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

<u>IN THE HIGH COURT OF JUSTICE</u>

<u>CHANCERY DIVISION</u>

<u>COMPANIES COURT</u>

The Honourable Mr Justice David Richards

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)

<u>Applicants</u>

-AND-

(1) LEHMAN BROTHERS HOLDINGS, INC
(2) LYDIAN OVERSEAS PARTNERS MASTER FUND LIMITED

<u>Respondents</u>

SKELETON ARGUMENT ON BEHALF OF THE SECOND RESPONDENT

INTRODUCTION

1. At the heart of this application is the question of priority between (1) debts owed to members of LBIE and (2) amounts due to independent creditors of LBIE in respect of (a) statutory interest and (b) claims by creditors with a contractual entitlement to be paid in a currency other than sterling, that suffer a shortfall (measured in that other currency) upon payment in full, in sterling, of their proof (a "Currency Conversion Claim").

2. The independent creditors succeed on one or both of two bases:

   (1) first, because the subordinated claims of LBHI2 are contractually subordinated to the claims of independent creditors. This raises an issue of interpretation in respect of the subordinated facility agreements between LBIE and LBHI2.

   (2) second, because of the operation of the equitable rule which precludes a member from proving or from receiving any amount due to it (whether in its capacity as member or creditor) until such time as it has contributed all amounts owing by it, qua member, to the insolvent estate (the "Contributory Rule"). This raises issues as to (a) the extent and scope of the members' obligation to contribute; (b) the application of the Contributory Rule in the context of a distributing administration.

3. Lydian's position is aligned with that of LBIE. Lydian's legal advisors have, in accordance with submissions made by Lydian at Lydian's application for joinder in March 2013, liaised with the legal advisors to LBIE, with a view to minimising duplication of written or oral submissions.

4. To that end, Lydian focuses in this skeleton primarily on the issues as they relate to the Currency Conversion Claims, otherwise adopting generally the arguments developed in LBIE's written submissions.

CURRENCY CONVERSION CLAIMS

5. So far as the Currency Conversion Claims are concerned, Lydian's submissions are grouped under the following headings:

    (1) the existence of the Currency Conversion Claims;

    (2) the existence and ranking of non-provable liabilities generally;

    (3) priority as between the Currency Conversion Claims and debts owed to the members of LBIE.

(1) The existence of Currency Conversion Claims

6. A Currency Conversion Claim is premised on the contractual right of a creditor, as against LBIE, to be paid a debt in a currency other than sterling.

7. Such a claim exists wherever the amount paid to the creditor, in sterling, on its proof in LBIE's insolvency, although equal to 100% of the creditor's proof, is – when converted into the relevant contractual currency upon the date it is paid – less than 100% of the full amount of the debt expressed in that contractual currency.

8. The basis for the claim is straightforward, and involves the following steps.

9. First, prior to LBIE's insolvency, the creditor was entitled to be paid in a foreign currency[1]. This carried with it the entitlement, if the debt were enforced by action, to obtain a judgment expressed in the foreign currency and to obtain execution against assets in England in a sum of sterling representing the judgment debt converted into sterling at the prevailing exchange rate on the date of execution: see *Miliangos v George Frank (Textiles) Ltd* [1976] AC 443.

[1] This will be a matter of construction of the relevant contract pursuant to which the claim arises.

10. Accordingly, any payment in sterling which, at the relevant exchange rate on the date it was paid, amounted to less than 100% of the amount of the debt expressed in that other currency, would leave a shortfall still owing to the creditor.

11. The underlying principle is 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* [1983] Ch 1, per Brightman LJ at 16D.

12. Second, the conversion of a foreign currency debt into sterling in the context of liquidation is solely for the purposes of proving: in an administration, IR 2.86(1) states that a foreign currency debt is to be converted into sterling "*for the purpose of proving...*" and the same expression appears in the context of liquidation in IR 4.91(1).

13. The function of the proof process is to arrive at a value for each creditor's debt so as to ensure that distribution of the insolvent estate is on a *pari passu* basis. The requirement to convert all claims into sterling as at the same date is fundamental to the *pari passu* principle. As Brightman LJ observed in *Re Lines Bros Ltd* [1983] Ch 1, at 16E-F, the reasoning behind the *Miliangos* decision "*has no role to play in the distribution of assets of an insolvent company. The sterling creditors are not in default vis a vis the foreign currency creditors. Therefore, there is no obvious reason why the risk of depreciation in the value of sterling pending distribution of the assets should be borne by the sterling creditors. The company is the wrongdoer towards both the sterling creditors and the foreign currency creditors. There is no particular reason, in the field of abstract justice, why the currency risk should be borne by one description of creditor rather than by another description of creditor when they are all directed to rank pari passu. They do not rank pari passu if the sterling creditors are required to underwrite the exchange rate of the pound for the benefit of the foreign currency creditors*."

14. Third, the process by which creditors prove their debts, and receive dividends in respect of their proofs, does not operate to discharge, vary or release the underlying contractual right of the creditor, save to the extent that payment in full in respect of the proof in fact exhausts the underlying contractual entitlement of the creditor: see

Wight v Eckhardt Marine GmbH [2004] 1 AC 147, per Lord Hoffmann at [26]-[27] ("*The winding up leaves the debts of the creditors untouched. It only affects the way in which they can be enforced*"); *Re Lines Bros Ltd* (above), per Brightman LJ at 21F.

15. In other words, LBIE's contractual obligation to pay a debt denominated in a foreign currency, in that foreign currency, subsists notwithstanding LBIE's administration (or liquidation), and notwithstanding the requirement to convert that debt for the purposes of proof and distribution of the estate among creditors. It is just that the foreign currency creditor is precluded from taking any action to enforce or recover its foreign currency debt in competition with other creditors, i.e. until all proved debts and statutory interest on such debts have been paid in full.

16. Fourth, if and when LBIE has paid in full all amounts proved against it, plus statutory interest down to the date of payment, the restriction on recovery by the foreign currency creditor of the full amount of its foreign currency debt falls away. LBIE is thereafter obliged to make payment of such amount as will ensure satisfaction of the full amount of foreign currency debts, before any surplus is returned to its members.

17. This conclusion follows from the fact that the rationale for preventing a foreign currency creditor from recovering in respect of any such shortfall ceases to apply once all proved debts have been satisfied in full. That rationale (as noted above) is that it is the company itself, and not its other (sterling) creditors who should bear the risk of a fall in the value of sterling. Once the interests of other creditors are removed from the equation, the principle underlying the *Miliangos* decision comes back into play: as between the foreign currency creditor and the company (and its members) it is the company (and its members) who should bear the risk of a fall in value of sterling.

18. In summary, the Currency Conversion Claim subsists, notwithstanding the conversion of the foreign currency debt into sterling for the purposes of proof, and the payment in full of a dividend on that sterling proof, as the Currency Conversion Claim is not itself a provable debt. The existence of such a claim was envisaged by Brightman LJ in *Lines Bros* (above) at 21F, as follows:

"*It may well be the duty of the liquidator, in the case of a wholly solvent liquidation, if a foreign currency creditor has been paid less than his full contractual foreign currency debt, to make good the shortfall before he pays anything to the shareholders. I do not say that this is necessarily the solution to the problem posed, but I have not heard any convincing objection to that solution.*"

See also, at 22B:

"*I do not think, therefore, that a foreign currency creditor can base a claim on the depreciation in the cross rate between sterling and the foreign currency until the liquidator has assets in his hands which will otherwise go to the shareholders. At that stage, but not earlier, as it seems to me, it would be entirely just to allow the foreign currency creditor to recover the same amount as he would have been able to recover if no liquidation had ever taken place.*"

(2) The existence and ranking of non-provable liabilities

19. The existence of a category of liabilities which are non-provable and which rank for payment following the discharge of provable debts and statutory interest, but prior to any sums being returnable to members, is clearly established by a substantial body of authority. To give three examples:

(1) In *Re Humber Ironworks & Shipbuilding Co* (1869) LR 4 Ch App 643, the Court of Appeal considered whether interest accruing after the commencement of the liquidation (i.e. non-provable interest) under a pre-liquidation contract needed to be discharged before any surplus was returned to the shareholders. Giffard LJ stated as follows (at 647):

"*I am of opinion that dividends ought to be paid on the debts as they stand at the date of the winding-up; for when the estate is insolvent this rule distributes the assets in the fairest way; and where the estate is solvent, it works with equal fairness, because, as soon as it is ascertained that there is a surplus, the creditor whose debt carries interest is remitted to his rights under his contract.*"

(2) In *Re T& N Ltd* [2006] 3 All ER 697, David Richards J considered that tort claimants who suffered actionable damage after the commencement of the winding-up did not have a provable claim in the liquidation, but that their claims would need to be met prior to any distribution to shareholders[2]. David Richards J stated as follows (at [107]):

> "*It would indeed be extraordinary if a company's assets could be, and were required to be, distributed to shareholders without paying tort claims which had accrued since the liquidation date, or other claims not provable in a liquidation, such as costs incurred in litigation against the company before the liquidation date but not then the subject of an order. In my judgment, this is not the position.*"

(3) In *Re Nortel GmbH* [2013] 3 WLR 504, the Supreme Court recognised that non-provable liabilities exist as a category of liabilities to be discharged after statutory interest, and before any surplus is returned to members: see [39] *per* Lord Neuberger P.

20. There is, accordingly, nothing novel in the fact that a foreign currency creditor should be barred from proving a Currency Conversion Claim, but may nevertheless still be entitled to pursue such a claim once all proved debts have been paid with statutory interest, before any surplus is returned to members.

(3) Priority as between the Currency Conversion Claim and debts due to the members

21. Lydian contends that the Currency Conversion Claims rank for payment ahead of any amounts due by way of debt from LBIE to LBHI2 and LBL, notwithstanding the basic rule that a Currency Conversion Claim cannot compete with the claims of other creditors.

22. As against LBHI2 there are two independent reasons for this conclusion: first, because LBHI2 has contractually subordinated its debt to all other liabilities of LBIE, including Currency Conversion Claims and, second, because of the operation of the

[2] This led to the revision of rule 13.12(2) of the Rules pursuant to rule 4 of the Insolvency (Amendment) Rules 2006 so as to make such claims provable.

Contributory Rule which precludes a member from recovering anything in respect of a debt owed to it by the company until it has discharged its obligation, in full, to contribute to the assets of the company.

23. As against LBL, only the second of these reasons applies, because LBL's debt is not subordinated.

24. LBIE, in its skeleton, addresses fully the contractual subordination arguments, and Lydian does not wish to add anything to those arguments.

25. In the following paragraphs, this skeleton addresses briefly:

(a) the nature of the Contributory Rule;

(b) the inclusion of Currency Conversion Claims within the scope of members' liability to contribute to the assets of the company; and

(c) the application of the Contributory Rule in the context of administration.

(a) The Contributory Rule

26. The existence of the Contributory Rule is clearly established by authority. It was recently expressed in *Re Kaupthing Singer & Friedlander (No.2)* [2012] 1 AC 804, per Lord Walker JSC at [52]-[53] as *"[the shareholder] can receive **nothing** until he has paid **everything** he owes as a contributory*", and "*payment of the call is a condition precedent to the shareholder's participation in any distribution*". It arises out of the rule in *Cherry v Boultbee* which may be summarised as follows[3]:

> *"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*

3 By Kekewich J in *In re Akerman* [1891] 3 Ch 212, at 219, cited with approval by Lord Walker JSC in *Kaupthing Singer & Friedlander* (above) at [13].

> *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 …"*

27. It differs from, and goes further than, the rule in *Cherry v Boultbee*, however, in that it precludes any off-set between the member's obligation to contribute and the debt owed to the member. As Lord Walker JSC put it in *Kaupthing Singer & Friedlander* (above, at [53]):

> *"it produces a similar netting-off effect except where some cogent principle of law requires one claim to be given strict priority to another.* ***The principle that a company's contributories must stand in the queue behind its creditors is one such principle."***

28. Thus, the Contributory Rule is underpinned by the basic principle of company law that shareholders are liable (to the extent of any limit on their liability, if applicable) to contribute to the capital of the company for the purpose of payment of its debts and liabilities. Whereas the rule in *Cherry v Boultbee* relates more generally to the circumstance that a beneficiary of a fund owes a debt *to* the fund, the Contributory Rule relates to the circumstance that the shareholder, as the person liable to contribute to the fund, is obliged to do so on terms that require its claims to be repaid last, after all the company's debts have been paid.

29. In the case of a limited company, that basic principle would be turned on its head if a shareholder was permitted to offset a debt owed to it against its liability to contribute to the assets: see *Grissell's Case* (1866) LR 1 Ch 528, at 536 per Lord Chelmsford LC:

> "*taking the [Companies Act 1862] 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 … 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".

30. It is true that in *Grissell's Case*, the case of an unlimited company was distinguished, as to set-off, on the basis that since a member in an unlimited company was liable to contribute any amount until all the liabilities of the company were satisfied, so that it "*signifies nothing to the creditors whether a set-off is allowed or not*"[4]. LBIE's written submissions explain that, on the true construction of s.149 IA 1986, there is no set-off against a member's liability in respect of a call made during the winding-up. In practice, the availability or otherwise of set-off is irrelevant since any set-off between the member (with unlimited liability for the company's debts) and the company would simply result in the member continuing to have a liability to contribute more until the company was provided with sufficient assets to discharge the independent debts in full. Nothing in the dicta in *Grissell's Case* undermines the application of the underlying principle as described by Lord Walker JSC (the shareholder can receive nothing until he contributes everything he owes) to unlimited companies.

31. The irrelevance of set-off to the application of the Contributory Rule to an unlimited company can best be explained by the following simple example: the unlimited company has assets of £1bn and outstanding liabilities to independent creditors of £2bn; the company also owes a debt to the member of £2bn. Set-off between the member and the company would have the following result:

    (1) the member starts off with an obligation to contribute £1bn to the assets of the company to enable the independent liabilities to be paid in full;

    (2) set-off would result in £1bn of its debt claim against the company being 'satisfied' by set-off against its obligation to contribute £1bn;

    (3) immediately after the set-off, the company is left with assets of £1bn and independent creditors of £2bn, and it now owes the member £1bn;

[4] Per Lord Chelmsford LC, at 536.

(4) the member still has an obligation to contribute £1bn to the assets of the company, because there is still a shortfall of £1bn between its assets and the claims of independent creditors;

(5) again assuming the availability of set-off, its obligation to contribute £1bn is set-off against the remaining £1bn of the debt due from the company to the member;

(6) immediately after this second set-off, the company still has assets of £1bn and independent creditors of £2bn, but no longer owes anything to the member;

(7) at that point, the member remains liable to contribute a further £1bn, because there is still a shortfall viz a viz the independent creditors.

32. Alternatively, to avoid the circle of set-off and repeat calls, it is better to analyse the member's liability to contribute as extending to the amount necessary to satisfy *all* debts and liabilities of the company, including the debt owed to the member. Thus, in the above example, the company has assets of £1bn, but creditors of £4bn, and there is thus a shortfall of £3bn. Even if set-off were permitted between the member and the company, that would simply result in the member's debt being satisfied out of the first £2bn which it is obliged to contribute to the company's assets, leaving it with an obligation to contribute a further £1bn so as to enable independent creditors to be paid in full.

33. In short, even if set-off were to apply against a member's liability to contribute, the debt owed by an unlimited company to its member could never exhaust the member's unlimited liability to contribute, and the member's debt would never be left extant to compete with independent creditors as regards any assets of the company available for distribution.

(b) Members' liability to contribute encompasses Currency Conversion Claims

34. The members' liability to contribute to the assets of the company is provided for in s.74 IA 1986. Pursuant to this section, in relation to an unlimited company, a

member's liability to contribute to the assets of the company in liquidation is limited only by reference to the overall liabilities of the company. For the purposes of defining the members' liability to contribute, those liabilities are broadly defined as the company's "…***debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories among themselves***".

35. This broad definition clearly extends beyond provable debts. It is "debts" which are to be proved: IR 4.73(1). "Debt" has the meaning set out in IR 13.12(1). "Liabilities", on the other hand, has a broader meaning, and is defined in IR 13.12(4) as "*a liability to pay money or money's worth, including any liability under any enactment, and liability for breach of trust, any liability in contract, tort or bailment, and any liability arising out of an obligation to make restitution*".

36. As noted above, the liabilities of a company in winding up were exhaustively listed by the Supreme Court in *Re the Nortel Companies* [2013] 3 WLR 504, at [39] in their order of priority. These included (after secured creditors, expenses and preferential creditors): unsecured provable debts; statutory interest; non-provable liabilities; and shareholders (in that order).

37. There is no doubt that the liabilities referred to in s.74 (towards the payment of which shareholders must contribute) include all of these, if only because s.74 expressly includes such amount as is necessary "*for the adjustment of the rights of the contributories among themselves*", i.e. payments to shareholders[5], which rank last of all. If the members' obligation extends to enabling the company to make payments to shareholders qua shareholders, then it must follow that their obligation extends to any and all liabilities which rank for payment ahead of such payments to shareholders, including therefore any non-provable liabilities.

[5] *Re West Coast Gold Fields Ltd* [1905] 1 Ch 597 is an example of a case where the member's obligation to contribute related to payments that were to be made to shareholders, there being a surplus in the winding up.

(c) The application of the Contributory Rule to a company in administration

38. It is common ground that a member of an unlimited company has no actual liability to contribute to the assets of the company (save for any obligation to pay amounts which remain unpaid on its shares[6]) unless and until the company goes into liquidation. That is because the obligation to contribute is found in s.74 IA 1986, which itself applies only to a company in liquidation. There is no equivalent provision for a company that is in administration, even a distributing administration. This appears to be the result of an oversight, rather than a deliberate policy decision.

39. The consequence is simply that, in the case of an unlimited company, if it is in practice necessary to make a call on members, beyond the amount remaining unpaid on their shares, the company would have to be placed into liquidation.

40. While the company is in administration, however, the members have a contingent liability to contribute to the assets of the company, if and when the company goes into liquidation and a liquidator makes a call. If the court's conclusion in this case is that the creditors of LBIE will take priority over the claims of members only in the event that LBIE is in, or will subsequently go into, liquidation, there could be no realistic doubt as to whether LBIE would go into liquidation, such that there would be no reason to discount the value of the contingent claim against members.

41. A member incurs an obligation, which may or may not give rise to a liability, under s.74 from the moment it acquires its shares: s.80 IA 1986; *Ex p Willam Canwell* (1864) 4 De G.J.&S. 539.

42. The liability is thus one which is provable in an insolvency of the member, irrespective of whether a call has been made by the liquidator or even of whether the company is yet in liquidation: *re McMahon* [1900] 1 Ch 173, Stirling J.

43. As noted above, the Contributory Rule applies in practice to prevent a member of an unlimited company recovering any amount out of the assets of the company in respect

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[6] Paragraph 19 of Schedule 1 to the Insolvency Act 1986 enables an administrator to call up any uncalled capital of the company.

of its debt due from the company, unless and until the claims of independent creditors have been met in full – because unless those claims can be met in full from the assets of the company, the member is at least contingently liable to contribute to the assets of the company for the purpose of enabling the company to meet those very claims.

44. As a matter of principle, the Contributory Rule applies as much where the company is in administration, as where it is in liquidation. It cannot have been intended that the introduction of a distribution regime within administration removed the principle that a company's contributories stand in the queue behind its creditor (per Lord Walker JSC in *Kaupthing*), notwithstanding the failure to incorporate a statutory equivalent to s.74 IA 1986 in the context of administration. In circumstances where a member has undertaken unlimited liability, it would run counter to the principles underlying the Contributory Rule to hold otherwise.

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