to payment, because the contributory rule does not operate to prevent the member making a claim in the company's insolvency, notwithstanding the contingent liability to contribute, it would be absurd to rely upon those comments of Lord Chelmsford and Lord Selborne to prevent the company from taking advantage of set-off[22]. They simply have no relevance if the premise (the application of the contributory rule) is removed.

(3) As to the contention that LBIE's administrators cannot prove for the contingent liability of the Members, LBL is wrong, for the reasons referred to above at [6] to [15] above. Accordingly, that argument too falls away.

60. Where LBIE is in liquidation, LBL's only reason for maintaining that there is no set-off appears to be the first reason referred to above (in paragraph 55(1). It is equally wrong in the context of LBIE's liquidation, for reasons set out above.

The contractual subordination

61. A number of arguments are made by LBHI2 and LBHI as to why, as a matter of contract, the Subordinated Debt is only subordinated behind the debts provable in LBIE's administration. They are addressed below.

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[21] (1866) LR 1 CH App 528, at 536.

[22] In any event, as Lord Chelmsford made clear in *Grissell's Case* (at 536), the rationale for excluding set-off is removed if the member has unlimited liability.

62. Before those arguments are addressed, LBIE addresses LBHI's contention that, because Standard Term 4 gives LBHI2 rights in certain circumstances to institute insolvency proceedings against LBIE, it must follow that LBHI2 is entitled to prove in LBIE's administration. For two reasons, LBHI's contention is wrong:

(1) First, the whole of Standard Term 4 is subject in all respects to the provisions of Standard Term 5, the subordination provision.

(2) Secondly, a person owed a non-provable liability has standing to institute insolvency proceedings[23]. It does not, therefore, follow from LBHI2's right to institute insolvency proceedings that LBHI2 is entitled to prove in such proceedings in respect of the Subordinated Debt.

63. LBHI contends further that LBHI2 is not, by Standard Term 5, prevented from proving in LBIE's administration. However, as explained at [32(1)] of LBIE's written opening submissions, if LBHI2 were to seek to prove for the Subordinated Debt in competition with LBIE's other creditors, it would be in breach of the undertaking given in Standard Term 7(d) not to "*attempt to obtain repayment of any of the Subordinated Liabilities other than in accordance with the terms of [the Subordinated Loan Agreement]*".

64. Nothing in the factual matrix relied upon by LBHI cuts across the analysis set out in the preceding paragraphs and in LBIE's written opening submissions. LBIE does not contend that LBHI2 is prevented from proving in LBIE's administration altogether. LBHI2 would be entitled to prove as and when all of the provable debts, statutory interest on them and all non-provable liabilities have been paid in full.

65. That analysis is consistent with GENPRU 2.2.159R, referred to at [44] of LBHI's written opening submissions because, although the lender's remedies must be limited to, but may include, proving for the subordinated debt, by paragraph (4) of that rule, the remedies are expressly required not to prejudice the subordination in paragraph (1)

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[23] See *Re T&N Limited* [2006] 1 WLR 1728 at [44]

by which the lender's claims "*must rank behind those of all unsubordinated creditors*".

66. At [24] of its opening submissions, LBHI2 queries whether contracting parties can validly agree "*to move a debt which is by statute put in a particular class of liability… into a different class*". LBIE contends that, it being established (in *Re Maxwell Communications Corp plc (No. 2)*[24]) that a creditor can, by contract, give up its right to receive a distribution on a *pari passu* basis, there can be no doubt that it can also contract to be paid only after another category or other categories of liabilities have been paid. Subordination being possible, the extent of any given subordination is a matter of contractual construction. That this is so is clear from the judgment in *Re Maxwell Communications Corp plc (No. 2)* itself:

    (1) First, the decision that contractual subordination should be respected was based on there being no public policy which was offended by it and the fact that, because it was open to a creditor not to prove his claim, it should equally be open to a creditor only to do so when other claims had been paid in full and to make that a term of his contract (at 1411G-1412C).

    (2) Secondly, Vinelott J. expressly referred at 1412A to a preferential creditor being able to agree that his claim should rank alongside the non-preferential debts.

67. Accordingly, the extent of LBHI2's contractual subordination is to be determined as a matter of construction of the Subordinated Loan Agreements. The framework of the Insolvency Act 1986 (referred to extensively by LBHI2 at [25] to [31] of its opening submissions) is, at this stage of the analysis, of little significance or assistance.

68. LBHI contends that the Subordinated Debt must be repaid before any statutory interest is paid to LBIE's creditors. Its argument (at [91] to [92]) is that statutory

[24] [1993] 1 WLR 1402

interest can only be paid once all debts proved have been paid. LBIE's response to this is that:

(1) Unless and until all of the higher ranking debts and liabilities have been paid in full, as explained above, LBHI2 is not, in fact, entitled to prove in LBIE's administration. This is consistent with the approach taken by the legislature as regards certain liabilities which become provable only when all of the provable debts and statutory interest on them have been paid in full: see IR 12.3(2A).

(2) In any event, LBIE refers to [40] to [43] of its written opening submissions in which the argument was anticipated and the reasons why it is wrong set out.

69. At [32] of LBHI2's opening submissions and at [97(1)] of LBHI's written opening submissions, it is contended that statutory interest is not a "Liability" within the meaning of the Subordinated Loan Agreements. This is wrong.

(1) The definition of "Liability" in the Subordinated Loan Agreements is in the broadest possible terms.

(2) LBIE is only to be regarded as being "solvent" having gone into an insolvency process, rendering the Subordinated Debt re-payable, where it is able to pay all of its "Liabilities" in full.

70. At [97(2)] of LBHI's written opening submissions, LBHI contends that statutory interest is not "*capable of being of being established or determined*" in LBIE's administration such that it is not to be taken into account when determining whether LBIE is solvent within the meaning of Standard Term 5(1)(b). The argument is misconceived:

(1) Standard Term 5(2) excludes from this calculation two things: (i) "*obligations which are not payable or capable of being established or determined in [LBIE's insolvency proceeding]*"; and (ii) "Excluded Liabilities".

(2) Statutory interest is both payable in, and capable of being established and determined in, LBIE's administration or liquidation. That is precisely what IR 2.88(7) and section 189(2) provide for.

(3) The fact that statutory interest would not be taken into account outside of an insolvency situation for the purposes of determining whether the company is unable to pay its debts or should be deemed unable to pay its debts (LBHI at [110]) is beside the point. The term "solvent" is a term which bears a particular meaning in the Subordinated Loan Agreements and LBHI cannot draw any support from how the term might be applied outside the very particular circumstances of the Subordinated Loan Agreements.

(4) The definition of "solvent" in Standard Term 5(1)(b) applies only where LBIE is in an insolvency process and that is why what is disregarded from the calculation of LBIE's insolvency is limited to (i) "*obligations which are not payable or capable of being established or determined* ***in [LBIE's insolvency proceeding]***" (emphasis added); and (ii) "Excluded Liabilities".

(5) Therefore, whilst LBIE accepts LBHI's contention that payment of statutory interest is not relevant to the question whether a company should be placed into a formal insolvency process (LBHI at [115(3)]), it is absolutely relevant to the question of whether LBIE is solvent for the purposes of Standard Term 5(1)(b).

71. The same analysis applies to non-provable liabilities. They are capable of being established or determined and will be payable in LBIE's administration or liquidation to the extent that there are surplus funds available after the payment of statutory interest.

72. At [33] of its opening submissions, LBHI2 contends that, if statutory interest is a "Liability" within the meaning of the Subordinated Loan Agreements, then it falls within the definition of "Excluded Liabilities". This too is wrong. The definition of "Excluded Liabilities" is "*Liabilities which are expressed to be and, in the opinion of the Insolvency Holder of the Borrower, do, rank junior to the Subordinated Liabilities*

in any Insolvency of the Borrower"[25]. This does not cover statutory interest. Statutory interest is nowhere expressed to rank junior to the "Subordinated Liabilities" in LBIE's administration and, in the opinion of LBIE's administrators it does not so rank.

73. Unlike LBHI2, LBHI does not advance an argument that the statutory interest falls within the definition of "Excluded Liabilities". It says, at [99] of its written opening submissions, that: "*For present purposes, it may be assumed that there are no 'Excluded Liabilities'*".

Currency conversion claims

74. LBIE contends, for the reasons set out in its and Lydian's written opening submissions, that the currency conversion claims exist and that they rank for payment ahead of any amounts due by way of debt from LBIE to LBHI2 and LBL.

75. This section of LBIE's supplemental written submissions addresses certain of the arguments raised by LBL, LBHI2 and LBHI against the existence of the currency conversion claims.

76. LBHI relies (at [136]-[140] of its written opening submissions) on certain passages contained in two Law Commission Reports[26] and the Cork Report in support of its

[25] LBHI2 suggest that "expressed" means expressed in the 1986 Act. This is wrong. The natural meaning is that it refers to something expressed within the agreement, or another agreement, to rank below the Subordinated Liabilities. The reference to the "*opinion of the Insolvency Officer of the Borrower*" would make no sense if the cross-reference was to the 1986 Act: an Insolvency Officer's opinion would be irrelevant if there was a statutorily imposed subordination. Given that the standard form of agreement could be used in circumstances where there were also "junior" liabilities which the parties wished to subordinate to the Subordinated Liabilities, it is irrelevant that there are in fact no such "junior" liabilities in the agreement as between LBHI2 and LBIE or in any other agreement.

[26] Working Paper No. 80: Private International Law Foreign Money Matters and Working Paper No. 134: Private International Law Foreign Money Matters

assertion that following the enactment of the 1986 Act currency conversion claims do not exist[27].

77. LBIE contends that the Court gains no assistance from the reports:

(1) First, because on proper analysis the reports are concerned solely with identification of the appropriate date (or dates) for conversion of foreign currency claims into sterling, and say nothing of the possibility of a foreign currency creditor maintaining against the company, once all other claims have been paid and before returning the surplus to members, a claim for the loss suffered by reason of having been paid in sterling; alternatively,

(2) Even if the reports are to be interpreted as recommending that Parliament exclude the possibility of a claim as envisaged by Brightman LJ in *Lines Bros (No. 1)*, in fact Parliament declined to follow that recommendation when enacting the 1986 Act.

78. As to the first point:

(1) The first report relied upon by LBHI (Working Paper No. 80) pre-dated the decision of the Court of Appeal in *Lines Bros (No. 1)*. In the passage quoted by LBHI, it addressed the question of whether there should be different dates for the conversion of creditors' claims into sterling depending upon the solvency of the company. The Law Commission rejected that suggestion, and expressed its support for the approach taken by Oliver J in *Re Dynamics Corporation of America*[28], that there should be a once-for-all conversion as at the date of winding-up irrespective of the solvency of the company. The Law Commission also rejected the possibility of a *second* conversion as at the date

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[27] LBHI's written opening submissions at [136]-[142]. LBL makes a similar point in its written opening submissions at [154(1)-154(4)], contending that *Re Lines Bros (No. 1)* pre-dates the introduction of the Insolvency Rules 1986 and that there can be no basis for the existence of currency conversion claims following the introduction of IR 2.86 and IR 4.91.

[28] [1976] 1 WLR 757

of payment. It is clear that it was considering only the possibility of a further statutorily imposed date for conversion of foreign currency debts. Its conclusion thus has no bearing on the question whether a foreign currency creditor, who has suffered a loss as a result of the conversion of its debt into sterling, might have a claim to payment in respect of that loss before any surplus was returned to members.

(2) Moreover, the rationale for rejecting a second conversion date only where the currency movement was against the relevant creditor, was that it would involve discrimination between foreign currency creditors depending on whether the currency moved in their favour or against them. There is no such discrimination involved in the recognition of a claim by those creditors who have suffered loss as a result of the conversion of their foreign currency debts. Indeed, on the contrary, recognition of such a claim rebalances the discriminatory effect which conversion of debts at a date earlier than payment has on the such foreign currency creditors.

(3) The passage in the Cork Report cited by LBHI is concerned principally with recommending the enactment of the conclusion reached in *Lines Bros (No. 1)* that the commencement of winding-up should be adopted as the date for converting all foreign currency claims, to avoid inequality between sterling and foreign creditors. For reasons set out in LBIE's (and Lydian's) written opening submissions, recognising the right of creditors who have suffered a loss as a result of currency conversion, but only when all other creditors have been paid, creates no inequality between creditors. Insofar as the Cork Report addressed the possibility of a solvent company, it did no more than agree with the Law Commission Working Paper No. 80. Importantly, therefore, it focussed only on the discriminatory effect of a second conversion date, but did not address the possibility raised by Brightman LJ in *Lines Bros (No .1)* of a subsequent (non-provable) claim by those foreign currency creditors who had sustained a loss.

(4) The final report relied upon by LBHI (Working Paper No. 124) adds nothing, since it merely confirms the position previously taken as to the conversion of

foreign currency claims in winding up. Moreover, although the *obiter* comments of Brightman LJ are expressly cited in this working paper (at [2.23][29]), there is no suggestion in the report that the approach of Brightman LJ should not be followed going forwards.

79. As to the second point, if the reports are read as suggesting that a once-for-all conversion of claims into sterling would preclude any possibility of currency conversion claims along the lines envisaged in *Lines Bros (No. 1)*, then it is clear that the suggestion was not taken up by Parliament. IR 2.86 and IR 4.91 expressly provide that the conversion into Sterling is made "*for the purpose of proving*", and there is no suggestion that the conversion for the purpose of the proof process affects the underlying contractual right of a creditor to be paid a debt in a currency other than sterling. As noted in LBIE's (and Lydian's) written opening submissions, the process of proof and payment of dividends does not operate to discharge the underlying contractual entitlement of creditors, save to the extent that they are paid in full.

80. LBHI, LBHI2 and LBL contend that the existence of currency conversion claims should be denied as such claims would work only to the advantage of an unsecured creditor with such a claim[30]. There is no substance to this objection as:

(1) it fails to engage with the underlying principle that the foreign currency debtor should not be entitled to impose on the foreign currency creditor the risk of a fall in value of sterling: see *Re Lines Bros Ltd (No.1)*, per Brightman LJ at 16D;

(2) it fails to provide any justification for why the company (and the members which stand behind it) should benefit from a movement in foreign exchange

[29] "*There is no direct authority as to the rule governing the situation in which the debtor is solvent, but it was suggested, obiter, in the Lines Bros. case that in those circumstances it might well be that a foreign-currency creditor is entitled to be paid the balance of his full contractual debt before the shareholders receive anything.*"

[30] LBHI's written opening submissions at [145]; LBHI2's written opening submissions at [90]; LBL's written opening submissions at [154(7)].

rates between the date of the commencement of the insolvency process and any distribution of the assets of the company; and

(3) it fails to pay any regard to the fact that currency conversion claims are not payable in competition with the provable claims of other external creditors, thereby ensuring that other external creditors do not suffer from the existence of the currency conversion claims.

81. LBL and LBHI contend that it is difficult to see how the set-off provisions in the IR could work if there were currency conversion claims[31]. The exercise of a right of set-off is, however, simply one form of payment of a provable debt owed by LBIE. The provable debt will either be paid by a distribution or by the exercise of a right of set-off. There is no basis for the contention that the mandatory set-off is capable of discharging the underlying (non-provable) contractual right of a creditor to be paid in a different currency.

82. LBHI refers to the cases of *Re House Property and Investment Co Ltd* and *Re Danka Business Systems plc* in support of a submission that currency conversion claims do not exist[32]. These cases are, however, completely removed from the present case. They are concerned with the question of whether a liquidator who has already valued contingent claims and admitted them to proof in the amount of the valuation comes under a legal duty to provide for the contingency in full by making a reserve prior to any distribution to members. It is, of course, always open to a contingent creditor to revalue its claim in light of subsequent events, and share in future distributions. The process for proving such claims thus contains within it the mechanism for ensuring that the full value of the creditors' claim is satisfied, if that value changes over time. The cases have nothing to do with the rights of a creditor which are excluded from the proof process, such as currency conversion claims.

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[31] LBL's written opening submissions at [154(8)]; LBHI's written opening submissions at [146].

[32] LBHI's written opening submissions at [149].

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4 November 2013

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

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN administration) AND OTHERS

Applicants

-and-

LEHMAN BROTHERS HOLDINGS, INC AND ANOTHER

Respondents

LBIE'S SUPPLEMENTAL WRITTEN SUBMISSIONS (for hearing on 11-20 November 2013)

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