WATERFALL APPLICATION

Nos 7924 and 7945 of 2008 and No 429 of 2009

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N:

(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 (a company incorporated in the State of Delaware, USA)
(2) LYDIAN OVERSEAS PARTNERS MASTER FUND LIMITED

Respondents

SUPPLEMENTAL WRITTEN SUBMISSIONS

OF LEHMAN BROTHERS HOLDINGS, INC

BARRY ISAACS QC
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4 November 2013

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Ref: MJL/AP/58399.0011

1. LBHI replies below to certain of the submissions made by LBIE in their written opening submissions.

Paragraph 74: whether the liability of a contributory under section 74 arises if the company is in administration

2. There is an important difference between the contractual liability of a member to pay unpaid share capital and the statutory liability of a contributory under section 74 of the Act. The former is payable where the company is in administration; the latter is not. LBHI2 has no present liability to LBIE under section 74, whether contingently or at all.

3. The liability in respect of the company's unpaid share capital commences at the time the contributory becomes a shareholder. It is created by the company's constitution.

4. Section 74 of the Act is in Chapter 1 of Part IV of the Act, entitled "Winding Up of Companies Registered under the Companies Acts". Chapter 1 (which includes sections 73 - 83) relates to winding up generally, except where otherwise stated (section 73(2)). The liability of a contributory under section 74 of the Act is statutory. Section 74 (which is derived from section 75 of the Companies Act 1862) applies only when the company is being wound up (*Whittaker v Kershaw* (1890) 45 Ch D 320 (CA), 326, 328 - 329). "The enactment is, that in the event of the company being wound up, and in that event only, a debt is created due from the shareholder, but payable at the time when the calls are made…" When a call is made it has reference back, and the debt becomes due at the time the winding up began (*Re China Steamship Company, ex p Mackenzie* (1869) LR 7 Eq 240, per Lord Romilly

MR at 244, 246). Calls under section 74 may be made only by the company's liquidator (*Re Whitehouse & Co* (1878) 9 Ch D 595, 599 - 600).

5. Section 82(4) of the Act (which is also derived from section 75 of the Companies Act 1862) permits a proof against the bankrupt's estate of the estimated value of his liability to future calls as well as calls already made. This provision only applies where the bankruptcy of the contributory is contemporaneous with the winding up of the company: *Martin's Patent Anchor Co Ltd v Morton* (1868) LR 3 QB 306.

6. The difference between the contractual liability to pay unpaid share capital and the liability under section 74 was expressed in *West of England and South Wales District Bank, Re, ex p Branwhite* (1879) 40 LT 652, per Fry J at 653 as follows:

> *"The liability to contribute to the assets of the company while it is a going concern, and the liability to contribute to the assets of the company when it is being wound-up, are separate and distinct liabilities - the one is created in effect by the articles of association of the company and the deed of settlement and its registration under the 16th section of the Act; the other arising only in the event of the company being wound up. The one requires payment of the amount of the calls to the company; the other requires payment of the amount of the calls to the liquidator or the officer of the court."*

7. This distinction is reflected in the difference between section 16 of the Companies Act 1862 (from which section 33 of the Companies Act 2006 is derived) and section 75 of the Companies Act 1862 (from which section 74 of the Act is derived). It is only the former provisions, which relate to the contractual liability to pay unpaid share capital, which provide that a debt is

owed *to the company*.

8. Thus section 16 of the Companies Act 1862 provided:

> *"all monies payable by any member to the company … shall be deemed to be a debt due from such member to the company"*

9. In contrast, section 75 of the Companies Act 1862 provided:

> *"The liability of any person to contribute to the assets of the company under this Act, in the event of the same being wound up, shall be deemed to create a debt … accruing due from such 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 ..."*

10. The same distinction is maintained between section 33 of the Companies Act and section 74 of the Act.

11. If (as LBIE contends), LBIE may claim against LBHI2 in respect of its potential liability under section 74 because LBHI2 is in administration, LBIE would be able to claim even if it were solvent. Not only is such a scenario impossible to reconcile with the Act and the authorities referred to above, it would allow a company of doubtful solvency to shore up its financial position by proving and receiving a dividend in respect of a call while still trading, thereby potentially avoiding the very situation (ie winding up) in which a call may be made.

12. LBIE's analysis would, if correct, impose on LBHI2 the obligations which come into existence upon LBIE's winding up (viz the potential liability as a contributory), but not the rights (viz to share in the adjustment of the rights of the contributories among themselves) which come into existence upon LBIE's

winding up. According to LBIE's analysis, LBHI2 would be obliged to pay a sum in respect of a call which has not been (and may never be) made against it, yet it would have no right to claim an adjustment from other members, because section 74 provides that the liability for the adjustment exists when a company is wound up. There would be no mechanism for adjusting the rights of contributories.

13. Consider the following example. The director of a company concludes that the company has no reasonable prospect that it will avoid insolvent liquidation, but he takes none of the steps with a view to minimising the potential loss to the company's creditors which he ought to take. He is subsequently adjudged bankrupt and, some months later, the company goes into insolvent liquidation.

14. The liquidator may pursue a claim for wrongful trading against the director, and would be able to prove in the director's bankruptcy in relation to that claim in accordance with section 382(1)(b) of the Act, which is in substantially the same terms as Rule 13.12(1)(b).

15. It does not follow, however, and it is not the case, that any such claim could be pursued as a contingent liability of the director *prior* to the company's liquidation. The reason for this is obvious: such a claim could only arise after the company went into liquidation and could only be pursued by a liquidator. It is only the liquidator, therefore, who could prove in relation to the claim.

16. This is consistent with the analysis of contingent liabilities in *Re Nortel* [2013] 3 WLR 504 at [77] - [78], since the relationship between the company and the director is insufficient to amount to the incurring of any relevant obligation. Rather, the relationship which gives rise to the incurring of the obligation is

between the company's liquidator and the director; and this does not exist before the liquidator is appointed. Further or alternatively, the regime under which the liability for wrongful trading is imposed gives rise to no obligation before the liquidator is appointed.

17. So too with the present case: LBHI2 has no contingent liability, whether to LBIE or anyone else, under section 74 because the relationship between LBIE's liquidator and LBHI2 which would amount to the incurring of an obligation does not exist (since LBIE has no liquidator); and/or the regime under which the section 74 liability is imposed gives rise to no relevant obligation to LBIE or to anyone else, unless and until LBIE is wound up and a liquidator is appointed. In much the same way, in relation to asbestos personal injury claimants, until their future spouses or civil partners become spouses or civil partners, or their children are born, they cannot qualify as dependants for the purposes of the Fatal Accidents Act 1976, and no liability on the part of the employer (contingent or otherwise) arises in relation to them: *Re T&N Ltd* [2007] 1 BCLC 563 at [82]-[83].

18. This analysis also explains why the contributory rule does not apply. As Lord Walker said in *Re Kaupthing* (at [20] and [52]), payment-up of the shares in full or payment of the call is a condition precedent to the shareholder's participation in any distribution. Since no winding up order has been made against LBIE, no call may be made; LBHI2 therefore has no obligation to pay a call; and there is therefore no impediment to LBHI2's participation in any distribution.

19. To similar effect, Lord Chelmsford LC said in *Re Overend, Gurney, and Co*

Grissell's case (1866) LR 1 Ch App 528 at 536 - 537:

> *"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."*

Paragraph 91: whether the liability of a contributory under section 74 extends to liabilities in the fifth, sixth and seventh tiers of the waterfall

20. LBIE refers to the liability of members under section 74 to contribute an amount sufficient for the adjustment of the rights of the contributories among themselves (the "adjustment"). It contends that "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".

21. This argument is mistaken for two reasons. First, the liability of members to contribute for the adjustment is a means for adjusting between holders of fully and partly paid shares: *Re Phoenix Oil and Transport Co Ltd* [1958] Ch 560, 564; *Re Shields Marine Insurance Association, Lee and Moor's Case* (1868) LR 5 Eq 368, 372.The adjustment is not a means of making payments to the company so that they may be applied to creditors.

22. Secondly, the effect of section 74(2)(f) is that a sum due to any member of the company in his character as a member by way of dividends, profits or otherwise (a "section 74(2)(f) sum"):

    (1) is a deferred debt, ie it falls within Rule 12.3(2A)(c), which is the seventh tier of the waterfall summarised in *Re Nortel* [2013] 3 WLR

504 at [39] (the “deferral provision”);

(2) may be taken into account for the purpose of the adjustment (the “adjustment provision”).

23. If section 74(2)(f) did not include the adjustment provision, a section 74(2)(f) sum would not be taken into account for the purpose of the adjustment. This demonstrates that the adjustment does not include any sums below the fifth tier of the waterfall (other than the section 74(2)(f) sum); the adjustment provision would be unnecessary if such sums were included.

24. The adjustment provision demonstrates that the section 74(2)(f) sum does not fall within the “debts and liabilities” of the company referred to in section 74(1), since the adjustment provision would be unnecessary if it did. So the “debts and liabilities” of the company referred to in section 74(1) cannot refer to *all* the company’s debts and liabilities.

Paragraphs 102 - 104: whether Rule 2.88(7) interest is payable in liquidation

25. Section 189(2) provides that, in a winding up, statutory interest is payable out of any surplus remaining after the payment of the debts proved in a winding up in respect of the periods during which they have been outstanding since the company went into *liquidation*.

26. LBIE contends that, in a winding up which immediately follows an administration, statutory interest is payable out of any surplus remaining after the payment of the debts proved in a winding up in respect of the periods during which they have been outstanding since the company went into *administration*.

27. This contention is said to reflect the legislature's intention. This is to assume the truth of that which LBIE seeks to establish. If the legislature had intended to provide that, in a winding up which immediately follows an administration, statutory interest is payable in respect of the period between the company going into administration and going into liquidation, it would have done so.

28. There are advantages and disadvantages for creditors if a debtor company is in administration, just as there are if the company is in liquidation. For example, an advantage of liquidation (but not of administration) is the right to disclaim; a disadvantage is the ad valorem fees payable in liquidation (but not in administration). It cannot be assumed that the legislature intended that an advantage which exists in administration (viz the right to receive Rule 2.88(7) interest if there is a surplus after payment of the debts proved) survives the entry of the company into liquidation immediately after the administration. Such an approach would be as unjustified as assuming that the legislature intended that the creditors of a company in administration should have the benefit of the right to disclaim, even though that right exists only in a winding up.

29. LBIE's case amounts to asserting that there is an error in the relevant provisions (described by LBIE in paragraph 107 as an "obvious lacuna"), namely that section 189 does not contemplate a prior administration. There is no warrant for this assertion, still less can the court be "abundantly sure" that there is an error (cf *Re Nortel GmbH; Re Lehman Brothers International (Europe)* [2010] EWHC 3010 (Ch) at [115] - [117] per Briggs J). This is particularly the case where provisions governing statutory interest (viz, Rules

2.88 and 4.93) were amended (by SI 2005/527 and SI 2010/686) in contemplation of a prior administration. The Explanatory Note to SI 2005/527 stated as follows:

> *"As a result of the changes made to the law on administration by the Enterprise Act 2002 (c 40) a company can move between liquidation and administration or between administration and liquidation. Both of these procedures enable creditors to prove their debts at the date of the administration or liquidation respectively. By way of clarification of the existing rules, the amendments provide that the relevant date is the date of the first insolvency procedure commenced. The Rules affected are: Rules 2.86, 2.87, 2.88, 2.89, 4.91, 4.92, 4.93 and 4.94."*

30. Rule 4.73(8) provides that, 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. Such a creditor is entitled to statutory interest (if at all) under section 189(2). LBIE contends (in paragraph 107(4) and (5)), however, that section 189(2) should be disapplied, so that a creditor who has proved in the administration receives Rule 2.88(7) interest in winding up. This relies on the circular argument that it would be "wrong" to apply section 189(2) because the result of applying section 189(2) is that Rule 2.88(7) interest is not payable. It would in any event be particularly bizarre if the effect of a Rule (in secondary legislation) was to disapply a section of the Act (in primary legislation).

Paragraph 159: *Re Rhodesia Goldfields Ltd* [1910] 1 Ch 239

31. LBIE submits that *Re Rhodesia Goldfields* is authority for the general principle that: (i) where an estate is being administered by the court, a party cannot take anything out of the fund until he has made good what he owes to the fund; and (ii) it is immaterial that what he owes to the fund is not ascertained. In fact, *Re Abrahams* [1908] 2 Ch 69 establishes that the general principle only applies where what the party owes to the fund is presently payable. This is consistent with *Re Rhodesia Goldfields*, in which Swinfen Eady J said (at 242) that "The claim is for a liquidated demand. A plaintiff can sue for money had and received without specifying the amount… The present claim is for an existing debt … [which] is immediately payable subject to the amount (if any) being ascertained." The correctness of *Re Abrahams*, which was referred to in argument (at 242), was not questioned. Rather, it was distinguished on the basis that the instalments of the debt in *Re Abrahams* were not presently payable, whereas the debt in *Re Rhodesia Goldfields* was immediately payable. Since there is no call which is presently payable by LBHI2, the present case is governed by *Re Abrahams* and not *Re Rhodesia Goldfields*.

Paragraph 162 and 177: *Re McMahon* [1900] 1 Ch 173

32. LBIE contends that it follows from *Re McMahon* that LBIE's potential claim under section 74 will be provable in LBHI2's distributive administration or liquidation. This contention is incorrect.

33. *Re McMahon* establishes that a company may prove, in the administration of the estate of a deceased shareholder whose estate is insolvent, for the estimated value of the liability to future calls in respect of unpaid amounts on

the shares standing in his name. As explained above, a company may prove for a liability in respect of unpaid share capital while it is a going concern. *Re McMahon* says nothing about proof in respect of calls under section 74, which may be may made only by a liquidator. Section 74 is irrelevant unless and until LBIE goes into liquidation.

34. Furthermore, LBHI2 may choose not to enter a distributive administration or liquidation until such time as LBIE has paid LBHI2 sums which are due to LBHI2. LBHI2's administrators are entitled not to cause LBHI2 to enter a distributive administration or liquidation if the result of not doing so is that LBHI2 will avoid incurring a substantial liability. This is because LBHI2's administrators must perform their functions in the interests of its creditors as a whole, and one of their functions is to achieve a better result for the company's creditors as a whole than would be likely if the company were wound up (Schedule B1, paragraph 3); and because "If a company is lawfully entitled to take steps which will preclude a large liability from coming into existence, the duty to creditors would seem to require those steps to be taken" (*Re T & N Ltd* [2004] EWHC 1680 (Ch), per David Richards J at [13]). The position would be similar if administrators caused a company to exit administration by dissolution rather than winding up in circumstances in which a substantial tax liability would be incurred if and only if the company were wound up.

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