

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

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

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

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

Applicants

-AND-

(1) LEHMAN BROTHERS HOLDINGS, INC

(2) LYDIAN OVERSEAS PARTNERS MASTER FUND LIMITED

Respondents

POSITION PAPER ON BEHALF OF THE SECOND RESPONDENT

This position paper is filed on behalf of Lydian Overseas Partners Master Fund Limited (“Lydian”). The cross-references are to the paragraph numbers of the Amended Application.

- 1. Are the members of LBIE (being LBHI2 and LBL) (together the “Members”) entitled to prove in LBIE’s administration in respect of sums owed by LBIE to the Members (other than in respect of sums owed to LBHI2 pursuant to three subordinated loan agreements entered into on 1 November 2006 between LBHI2 (as lender) and LBIE (as borrower) (the “LBHI2***

Subordinated Debt” notwithstanding that LBIE is an unlimited company and, in the event of LBIE being wound up, one or both of the Members may be called upon to contribute, pursuant to Section 74 of the Act, to LBIE’s assets an amount sufficient for payment of LBIE’s debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories amongst themselves (hereinafter defined in respect of each member as the “Potential Liability as Contributory”)? In particular, what (if any) is the effect of Section 74(2)(f) of the Act on each of the Members’ Potential Liability as Contributory?

- 1.1 Lydian relies on the principle that a contributory is not entitled to recover anything in respect of any amount due to it from the company unless and until it has paid everything which it owes to the company (the “Contributory Rule”): see, e.g. *Kaupthing Singer and Friedlander Ltd (in administration)* [2011] UKSC 48, at [51]-[53].
- 1.2 The Contributory Rule applies equally whether the company is in liquidation or in a distributive administration.
- 1.3 In the present case, the Contributory Rule applies so as to prevent the Members (LBHI2 and LBL) from proving in LBIE’s administration (or liquidation), alternatively from receiving any dividend in LBIE’s administration (or liquidation), unless and until they have discharged in full their Potential Liability as Contributory (which represents a contingent liability owed by the Member to LBIE).
- 1.4 The Members’ Potential Liability as Contributory extends to an amount sufficient to enable payment of the expenses of the administration (and/or liquidation), all proved debts, statutory interest on all proved debts, and all non-provable liabilities of LBIE including its liability in respect of the Currency Conversion Claim.
- 1.5 It is Lydian’s understanding that the sums owed by LBIE to the Members are unsecured debts arising from contracts unconnected to the Members’ status as members of LBIE. If correct, then Lydian does not contend that the sums owed by LBIE to the Members would fall within section 74(2)(f) of the Act: see *Soden v British and Commonwealth Holdings* [1998] AC 298.
2. *If LBIE were wound-up, would the Members be entitled to prove in LBIE’s liquidation in respect of sums owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt). In particular, to what extent would the Members’ ability to prove in a winding-up of LBIE be affected by: (i) each of the Members’ Potential Liability as Contributory; and (ii) Section 74(2)(f) of the Act?*

2.1 See response to Paragraph 1 above.

3. *Is LBHI2 entitled to prove in LBIE’s administration, or would LBHI2 be entitled to prove in any subsequent liquidation of LBIE, in respect of the LBHI2 Subordinated Debt notwithstanding: (i) the terms of the LBHI2 Subordinated Debt; and (ii) LBHI2’s Potential Liability as Contributory? What (if any) is the effect of Section 74(2)(f) of the Act?*

3.1 **Paragraph 3(i):** the standard terms of the LBHI2 Subordinated Debt (the “Terms”), on their true construction, preclude LBHI2 from proving in LBIE’s administration or any subsequent liquidation in respect of the LBHI2 Subordinated Debt until such time as all other liabilities of LBIE have been discharged in full, including expenses, all proved debts, statutory interest on all proved debts, and any and all non-provable liabilities of LBIE including the Currency Conversion Claim. In summary:

- (a) Clause 5(1) of the Terms provides that the LBHI2 Subordinated Debt is subordinated to the Senior Liabilities;
- (b) The commercial purpose of the LBHI2 Subordinated Debt was to provide funding to LBIE by way of regulatory capital;
- (c) Senior Liabilities is defined as meaning “all Liabilities except the Subordinated Liabilities and Excluded Liabilities”;
- (d) Liabilities is defined as “all present and future sums, liabilities and obligations payable or owing by the Borrower (whether actual or contingent, jointly or severally or otherwise howsoever)”; Subordinated Liabilities is defined as “all Liabilities to the Lender in respect of each Advance made under this Agreement and all interest payable thereon”; Excluded Liabilities is defined as “Liabilities which are expressed to be and, in the opinion of the Insolvency Officer of the Borrower, do, rank junior to the Subordinated Liabilities in any Insolvency of the Borrower”;
- (e) Statutory interest on all proved debts and the Currency Conversion Claim fall within the definition of Liabilities, and do not fall within the definition of Subordinated Liabilities or Excluded Liabilities;
- (f) Clause 5(1)(b) of the Terms provides that payment of any amount of the Subordinated Debt is conditional upon LBIE being solvent “at the time of, and immediately after, the payment by [LBIE] and accordingly no such amount which would otherwise fall due for

payment shall be payable except to the extent that [LBIE] could make such payment and still be “solvent”;

(g) Pursuant to clause 5(2), LBIE is solvent only if it is “able to pay its Liabilities (other than the Subordinated Liabilities) in full, disregarding (a) obligations which are not payable or capable of being established or determined in the Insolvency of [LBIE], and (b) the Excluded Liabilities”;

(h) Neither statutory interest on all proved debts, nor the Currency Conversion Claim falls to be disregarded under clause 5(2).

3.2 Alternatively, for the reasons set out in paragraph 3.1 above, even if the Terms do not prevent LBHI2 from submitting a proof in LBIE’s administration or any subsequent liquidation in respect of the LBHI2 Subordinated Debt, the Terms in any event preclude LBHI2 from receiving any distribution in respect of the LBHI2 Subordinated Debt until such time as all other liabilities of LBIE, including statutory interest on all proved debts and the Currency Conversion Claim, have been paid in full.

3.3 **Paragraph 3(ii):** see the response to paragraph 1 above. The Contributory Rule applies equally to the LBHI2 Subordinated Debt.

3.4 Lydian does not contend that the LBHI2 Subordinated Debt would fall within section 74(2)(f) of the Act.

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

4.1 As noted above in the response to Paragraphs 1 to 3 the Members are precluded by the Contributory Rule from proving, alternatively from receiving any distribution, in the administration or a subsequent liquidation of LBIE until they have paid everything that they owe as a contributory (including an amount sufficient to enable LBIE to pay statutory interest on all proved debts and the Currency Conversion Claim).

4.2 It follows that the Members do not have any entitlement to deduct from, or credit against, their Potential Liability as Contributory any amount owed by LBIE to the Members (whether in

respect of the LBHI2 Subordinated Debt or otherwise), whether by set-off, pursuant to the rule in *Cherry v Boulton* or otherwise.

4.3 LBHI2 (even if it is entitled to prove in respect of the LBHI Subordinated Debt) is precluded by the Terms from receiving any distribution in respect of the LBHI2 Subordinated Debt until all liabilities of LBIE (including statutory interest on all proved debts and the Currency Conversion Claim) have been paid. Accordingly, it is unable to deduct from, or credit against, its Potential Liability as Contributory any amount owed by LBIE to the Members, whether by set-off, pursuant to the rule in *Cherry v Boulton* or otherwise.

4.4 If, contrary to the answers given above in respect of Paragraphs 1 to 4, the Members are entitled to prove, alternatively to receive a distribution, in the administration and/or liquidation of LBIE, then credit is required to be given, against the proof that leads to such distribution, in respect of each of the Members' Potential Liability as a Contributory pursuant to the rule in *Cherry v Boulton*, alternatively set-off.

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

5.1 LBIE is entitled to prove in the administrations (and any subsequent liquidations) of the Members in respect of the Members' Potential Liability as Contributory. The Members' Potential Liability as Contributory constitutes a liability to which the Members may become subject after going into administration by reason of any obligation incurred before that date (when becoming a member of LBIE) and is thus a provable debt.

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

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

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

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

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

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

(a) ***the LBHI2 Subordinated Debt; and/or***

(b) the Members' respective non-subordinated debt claims?

6.1 By reason of the Contributory Rule, the Members will not be able to exercise any right of set-off or deduction against the LBIE's Claim (whether by means of insolvency set-off or otherwise).

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

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

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

7.1 Section 149(1) of the Act provides a summary remedy for recovering debts due from a member to a company, other than any sum owed in respect of a call, which is governed by section 150.

7.2 The Members' Potential Liability as Contributory is a claim in respect of a call within section 150.

7.3 Accordingly, section 149(2)(a) (which applies only to claims made under section 149(1)) does not create any right of set-off between the Members' Potential Liability as Contributory and the amounts owed by LBIE to the Members.

7.4 Section 149(3) of the Act, which does apply to claims in respect of a call, would apply, so as to create a right of set-off between the Members' Potential Liability as Contributory and any amounts owed by LBIE to the Members, but only following payment by LBIE of all claims of its creditors, including statutory interest on all proved debts and the Currency Conversion Claim (i.e. it creates a right of set-off where the call is to effect an adjustment of the rights of contributories amongst themselves).

8. To the extent that LBIE is entitled to prove in respect of it, or it is required to be brought into the account on any proof which either of the Members is entitled to file in LBIE's administration or a subsequent liquidation, in circumstances in which each Member's Potential Liability as Contributory is contingent, is that Member's Potential Liability as Contributory capable of being ascertained and quantified and, if so, how should the quantum of that Member's Potential Liability as Contributory be quantified?

8.1 LBIE's claim is capable of being ascertained and quantified.

8.2 The quantum of LBIE's Claim is the amount required to enable payment in full (after taking account of the assets of LBIE available for distribution) of the expenses, all proved debts, statutory interest on all proved debts, and all non-provable liabilities of LBIE (including its liability in respect of the Currency Conversion Claim).

9. ***Whether, and in what circumstances each of the Member's Potential Liability as Contributory extends to contributing to LBIE's assets an amount sufficient for payment of:***

- (a) *interest provable and/or payable pursuant to Rule 2.88 of the Rules on the principal of the debts and liabilities owed to LBIE's creditors by LBIE; and/or*
- (b) *the LBHI2 Subordinated Debt; and*
- (c) *Currency Conversion Claims (as defined at paragraph 12 below), to the extent that paragraph 12 is answered in the affirmative.*

9.1 The Members' Potential Liability as Contributory extends to contributing to LBIE's assets an amount sufficient for payment of the each of the items identified in paragraphs 9(a) to 9(c). Lydian adopts the analysis contained in the response to Question 9 set out in LBIE's position paper.

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

- (a) *whether their obligations are joint, several or otherwise as against LBIE;*
- (b) *whether they are entitled to seek a contribution or indemnity from one another in respect of any payments made pursuant to any such obligation and, if so, the nature and extent of such right of contribution or indemnity;*
- (c) *to what extent any right to contribution or indemnity as referred to in sub-paragraph (b) above is affected by any other claims which LBHI2 and LBL have against one another.*

10.1 The liability of LBL and LBHI2 is joint and several.

11. ***In the event that there are sufficient funds in LBIE's administration to permit the LBIE Joint Administrators to make payment in full to LBIE's general, unsecured creditors in respect of***

the principal of the debts and liabilities owed to them by LBIE, in what order would the LBIE Joint Administrators be required to apply any surplus in discharging the following:

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

(b) Currency Conversion Claims (as defined at paragraph 12 below), to the extent that paragraph 12 is answered in the affirmative;

(c) to the extent that the Members have been unable to prove in respect of them, debts owed by LBIE to the Members (other than in respect of the LBHI2 Subordinated Debt); and

(d) to the extent that LBHI2 has been unable to prove in respect of it, the LBHI2 Subordinated Debt.

11.1 The LBIE Joint Administrators would be required to apply any surplus in the following order:

(a) first to discharge in full statutory interest payable pursuant to rule 2.88(7) of the Rules;

(b) second, to discharge the Currency Conversion Claim;

(c) third, the Members (Lydian does not take a position on whether the LBHI2 Subordinated Debt is at this stage subordinated to the other amounts due to Members).

11.2 So far as the liability to apply the surplus in discharge of statutory interest is concerned, this is payable in priority to any amount being paid to the Members because (a) in relation to the LBHI2 Subordinated Debt, this is required by the subordination provisions in the Terms (see paragraphs 3.1 and 3.2 above); and (b) in relation to LBHI2 and LBL, this is required by the Contributory Rule (see paragraphs 1.1 to 1.4 above).

11.3 So far as the liability to apply the surplus in discharge of the Currency Conversion Claim is concerned, this is payable after payment of statutory interest by reason of the terms of Rule 2.88(7), but in priority to any amount being paid to the Members for the same reasons referred to in paragraph 11.2 above.

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

(i) all creditors’ proved debts; and

(ii) interest on such debts in respect of periods during which they have been outstanding since LBIE entered administration pursuant to Rule 2.88(7) of the Rules,

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

- 12.1 An unsecured creditor is entitled to payment from LBIE in respect of a Currency Conversion Claim once the provable debts (other than, to the extent they may be provable, debts of the Members who have yet to contribute amounts owed by them pursuant to their Potential Liability as Contributory, or the LBHI2 Subordinated Debt, the terms of which preclude LBHI2 receiving a distribution until payment in full of the Currency Conversion Claim) and statutory interest thereon have been paid by LBIE.
- 12.2 The Currency Conversion Claim is not a provable debt, as a result of the provisions in rules 2.86 (administration) and 4.91 (liquidation).
- 12.3 The statutory scheme of the Act and the Rules does not, however, effect a discharge, variation or release of the contractual liability of LBIE in respect of a Currency Conversion Claim. The company (LBIE) accordingly remains liable in respect of the Currency Conversion Claim such that, once all provable debts (other than, to the extent they may be provable, debts of the Members who have yet to contribute amounts owed by them pursuant to their Potential Liability as Contributory, or the LBHI2 Subordinated Debt) and statutory interest thereon have been paid by LBIE, the Currency Conversion Claim becomes entitled to payment by LBIE: see the dictum of Brightman LJ in *Re Lines Bros* [1983] 1 Ch 1, at 21F.
- 12.4 The Currency Conversion Claim is accordingly an example of a non-provable liability which must be discharged before any distributions are made to the Members.

ANTONY ZACAROLI QC
DAVID ALLISON

South Square
3-4 South Square
Gray's Inn

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