IN THE COURT OF APPEAL (CIVIL DIVISION)

Appeal Court Ref. Nos. 2014/1833, 2014/1826 and 2014/1839

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

ATTENDED
11 MAR 2015
APPEALS OFFICE

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

IN THE MATTER OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

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

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 (a company incorporated in the State of Delaware, USA)

Respondents

REPLACEMENT RESPONDENT'S SKELETON ARGUMENT OF THE LBL JOINT ADMINISTRATORS

References in the form [1/1/1] are to the relevant appeal bundle/tab/page

Introduction

1. This skeleton argument is served on behalf of the Joint Administrators of Lehman Brothers Limited ("**LBL**", and the "**LBL Joint Administrators**"), as Respondents to the appeal by Lehman Brothers International (Europe) ("**LBIE**").

2. Each of the parties appeals against different paragraphs of the Order of David Richards J dated 19 May 2014 (the "**Order**") [C/6/101] granting declaratory relief.

3. LB Holdings Intermediate 2 Limited ("**LBHI2**") and Lehman Brothers Holdings Inc ("**LBHI**") each appeals against the same paragraphs of the Order as LBL (i.e. sub-paragraphs (ii) and (iii) in relation to "Currency Conversion Claims", and sub-paragraph (vi), in relation to the scope of the members' obligation to contribute under s.74(1) of the Insolvency Act 1986 (the "**Act**")). LBL adopts the further submissions made by LBHI2 and LBHI in relation to these issues.

4. LBHI2 and LBHI also appeal against certain other paragraphs of the Order (namely sub-paragraphs (v), (viii), (ix), and (x)). Success by LBHI2 and LBHI in their appeals against these sub-paragraphs of the Order will also inure to LBL's benefit.

5. As for LBHI2's and LBHI's appeal against sub-paragraph (i) of the Order (in relation to the subordinated debt), LBL's position is aligned with that of LBIE, but LBL does not make its own separate submissions in this regard.

6. Accordingly, this skeleton argument responds to LBIE's appeal against sub-paragraphs (iv) and (vii) of the Order,[1] namely the declarations that:

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

   (2) Neither the contributory rule nor the equitable rule in **Cherry v Boultbee**

[1] The LBL Joint Administrators also adopt the submissions made in LBHI2's Respondent's skeleton argument in relation to these issues.

[Auths/1A/1] 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 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 s.74(1).

7. A critical point to bear in mind as regards LBIE's appeal is that each insolvency procedure has its own advantages and disadvantages. An office-holder will choose carefully between the various options open to him before deciding which to select in light of those advantages and disadvantages. It is thus not "*entirely adventitious from the perspective of the Members that [LBIE] happens to be in administration rather than liquidation*" (para 50 of LBIE's skeleton [A/9/77]). It is the result of a deliberate decision on the part of LBIE's office-holders: as noted at para 50 of LBIE's skeleton, "*It is in administration, rather than liquidation, because the Joint 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*". The relevant decision makers have also decided to start making distributions in LBIE's administration.

8. There must be an acceptance of the consequences that follow from these decisions, which include the fact that: (i) in an administration, there is no power to make calls on the members in respect of their potential liabilities under s.74(1) of the Act; and (ii) if LBIE subsequently goes into liquidation and its creditors have not been paid in LBIE's administration in respect of post-administration interest under Rule 2.88(7), that interest will not be provable as a debt in LBIE's liquidation, nor payable as statutory interest under Rule 2.88 of the Rules or s.189 of the Act. Having decided to conduct a distributing administration rather than a liquidation, LBIE must take both the benefits and any disadvantages of that approach.

Post-administration interest in a liquidation

9. The Judge was correct to hold that 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 or s.189.

10. If the Judge reached this conclusion with "*considerable reluctance*" (para 13 of LBIE's skeleton [A/9/67]), he must have been doubly sure that the statutory scheme permitted no other conclusion. He was correct in that conclusion.

11. There is a clear regime for post-administration interest to be payable in an administration out of a surplus in the hands of the administrator, and for post-liquidation interest to be payable in a liquidation out of a surplus in the hands of the liquidator. That regime does not permit the payment of post-administration interest in a subsequent liquidation under either Rule 2.88 or s.189:

    (1) Part 2 of the Rules is entitled "*Administration Procedure*". Rule 2.68(1) provides that chapter 10 of the Rules (which contains Rule 2.88) "*applies where the administrator makes, or proposes to make, a distribution to any class of creditors ....*". Section B of Chapter 10 provides the machinery of proving a debt in an administration. Rule 2.72(1) provides that "*A person claiming to be a creditor of the company and wishing to recover his debt in whole or in part must (subject to any order of the court to the contrary) submit his claim in writing to the administrator*"; Rule 2.72(2) provides that "*A creditor who claims is referred to as* "proving" *for his debt and a document by which he seeks to establish his claim is his "proof"*". The remainder of the chapter goes on to set out the procedure for proving a debt in an administration, and the rules for quantifying certain types of claim and for set-off.

    (2) Rule 2.88(7) provides "*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.*" The "*surplus*" referred to in Rule 2.88(7) can only be a surplus in the hands of the administrator.

    (3) Part 4 of the Rules concerns the winding up of companies, and Part 9 is entitled "*Proof of Debts in a Liquidation*". Rule 4.73(8) provides: "*Where a winding up is immediately preceded by an administration, a creditor proving in the administration shall be deemed to have proved in the winding up*". Rule 4.93 provides for the proving of interest in respect of debts proved in the liquidation which bear interest,

insofar as that interest is for periods before the relevant date. Rule 4.93(1) (in the terms in force when LBIE went into administration) provides:

> "Where a debt proved in the liquidation bears interest, that interest is provable as part of the debt except in so far 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 the company entered administration**."

Thus, where a winding up is immediately preceded by an administration, post-administration interest will not be provable in the winding-up.

(4) S.189 is contained in Chapter VIII of the Act ("*Provisions of General Application in Winding up*"). S.189(1)-(2) provide:

> "(1) In a winding up interest is payable in accordance with this section on any debt proved in the winding up, including so much of any such debt as represents interest on the remainder.
>
> (2) Any surplus remaining after the payment of the debts proved in a winding up shall, before being applied for any other purpose, be applied in paying interest on those debts **in respect of the periods during which they have been outstanding since the company went into liquidation.**"

(5) This provision can only be construed as applying to a surplus in the hands of the liquidator after payments of the debts proved in the winding up. Further, it clearly circumscribes what the liquidator must do with such a surplus.

(6) The structure of these provisions is that Rule 2.88(7) only applies to the surplus in the administration, and s.189(2) applies to the surplus in the liquidation. LBIE is wrong to say (para 25 of its skeleton) that Rule 2.88(7) "*does not cease to apply merely because the distributing administration is succeeded by a winding-up*". As the Judge correctly pointed out (at [125]), "*Rule 2.88(7) requires the surplus remaining after the payment of debts proved to be applied in payment of interest on those debts in respect of the periods during which they have been outstanding since the company entered administration "before being applied for any purpose". That is impossible to reconcile with the equivalent provision in section 189(2) which 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"."

12. LBIE's argument that post-administration interest is payable in a liquidation, on the basis that Rule 2.88(7) somehow survives the company moving from administration into liquidation, cannot be squared with the relevant provisions. The Judge correctly noted (at [125] [C/4/65]) that there were "*a number of serious difficulties with this submission*".

    (1) LBIE's skeleton says at para 27(1) [A/9/71]: *"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"*. LBIE says the "*surplus remaining*" under Rule 2.88(7) "*refers simply to what remains after payment of the debts proved*" in the administration. But, as the Judge correctly concluded, s.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*". Treating Rule 2.88(7) as continuing into a liquidation is inconsistent with the requirements of s.189(2). S.189(2) cannot be "*inapplicable*" as LBIE says at para 12(1) of its skeleton [A/9/67], in the scenario there postulated. The Judge was correct to conclude (at [125] [C/4/65]) that, "*on a natural reading of 2.88(7) it applies to a surplus in the hands of the administrator rather than in the hands of a subsequent liquidator*".

    (2) Para 28(2) of LBIE's skeleton [A/9/10] says: "*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*". But this overlooks the express language of s.189(2), referring to "*Any surplus* ***remaining after the payment of the debts proved in a winding up***". This defines the surplus as the assets remaining after payment of the debts proved (or deemed to have been proved) in the winding up. S.189 exhaustively circumscribes how a surplus in a winding up is to be applied.

    (3) LBIE's skeleton says (at para 30) [A/9/73]: "*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*". But, in accordance with the structure of Part 2 of the

Rules, as set out above, the reference in Rule 2.88(7) to "*those debts*" means (and can only mean) the debts proved in the administration.

(4) Further, Rule 2.88(1) (in the version as it applies to LBIE's administration) provides that interest is provable as part of the debt "*except in so far as it is payable in respect of 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***". Rule 2.88(1) has since been amended to replace the words "*the date that the company went into liquidation*" with "*the relevant date*", which is now defined in Rule 2.88(A1) as "*the date on which the company entered administration or, if the administration was immediately preceded by a winding up, the date on which the company went into liquidation*".[2] The absence of any equivalent wording in s.189 where a winding up is immediately preceded by an administration renders the LBIE's argument untenable.

(5) Para 23 of LBIE's skeleton [A/9/8] says: "*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.*" LBIE thus suggests a very narrow interpretation of s.189, i.e. that it does not contemplate a preceding administration. However at para 25 of its skeleton [A/9/71], LBIE says that: "*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.*" LBIE is thus suggesting that rule 2.88(7) should be construed extremely broadly. This broad approach is inconsistent with its narrow suggested interpretation of s.189. There is no need for this inconsistent approach: rather, as set out above, s.189 applies to the surplus in the liquidator's hands in respect of all those proving (or deemed to have proved) in the

[2] The Judgment provides at [117] [C/4/63]: "*The provisions are therefore broadly the same. Interest on interest-bearing debts may be proved for any period before the company enters either administration or liquidation, whichever is the earlier. Until the amendments made with effect from 6 April 2010, statutory interest was payable out of any surplus remaining after the payment in full of proved debts from the date that the company entered administration, or from the date that it went into liquidation, but without in either case provision for the period of an earlier liquidation or administration respectively. By reason of the amendments made to rule 2.88 with effect from 6 April 2010, it is clear that statutory interest is payable out of any surplus with effect from the commencement of an earlier liquidation. No similar amendment was made to section 189*".

winding up, and rule 2.88(7) applies to the surplus in an administrator's hands in respect of all those proving in the administration.

(6) Also, as the Judge pointed out at [125] [C/4/65], LBIE's suggested approach *"provides no assistance in the case of an administration which has not become a distributing administration"*.

13. LBIE's alternative argument (at para 12(2) of its skeleton [A/9/67]), that – in the scenario there postulated – 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 s.189(2) to those creditors who prove during the winding up, cannot be reconciled with Rule 4.73(8). Rule 4.73(8) deems a creditor who proved in the administration to have proved in the winding up. Accordingly, under the clear words of s.189(2), such creditor's claims will only be payable from the surplus in respect of the period during which it has been outstanding *"since the company went into liquidation"*.

14. For the reasons set out above, the Judge was correct to reach the conclusion he did. The position is similar to that in **Bloom v The Pensions Regulator** [2011] BCC 277 [Auths/1C/88] (as set out in LBHI2's Respondent's Notice). It was submitted in that case that the pre-2010 version of Rule 13.12 should be construed as if it had always provided for an administration cut-off date in the context of proof of debts in an immediately following liquidation (in accordance with the amendments made in 2010). Briggs J rejected this argument. The relevant passage is at [111]-[123]. In particular:

(1) At [115], Briggs J referred to the submission that Rule 13.12 should be construed as always having contained the amendment introduced non-retrospectively in 2010 on the ground that the failure to introduce it earlier was an obvious drafting mistake, and to a passage of Lord Nicholls' speech in **Inco Europe Ltd v First Choice Distribution** [2000] 1 WLR 586, 592 [Auths/1B/70].

(2) *"Sorely tempted"* ([116]) though he was to accede to the submission, Briggs J concluded that it would not be a permissible exercise of the court's interpretive function, in particular because:

a. While he thought it probable that the failure to amend rule 13.12 in 2005 was a mistake, the fact was that rule 13.12 had not been amended. *"This is not therefore a question of correcting a drafting mistake in an amendment actually made to rule 13.12 , but rather the insertion of a whole new and important provision which is, quite simply, not there."* ([117])

b. The alteration in language required was very far-reaching in its effect, because Rule 13.12 is the primary rule governing the identification of the cut-off date for the purposes of proof in insolvency processes. ([118])

c. Although the omission was probably a mistake, he was not "*abundantly sure*" of that, the requisite standard laid down by Lord Nicholls. ([119])

d. At [120]:

> "there is in my view a subtle dividing line between dealing with drafting mistakes by construction, which is a task for the court, and dealing with them by subsequent amendment, which is a task for the legislature. In my judgment the present task falls clearly on the legislative side of that dividing line. The statutory provisions in question consist of important parts of a highly sophisticated and technical code set out in rules which have to be applied on a daily basis by busy insolvency practitioners who ought, in principle, to be entitled to read the rules and apply them in accordance with their language, at least where it is unambiguous. Rule 13.12, in its pre-April 2010 form, is unambiguous in that respect. It clearly provides that the cut-off date in a liquidation, and in an administration, is in each case the date of the commencement of that insolvency process. No ordinary process of construction would lead to the conclusion that, where for example liquidation immediately follows an administration, proof in that liquidation is governed by the administration cut-off date. On the contrary, a careful comparison between rule 13.12 and the amended rules in Parts 2 and 4 to which I have referred would suggest that the legislature had quite deliberately made a cautious and limited alteration to the general principle, in relation only to specific aspects of the proof regime."

e. At [121]:

> "I have no doubt that there will have been numerous cases between 2005 and 2010 of administrations followed by liquidation, in which the liquidators have dealt with creditors' claims upon the basis that the relevant cut-off date was the commencement of the liquidation, as unambiguously described by rule 13.12 in its then form. The decision not to make the 2010 amendments to rule 13.12 applicable to existing insolvency processes demonstrates to me that the draftsman (and therefore the legislature) must have thought so as well, and

proceeded on the basis that, from 2005 until 2010, rule 13.12 did indeed mean what it clearly said."

f. At [122], treating rule 13.12 as always having contained, since 2005, the 2010 amendments would, in relation to such intervening insolvency processes "*cause an unacceptable degree of potential chaos*".

15. Many of the same reasons apply in this case so as to preclude the argument now made by the LBIE Joint Administrators.

The inapplicability of the contributory rule and the rule in *Cherry v Boultbee* in LBIE's administration

16. The Judge was correct to hold that neither the contributory rule (in **Grissell's Case** [Auths/1A/6]) nor the equitable rule in **Cherry v Boultbee** [Auths/1A/1] 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 refuse to pay dividends on such proof on the grounds that, if the company subsequently went into liquidation, the member would or might become liable to calls under s.74(1). It is not the position that a person cannot claim a share in a fund until he has discharged an unquantified potential future liability to the fund, whether generally, or in the specific context of the obligations of members of companies under s.74 of the Act. As LBIE acknowledges, it is unable to point to any authority which has held to the contrary.

17. As to the "contributory rule":

(1) This was recently summarised by the Supreme Court in **Re Kaupthing Singer & Friedlander Ltd (in administration) (No. 2)** [2012] 1 AC 804 [Auths/1C/89] at [52], as follows:

"The situation in this line of authority is that a shareholder is a creditor of an insolvent company, but his shares are not fully paid up, so that he is liable as a contributory. Suppose he has 10,000 £1 shares, 10p paid, and is owed £15,000, but the dividend prospectively payable is only 30p in the pound. If the liquidator calls on him for £9,000 to make his shares fully paid up, he has no right of set-off, and to that extent he is disadvantaged (that is *In re Auriferous Properties Ltd* [1898] 1 Ch 691). If he seeks to prove in the liquidation, the liquidator can rely on the equitable rule as it applies in a case of this sort—that

is, that he can receive nothing until he has paid everything that he owes as a contributory. That is *In re Auriferous Properties Ltd (No 2)* [1898] 2 Ch 428. The rule is also very clearly stated by Buckley J in *In re West Coast Gold Fields Ltd* [1905] 1 Ch 597 , 602 (affirmed [1906] 1 Ch 1, and cited in para 20 above). Payment of the call is a condition precedent to the shareholder's participation in any distribution, and again the shareholder is to that extent disadvantaged."[3]

(2) The decision which established this principle was **In re Overend, Gurney and Co v Grissell's Case** (1865-66) LR 1 Ch App 528 [Auths/1A/6]. Mr G was a holder of 80 shares in the company of £50 each, on each of which shares £15 had been paid up. He was a creditor of the company for £16,000 lent to the company on deposit with interest. A resolution was passed for the voluntary winding-up of the company and an order was made for continuing it under the supervision of the Court. The liquidators had made a call of £10 per share and at the time of the application it was expected that they would shortly be able to pay a dividend of 4s. or 5s. in the £ on the debts of the company. They informed Mr G that they should refuse to pay the creditors who were shareholders any dividend on their debts until the other creditors had all been paid in full. Two applications were made, and Lord Chelmsford LC summarised them at 533-534 as follows: *"in the first it was asked that the dividend might be paid upon the balance after deducting the call; and in the second, that the dividend might be calculated upon the entire debt due from the company, and then the amount of the call be deducted from the dividend."* At 534, Lord Chelmsford LC said that both applications "*may be regarded as raising the question whether a shareholder, who is also a creditor of a limited liability company, is entitled either to set-off, or to have credit for, so much of his debt as is equal to the amount of calls* ***which have been made upon****, but not paid by, him, and to receive a dividend for the balance*". Lord Chelmsford LC said that "*The question depends entirely upon the construction of the Companies Act, 1862*". His Lordship's reasoning was as follows:

a. S.133 of the 1862 Act provided that, in a winding up, *"the property of the company shall be applied in satisfaction of its liabilities pari passu, and subject thereto shall, unless it be otherwise provided by the regulations of the company, be distributed amongst the members according to their rights and*

33 The Judgment held that **In Re Auriferous Properties Ltd (No. 1)** [Auths/1A/29] was wrongly decided, and none of the parties has appealed this aspect of the Judgment.

interests in the company". It appeared to make no distinction between a creditor who is a member of the company and one who is not, and "*The Act would be a complete snare upon members of companies who are creditors if they were to be postponed to other creditors who are not members"*.

b. S.75 of the 1862 Act provided that the liability of any person to contribute to the assets of a company, in the event of its being wound up, "*shall be deemed to create a debt accruing due from such a person at the time when his liability commenced, but payable at the time or respective times when calls are made as hereinafter mentioned for enforcing such liability"* (c.f. s.80 of the Act). Lord Chelmsford LC noted that:

 > "The power to make calls is only to satisfy the debts and liabilities of the company, and the costs, charges, and expenses of winding it up, and for the adjustment of the rights of the contributories amongst themselves. But if the whole of the amount unpaid upon the shares were required to be paid up, more might be raised than would be requisite for these purposes, and it might be that a contributory thus paying in advance might lose all that he had so paid in the event of any of his co-contributories becoming insolvent."

c. The amount of the call not paid could not be set-off against the debt, because "*if a debt due from the company to one of its members should happen to be exactly equal to the call made upon him, he would in this way be paid twenty shillings in the pound upon his debt, while the other creditors might, perhaps receive a small dividend, or even nothing at all"*.

d. Because the amount of an unpaid call could not be satisfied by a set-off of an equivalent portion of debt due to the member, it followed that:

 > "the amount of such call must be paid before there can be any right to receive a dividend with the other creditors. The amount of the call being paid, the member of the company stands exactly on the footing of the other creditors with respect to a dividend upon the debt due to him from the company. The dividend will be of course upon the whole debt, and the member of the company will from time to time, when dividends are declared, receive them in like manner **when either no call has been made**, or, having been made, when he has paid the amount of it."

It is clear from this that the member **can** receive dividends from the company when no call has been made. Thus LBIE is wrong to argue (at paras 58-59 of its skeleton [A/9/80-81]) that the contributory rule can be relied upon between

the commencement of a liquidation and the making of any call.

(3) Each of the decisions referenced in **Re Kaupthing** in which the contributory rule has been applied involved the situation where the company was already in liquidation and a call had been made on the contributory. In **In Re West Coast Gold Fields Ltd** [1905] 1 Ch 597 [Auths/1A/33], Buckley J (at 600) summarised **Grissell's Case** as deciding:

> "that where a person is both a creditor of and a shareholder in a company, his shares being partly paid up, he must satisfy all his obligations as a shareholder and contributory, by paying into the common fund all sums **due from him in respect of calls**, before he can say, "As a creditor I am entitled to take something out of the common fund." There can be no set-off; the man must pay in before he can be heard to say that he can take out."

(4) The justification for this principle was explained by Lord Chelmsford LC in **Grissell's Case** at 536:

> "Taking the Act as a whole, the call is to come into the assets of the company, to be applied with the other assets in payment of debts. To allow a set-off against the call would be contrary to the whole scope of the Act. In support of this view it will be sufficient to refer again to the 133rd section as to the satisfaction of the liabilities of the company pari passu. And the argument against the allowance of a set-off addressed to the Court on behalf of the official liquidators, is extremely strong – that if a debt due from the company to one of its members should happen to be exactly equal to the call made upon him, he wold in this way be paid 20 shillings in the pound upon his debt, while the other creditors might, perhaps, receive a small dividend, or even nothing at all."

(5) Thus the policy behind this line of case law is that, if a contributory were to set off calls against a debt owed to him by the company, he would be paid his claim in full out of the proceeds of calls, which ought to be distributed rateably to the company's creditors (including the contributory). The Judge was correct to hold (at [182] [C/4/79]) that the contributory rule "*is a rule dictated by the nature and the purpose of the obligation imposed on contributories by the legislation in a winding up*".

(6) It does not follow from this line of case-law that, before an unlimited company is wound up, a member of the company cannot prove, or cannot receive distributions, in its administration for an independent debt owed to it by the company, when the

company is making distributions to its other unsecured creditors.

(7) The Judge was correct to hold that the contributory rule can have no application in LBIE's administration so as to permit the LBIE Joint Administrators to refuse to admit a proof of debt by the members or 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 s.74(1).

(8) In particular, under the express terms of s.74(1), it is only "*When a company is wound up*" that "*every present and past member is liable to contribute…*".[4] It is a key and unique feature of a **liquidation** that calls can be made on contributories. The provisions relating to the liability to contribute under s.74(1) are also expressly limited to the winding up: see e.g. s.148(1) (settling a list of contributories), s.149(1) (ordering a contributory to pay); s.150(1) (making calls), s.s160(1)(b) and (d), s.165(2), 4(a) and (b), and Rules 4.195-4.205 (delegation of court's power in relation to calls to the liquidator). In light of these provisions, the Judge was correct to conclude that there is a fundamental difficulty with 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] [C/4/80]). As the Judge said (at [188]):

> "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….In my judgment, if it was contemplated or intended that the contributory rule should apply in a distributing administration, either administrators would have been given the same power to make calls as liquidators or provisions of the sort just mentioned would have been spelt out

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[4] Also:

(1) Under s.79(1), a "*contributory*" is defined as:

> "every person liable to contribute to the assets of a company **in the event of its being wound up**, and for the purposes of all proceedings for determining, and all proceedings prior to the final determination of, the persons who are deemed contributories, including any person alleged to be a contributory".

(2) S.80 provides:

> "The liability of a contributory creates a debt …accruing due from him at the time when his liability commenced, but **payable at the times when calls are made for enforcing the liability**."

in the legislation."

(9) Neither of LBIE's suggested answers to this fundamental difficulty is satisfactory.

a. At para 54 of its skeleton [A/9/78], LBIE says administrators have wide powers of compromise in para 60 of Schedule B1 and para 18 of Schedule 1 of the Act. The list of administrators' powers do not include the express power given to liquidators to compromise "*all calls and liabilities to calls*", and to "*take any security for the discharge of any such call, debt, liability or claim and give a complete discharge in respect of it*" (Schedule 4 para 3), which is unsurprising since administrators do not have the power to make calls. LBIE says "*there is no reason why [the Members] could not agree to contribute to the extent of their contingent liability, which would then justify the Administrators in agreeing to admit those claims*". However, it is difficult to see on what basis the LBL Joint Administrators– who owe duties to LBL's creditors – could agree to make a payment to LBIE by way of compromise with LBIE's administrators, in circumstances where there may be a subsequent liquidation of LBIE and only LBIE's liquidators (if appointed) would have the power to make calls on the members and only LBIE's liquidators are expressly given the power to give a complete discharge in respect of a liability for calls.

b. The second suggested answer (at paras 55-56 [A/9/78-79]) is difficult to discern. It appears to be based on the dictum of Lord Walker in **Re Kaupthing** [Auths/1C/89] at [53] that members of a company "*must stand in the queue behind its creditors*". But s.74(2)(f) of the Act only subordinates to the claims of other creditors sums due to any member of a company in his character of a member (e.g. by way of dividends), and not generally. In **Soden v British & Commonwealth Holdings plc** [1998] AC 298, 322,326, [Auths/1B/68] Lord Browne-Wilkinson explained that sums due to a member "*in his character as a member*" means sums falling due under and by virtue of the statutory contract between members and the company and the members *inter se,* with the "*statutory contract*" being defined as the bundle of rights and liabilities created by the company's

memorandum and articles together with the rights and obligations of members conferred and imposed on members by the Companies Acts. Lord Browne-Wilkinson said at 324:

> "Moreover, the construction of the section which I favour accords with principle. **The principle is not "members come last:" a member having a cause of action independent of the statutory contract is in no worse a position than any other creditor. The relevant principle is that the rights of members as members come last, i.e. rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights of creditors based on other legal causes of action. The rationale of the section is to ensure that the rights of members as such do not compete with the rights of the general body of creditors.**"

Lord Chelmsford LC's judgment in **Grissell's Case** also explained: "*The Act would be a complete snare upon members of companies who are creditors if they were to be postponed to other creditors who are not members.*"[5] Reference is further made to paragraph 23 below.

(11) LBIE says at para 51 of its skeleton [A/9/78]: "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". But contributions from the members will never be part of the fund which will be available to pay creditors' debts in LBIE's administration, because no calls can be made on the members in LBIE's administration.

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[5] Further:

(1) Rule 2.69 (in the context of administration) provides:

> "Debts other than preferential debts rank equally between themselves in the administration and, after the preferential debts, shall be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves".

(2) Rule 12.3 provides:

> "(1) Subject as follows, in administration, winding up and bankruptcy, all claims by creditors are provable as debts against the company or, as the case may be, the bankrupt, whether they are present or future, certain or contingent, ascertained or sounding only in damages."

(3) Rule 12.3(2)(b) provides that certain specified matters are not provable in administration, winding up or bankruptcy. Rule 12.3(2A) provides that certain claims are not provable "*except at a time when all other claims of creditors in the insolvency proceedings (other than any of a kind mentioned in this paragraph) have been paid in full with interest under section 189(2), Rule 2.88 or, as the case may be, section 328(4)*". Sub-para (c) of that section refers to "*in an administration or a winding up, any claim which by virtue of the Act or any other enactment is a claim the payment of which in a bankruptcy, an administration or a winding up is to be postponed*".

(4) Nothing in the Act, the Rules, or any other enactment states that members' claims against a company in administration (or liquidation) are not provable or are to be postponed (other than s.74(2)(f), in the context of a claim by a member in its character as a member). Accordingly, claims by members which are not made in their character as members are provable and are not to be postponed or subordinated in any way to the claims of other unsecured creditors.

(12) Accordingly, the contributory rule can have no application in LBIE's administration.

18. As for the rule in **Cherry v Boultbee**:

(1) This too was considered by the Supreme Court in **Re Kaupthing** [Auths/1C/89]. At [13], Lord Walker referred to the description of the rule by Kekewich J in **In re Akerman** [1891] 3 Ch 212, 219 [Auths/1A/26] as follows:

> "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 ..."

(2) In **Re Kaupthing** [Auths/1C/89], Lord Walker said, at [8]:

> "The expression "the rule in Cherry v Boultbee" suggests a technical rule of some complexity. Any such impression would be misleading. It is basically a simple technique of netting-off reciprocal monetary obligations, even where there is no room for legal set-off, developed and used by masters in the Court of Chancery in giving directions for the administration of the estates of deceased persons. Complication arises only in a situation of insolvency, where the equitable rule produces a different outcome from that produced by statutory set-off: see para 43 below."

(3) The justification for the rule was described by Sargant J in **Re Peruvian Railway Construction Co Ltd** [1915] 2 Ch 144, 150 [Auths/1A/37] as being: *"where a person entitled to participate in a fund is also* ***bound*** *to make a contribution in aid of that fund, he cannot be allowed so to participate unless and until he has fulfilled his duty to contribute"*. Derham analyses the rule as *"an illustration of a more fundamental principle of equity, that he who seeks equity must do equity"* (Derham on the Law of Set-Off (4th edn., 2010) at [14.01]) [Auths/2/5]. These justifications can have no application where there is no present duty to contribute or no equity to be done.

(4) The Judge was correct to conclude at [193] [C/4/83] that *"It is well-established that*

the rule [in Cherry v Boultbee] *does not apply where the debt to the estate is not presently payable even if it is a future debt that will become payable"*:

a. In **Re Abrahams** [1908] 2 Ch 69 [Auths/1A/35] (stated to be correct by Lord Walker in **Kaupthing** at [45] [Auths/1C/89]), at the death of a testator a debt was owing to him by a person to whom a share of residue was immediately given by the will, but the debt was payable in instalments. It was held that the executors were not entitled to retain the share of the beneficiary as against future instalments of the debt that may become due, but were bound to pay it to the beneficiary without reference to such instalments. Warrington J applied the earlier case of **Re Rees** (1889) 60 LT 260 [Auths/1A/23].

b. Wood, *"English and International Set-Off"* (1989) [Auths/2/3] states at [8-93]: *"The administrator of a fund may not retain a share of a fund against a contribution if the share is presently payable but the contribution is payable in the future"*, explaining in the following paragraph that *"This accords with the principle that a creditor may not exercise a lien or other security interest for a debt not yet due and payable"*.

c. In **Jeffryes v Agra and Masterman's Bank** (1866) LR 2 Eq 674, 680, [Auths/1A/5] Sir W Page Wood VC said *"you cannot retain a sum of money which is actually due against a sum of money which is only becoming due at a future time"*.

d. In relation to contingent claims, in **Re SSSL** [2006] Ch 610 [Auths/1C/80], Chadwick LJ said at [79] that the following propositions could be derived from the judgments in **In Re Melton** [1918] 1 Ch 37 [Auths/1A/38]:

> "(1) The general rule applicable in the distribution of a fund is that a person cannot take an aliquot share out of the fund unless he first brings into the fund what he owes. ….
> (2) **That general rule is applicable not only where the claimant (X) is indebted to the fund but also where the fund has a right to be indemnified by X against a liability which the fund may be required to meet in the future, as surety for a debt owed by X to a creditor** (Y). It is not necessary that the liability to Y has been satisfied out of the fund: it is enough that it may have to be satisfied in the future."

e. However, in relation to this passage of Chadwick LJ's judgment, in **Re Kaupthing** [Auths/1C/89], Lord Walker said at [45]:

> "The first principle that Chadwick LJ extracted from *In re Melton* [1918] 1 Ch 37 is the equitable rule itself, which he set out as a mathematical formula. **The second principle is that the rule extends to cases where the fund has a right to be indemnified by the claimant against a liability which the fund may be required to meet in the future. That proposition seems to be too widely stated.** In the passage quoted from the judgment of Warrington LJ in *In re Melton*, at p 55, "that time" refers to the death of Richard Melton in 1907. His settled estate did not become distributable until his widow's death in 1916, and by then there was an immediate right to an indemnity for the £313 paid by the estate. The judgment of Warrington J in *In re Abrahams* [1908] 2 Ch 69, 73, states the correct rule:
> 'the debt due to the testator is one which is **not immediately payable**, whereas the right of the debtor to receive the residuary share is an immediate right. I think, therefore, that **the debtor is entitled to receive that share** ...'
> Chadwick LJ also relied on Warrington LJ's comments on *In re Binns* [1896] 2 Ch 584. But (as already noted) the facts of *In re Binns* were not identical, or even similar, to those of In re Melton."

f. LBIE accepts 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 to the fund*" [A/9/82]. It suggests that **Re Rhodesia Goldfields Ltd** [1901] 1 Ch 239 [Auths/1A/36] is an exception to this.

g. But in that case, as the Judge correctly concluded, 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. Para 64 of LBIE's skeleton [A/9/83] provides: "*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*". This is fallacious. S.80 provides that the liability of a contributory under s.74 creates a debt "*payable at the times when calls are made for enforcing the liability*". There is no presently payable debt before calls are made.[6]

[6] Para 65 of LBIE's skeleton [A/9/83] provides: "*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*

(5) Accordingly, the rule in **Cherry v Boultbee** does not apply in LBIE's administration as alleged by LBIE.

19. Further:

(1) The contributory rule precludes a set-off as between the liability for calls and claims of the contributories against the company.

(2) The rule in **Cherry v Boultbee** cannot apply where set-off applies.

a. Lord Walker in **Re Kaupthing** [Auths/1C/89] referred at [53] to the equitable rule being said to *"fill the gap left by disapplication of set-off"*.

b. In **MK Airlines Ltd v Katz** [2013] Bus LR 243 [Auths/1C/92], Nicholas Strauss QC (sitting as a deputy) explained at [69]:

> "...one of the conditions for the application of the rule in **Cherry v Boultbee** is precisely that there should be no right of set-off. The rule is stated in **Wood on English and International Set-off** (1989), p.396, para 8-1 as follows:
>
> > '(1) Where a person is liable to contribute to a fund which is not a legal entity, such as an insolvent's estate, a deceased's estate or a trust fund, and is entitled to a share of the fund as beneficiary or creditor in circumstances **where there is no set-off of the face amounts of the contribution and the share,** then in certain cases the administrator of the fund may retain the contributor's share to cover the unpaid contribution...' (My emphasis.)
>
> At para 8-4, it is stated that, where there is a right of set-off, there is no room for the rule in **Cherry v Boultbee** to apply. It operates most often where the claim is on a trust fund, which has no legal personality, so that set-off is unavailable."

c. The Judgment explains at [183] [C/4/79] that the rule:

> "produces a netting-off effect that is similar to set-off and applies in circumstances where set-off itself is not applicable, because there is not the necessary similarity in claims. The rule applies to net off a

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the company may prove in the member's insolvency, irrespective of whether a call has yet been made by the company, or indeed whether the company is yet in liquidation".
This is equally fallacious. The fact it may be possible to prove for a contingent future debt does not mean the debt is presently payable.

person's claim as a beneficiary of an estate against the estate's claim against him as a debtor".

20. The Judge held that there is insolvency set-off in LBIE's administration as between the members' (contingent) liability to contribute under s.74(1) and their unsecured unsubordinated claims against LBIE. In those circumstances, neither the contributory rule nor the rule in **Cherry v Boultbee** can apply.

21. Further, as set out in LBHI2 Respondent's Notice, if the contributory rule and/or the equitable rule apply in LBIE's administration, LBIE's contention in its ground of appeal that one or both of these rules would "*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 the member will or might become liable to calls under section 74(1)*" [A/5/44] is wrong, because: (a) neither the contributory rule nor the equitable rule prohibit proof; (b) the consequences of the rules applying would be that LBL's entitlement to a distribution would be calculated by ascertaining what it would have been if LBL had paid its contribution to the fund and then deducting its contribution from that notional share. See in particular Buckley J in **Re Leeds and Hanley Theatre of Varieties (No. 2)** [1904] 2 Ch 45, 51, [Auths/1A/31] Chadwick LJ in **Re SSSL** [Auths/1C/80] at [79(1)] and Lord Walker in **Re Kaupthing** [Auths/1C/89] at [43]. This approach is consistent with the principle that a person should not be ordered to pay that part of a liability which would come back to him on a distribution.[7]

Conclusion

22. For the reasons set out above, the Court is respectfully invited to dismiss LBIE's appeal.

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1 August 2014

[7] See **Re VGM Holdings Ltd** [1942] 1 Ch 235, 241 [Auths/1A/42]; **Selangor United Rubber Estates ltd v Craddock (No. 4)** [1969] 1 WLR 1773 [Auths/1B/51], in particular at 1779.