**IN THE HIGH COURT OF JUSTICE** **No. 7942 of 2008**

**CHANCERY DIVISION**

**COMPANIES COURT**

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

**AND IN THE MATTER OF THE INSOLVENCY ACT 1986**

**BETWEEN:**

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

**Applicants**

**- and -**

**(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)**

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

**(3) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS EUROPE LIMITED (IN ADMINISTRATION)**

**(4) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)**

**Respondents**

---

# WATERFALL III – PART A ISSUES

## OUTLINE SUBMISSIONS ON BEHALF OF THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)

---

*References in these outline submissions to the trial bundles are in the format:*

***[volume/tab/page/paragraph]***

## A. INTRODUCTION

1. These submissions are lodged on behalf of the joint administrators of Lehman Brothers Holdings Plc (in administration) (respectively, the "**LBH Administrators**" and "**LBH**") for the purposes of the trial of the Part A Issues.

2. The Part A Issues are Issues 1, 2, 3, 4, 5, 6, 7, 8, 10 and 12, as identified in the application notice dated 22 April 2016 (the "**Waterfall III Application**") **[1/1/pp.1-7[1]]** and an additional issue which was added by paragraph 5 of the order dated 4 November 2016 ("**Issue 9A**") **[1/4/pp.1-6]**.

3. The LBH Administrators continue to act in this matter through their fellow partner in the firm PwC, Robert Nicholas Lewis ("**Mr Lewis**"). Mr Lewis is not one of the LBH Administrators but has been authorised to act on behalf of the LBH Administrators for the reasons more particularly set out in paragraphs 16 to 27 of his witness statement dated 1 November 2016 **[1/24/pp.1-10]**.

4. As the Court will be familiar with the Waterfall III Application and the reasons why the various issues have arisen, it is not proposed to burden the Court further by rehearsing the background. To the extent that it may be thought helpful, the Court's attention is drawn to the useful summary set out in paragraphs [1] to [14] of the judgment of Lewison LJ in *The Joint Administrators of LB Holdings Intermediate 2 Limited (in administration) and others v Lomas and others* [2015] EWCA Civ 485 (the "**Waterfall I Court of Appeal Judgment**") **[1/9/pp.1-70]** and (for present purposes) the Agreed Statement of Facts prepared for use in the Waterfall I proceedings **[1/7/pp.1-10]**. Otherwise, it is understood that 30 and 31 January 2017 have been set aside as reading days and, as directed by the Court, the parties will be lodging an agreed reading list in advance of those dates.

5. For the purposes of these submissions, the LBH Administrators adopt the further definitions and abbreviations used in their position paper and which are set out below for convenience.

| | |
|---|---|
| Lehman Brothers International (Europe) (in administration) | **LBIE** |
| LB Holdings Intermediate 2 Limited (in administration) | **LBHI2** |
| Lehman Brothers Europe Limited (in administration) | **LBEL** |
| Lehman Brothers Limited (in administration) | **LBL** |
| The joint administrators of LBIE | **the LBIE Administrators** |

[1] See also Appendix 1 to the Ninth Witness Statement of Russell Downs dated 22 April 2016 **[1/21/1-38 at pp.27-38]** and the order of the Court dated 4 November 2016 **[1/4/pp.1-6]**.

| | |
|---|---|
| The joint administrators of LBHI2 | **LBHI2 Administrators** |
| The joint administrators of LBEL | **LBEL Administrators** |
| The joint administrators of LBL | **LBL Administrators** |
| The Insolvency Act 1986 | **IA 1986** |
| The Insolvency Rules 1986 | **IR 1986** |
| Section 74 of IA 1986 | **section 74** |
| LBIE's liability to LBHI2 under 3 subordinated loan agreements entered into on 1 November 2006 | **Sub-Debt and Sub-Debt Agreements** |
| Any claim by the LBIE Administrators under section 74 as against LBHI2 and/or LBL / LBH (insofar as LBH is a contributory of LBIE) | **Contribution Claim** |
| Any claim by the LBIE Administrators under section 74 as against LBHI2 and/or LBL / LBH (insofar as LBH is a contributory of LBIE) for a contribution in respect of the Sub-Debt | **Sub-Debt Contribution Claim** |

6. Subsequent to the PTR held on 16 January 2017, the parties have sought to identify between them those of the Part A Issues that remain in dispute. Where any issues are no longer in dispute, it is intended that an agreed form of declaration will be put before the Court for consideration. As a consequence, and as foreshadowed in the LBH Administrators' Position Paper, there has been a considerable narrowing of the compass of the matters in dispute in relation to the Part A Issues.

7. In view of the foregoing, the LBH Administrators propose to address substantively only three of the Part A Issues, those being:

   i) **Issue 1:** Whether the obligations of: (a) LBHI2; and/or (b) LBL to contribute to the assets of LBIE pursuant to section 74 include an obligation to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay sums owed to LBHI2 pursuant to the Sub-Debt;

   ii) **Issue 3:** Whether the value of the Sub-Debt Contribution Claim, for the purposes of proof and set-off, is: (a) for the full amount of the Sub-Debt; (b) limited to the estimated

value that is applied to LBHI2's claim for the Sub-Debt for the purposes of proof; or (c) some other value; and

iii) **Issue 7(v):** Whether the LBIE Administrators should be directed to assert less than 100% of the Contribution Claim against LBL and/or LBHI2 and, if so, by how much the Contribution Claim should be reduced as against LBL and/or LBHI2 and what factors should the Court take into account in reaching its decision.

8. In relation to the balance of the Part A Issues:

i) As regards Issues 2, 4, 5, 6 and 12, as indicated above, the parties to the Waterfall III Application will seek to agree the terms of appropriate declarations which will be put before the Court for its consideration and approval. The LBH Administrators' analysis of those issues is rehearsed in their position paper;

ii) As regards Issues 8 and 7(i) to (iv), again the LBH Administrators' analysis of those issues is rehearsed in their position paper; and

iii) As regards Issues 9A and 10, the LBH Administrators take no position.

9. The LBH Administrators' positions in respect of the Part A Issues proceed on the basis of the decision and reasoning of the Court of Appeal in the Waterfall I Court of Appeal Judgment. Where appropriate, the LBH Administrators' positions and/or arguments may be subject to revision in light of the pending decision and/or reasoning of the Supreme Court in relation to Waterfall I.

## B. THE PART A ISSUES

10. The Part A Issues are to be argued on the basis of a number of alternative factual assumptions. However, as would appear from the parties' position papers, the different factual hypotheses have no impact upon the outcomes of the various legal positions contended for by the parties in relation to most (if not all) of the Part A Issues.

11. The factual assumptions are that:

i) LBL is the legal and beneficial owner of a single share in LBIE and is not entitled to rectification of the share register of LBIE;

ii) LBL is entitled to rectification of the share register of LBIE with the effect that the single share in LBIE, currently registered in LBL's name, is: (a) cancelled; or (b) registered in the name of LBH; or (c) registered in the name of LBHI2;

iii) LBL holds the single share in LBIE as nominee for LBH and/or LBHI2 and is entitled to an indemnity from LBH and/or LBHI2 (as appropriate) in respect of its liability under section 74; and

iv) LBL is otherwise entitled to recharge its liabilities to LBH (and/or LBIE and/or LBHI2 and/or LBEL), including its liability to make contribution to LBIE's estate under section 74.

## C. ISSUE 1

12. Issue 1 concerns the extent to which LBIE's members could be liable to contribute funds to enable LBIE to repay a subordinated loan borrowed from one of its members and is in the following terms:

> **Whether the obligations of: (i) LBHI2; and/or (ii) LBL to contribute to the assets of LBIE pursuant to section 74 include an obligation to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay sums owed to LBHI2 pursuant to the Sub-Debt.**

13. Section 74(1) provides:

> "*When a company is wound up, every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories among themselves*".

14. There appears to be a degree of common ground in relation to Issue 1[2]:

i) It is agreed as between the LBH Administrators, the LBIE Administrators, the LBHI2 Administrators and the LBL Administrators that, in principle, the liability of shareholders in an unlimited company under section 74 can encompass a liability to contribute to the company's assets to enable it to pay a subordinated debt liability;

[2] With the LBEL Administrators taking no position on Issue 1.

ii) More particularly, it is agreed that there is no reason in principle preventing a lender that is also a shareholder of the borrower from being liable under section 74 to contribute to the assets of that borrower to enable the borrower to pay the debt which is in fact owed by it to the lender shareholder [**LBIE/1/16/p.3/paragraph 8; LBH/1/19/p.5/paragraphs 11(i); LBHI2/1/17/p.4/paragraphs 1.2-1.3; and LBL/1/20/p.4/paragraph 4]**.

15. The divergence of view is as to whether or not in the present case the Sub-Debt Agreements, when properly understood, are intended to and do indeed permit the borrower (LBIE) to make a call upon its lender and shareholder (LBHI2) and its other shareholder (LBL/LBH) for additional funds to enable the borrower to repay the debt owed by it to the lender. Issue 1 therefore turns upon the true meaning and effect of the terms of the Sub-Debt Agreements.

16. In relation to those issues, the LBH Administrators are aligned with the LBL Administrators, with the LBIE Administrators adopting a rival position.

17. The LBIE Administrators contend that liability under section 74 includes the obligation to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay the Sub-Debt and that such an outcome is not precluded by the terms of the Sub-Debt Agreements **[1/16/p.3/paragraph 8 and p.5/paragraph 12]**. Hence the LBIE Administrators assert that they are entitled to prove in the administrations of LBHI2 and LBL/LBH in respect of the totality of the Sub-Debt Contribution Claim.

18. However, the LBH Administrators and the LBL Administrators argue that:

i) As a matter of interpretation of the Sub-Debt Agreements, when taken in their commercial context and/or by reason of a term to be implied into the Sub-Debt Agreements, the funds of LBIE alone were to be resorted to for the purpose of meeting the Sub-Debt liability, such that there was to be no recourse by LBIE to its members; and

ii) Alternatively, on a proper interpretation of the Sub-Debt Agreements (and in particular clause 5 thereof) LBIE has, in effect, no liability under the Sub-Debt Agreements (and so there can be no Sub-Debt Contribution Claim) unless: (a) all of LBIE's prior-ranking liabilities have in fact been paid in full or are capable of being paid in full by LBIE; or (b) LBIE's own assets (excluding any right to make a future call under section 74) are sufficient to pay all remaining prior-ranking liabilities in full

**[LBH/1/19/pp.5-8/paragraphs 11-13; LBL/1/14/pp.37-43/paragraphs 104-116 and 1/20/pp.4-9/paragraphs 4-7]**.

19. It is understood that the LBL Administrators will develop the argument summarised in paragraph 18(i) above in their written and oral submissions. The LBH Administrators will focus their submissions upon the arguments referred to in paragraph 18(ii).

**The circumstances in which Issue 1 arises**

20. Issue 1 and those issues ancillary to it need to be put into context. In practical terms, the resolution of the arguments identified above as to the interpretation of the Sub-Debt Agreements might prove to be of limited significance.

21. This is because the answer to Issue 1 would appear to be moot even if the Sub-Debt is due and the LBIE Administrators are entitled to have recourse against LBIE's members in relation to the Sub-Debt:

    i) The LBIE Administrators accept that if the Sub-Debt becomes repayable to LBHI2, and if that gave rise to a Sub-Debt Contribution Claim, LBHI2's claim for the Sub-Debt would be extinguished immediately as a consequence of the operation of insolvency set-off in LBIE's administration as between the LBIE Administrators' Sub-Debt Contribution Claim and LBHI2's cross-claim for repayment of the Sub-Debt under the Sub-Debt Agreements **[1/16/p.12/paragraph 29]**;

    ii) As a consequence it follows, and appears to be common ground between the administrators of LBIE, LBH, LBL and LBHI2 that insolvency set-off would operate to discharge, whether completely or in part, the Sub-Debt Contribution Claim of the LBIE Administrators as against LBHI2[3];

[3] The LBHI2 Administrators suggest that it is possible that if the contingent Sub-Debt Contribution Claim was to be re-valued upwards because of the fulfillment of the conditions for its repayment, it would be for a sum which was "*necessarily less*" than the estimated value of the Sub-Debt Claim itself (rather than for the same amount) on the footing that the Sub-Debt Contribution Claim is subject to additional contingencies to which the Sub-Debt Claim is not subject, and which would therefore depress the estimated value of the Sub-Debt Contribution Claim **[1/17/p.7/paragraphs 3.5(iii) to 3.7]**. Whether that is correct, and if so, whether it would mean that there would be a material balance over due to LBHI2 is dealt with in paragraph 50(iv) below. Suffice to say for present purposes that it would not appear to be suggested that there would be any significant difference between the value of the contingent Sub-Debt Claim and the contingent Sub-Debt Contribution Claim and therefore any significant resulting net balance in favour of LBHI2 in the administrations of LBIE and LBHI2.

iii) In that event, it is agreed as between the administrators of LBIE, LBH, LBHI2 and LBL that LBHI2 would be treated as having made a contribution to LBIE's assets equivalent to the Sub-Debt, and so the other shareholder (be it LBL or LBH) would have no section 74 liability in relation to a Sub-Debt Contribution Claim, but might be contingently liable under section 74 to contribute to LBIE for the purposes of adjusting the rights of the members of LBIE (*i.e.* LBHI2 and LBL/LBH) as between themselves;

iv) However, it also appears to be common ground that in such circumstances (and assuming that the only contribution that LBHI2 had made was the amount of its extinguished Sub-Debt Claim) any adjustment claim as against LBL/LBH would be for a *de minimis* amount by reason of the huge imbalance in the respective shareholdings of LBHI2 and LBL/LBH – amounting to an adjustment claim for a sum of the order of £1 according to the LBL Administrators **[1/20/p.12/paragraph 15]**. Commercially, therefore, it appears that at least in many likely scenarios Issue 1 (and the related questions as to whether or not shareholders have rights of contribution against one another which arise in relation to Issue 7 and the answers to the same) would be of little practical significance.

22. Since it is accepted by all that if the Sub-Debt is due it will have been extinguished (or nearly extinguished) by set-off, one may have thought that Issue 1 might fall away altogether (on the basis that, if the Sub-Debt is not due, it would be impossible for a Sub-Debt Contribution Claim to arise). However, it would appear from the stance adopted by the LBIE Administrators in relation to Issue 3, that they may be contending that the Sub-Debt Contribution Claim is provable and should be valued at the full amount of the Sub-Debt even if the conditions for repayment of the Sub-Debt are not and will never be met **[1/16/p.9/paragraphs 20 - 25]**. If that is indeed the LBIE Administrators' position, it is somewhat surprising that it is suggested that LBIE's contingent proof for a contribution to enable it to pay the Sub-Debt is not actually dependent upon whether the Sub-Debt is or would be due. This is a reason why Issue 1 may be of continuing relevance[4].

**The proper interpretation of the Sub-Debt Agreements**

23. The LBH Administrators contend that, on a proper interpretation of the Sub-Debt Agreements (and in particular clause 5 thereof), LBIE has no liability to pay the Sub-Debt, and hence a Sub-Debt Contribution Claim does not arise, unless LBIE's own assets – excluding any possible

[4] Although, as set out below in relation to Issue 3, the LBH Administrators dispute the LBIE Administrators' assertion that a Sub-Debt Contribution Claim is to be valued at the full amount of the Sub-Debt even if the conditions for repayment of the Sub-Debt have not been and never will be met.

right to make a future call under section 74 – are sufficient to enable LBIE to pay all prior-ranking claims.

24. Clauses 5(1) and (2) of the Sub-Debt Agreements are the key provisions. They are in the following terms:

> *"**Subordination***
>
> *(1) Notwithstanding the provisions of paragraph 4, the rights of the Lender in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities and accordingly payment of any amount (whether principal, interest or otherwise) of the Subordinated Liabilities is conditional upon – ...*
>
> *(1)(b) the Borrower being 'solvent' at the time of, and immediately after the payment by the Borrower and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that the Borrower could make such payment and still be "solvent".*
>
> *(2) For the purposes of sub-paragraph (1)(b) above, the Borrower shall be 'solvent' 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 the Borrower; and*
>
> *(b) the Excluded Liabilities."*

25. As is clear:

i) The effect of clause 5(1) of the Sub-Debt Agreements is that the Sub-Debt is only payable if LBIE is "*solvent*" within the meaning of clause 5(2); and

ii) LBIE is only "*solvent*" within the meaning of clause 5(2) if, "*it is able to pay its Liabilities (other than the Subordinated Liabilities) in full*" disregarding the liabilities identified in clauses 5(2)(a) and (b).

26. The LBH Administrators say that, on a true interpretation of clause 5(2), having regard to the context and place in which the word "*it*" is used, the reference to "*it*" (*i.e.* LBIE) being able to pay its relevant liabilities "*in full*" is a reference to LBIE's ability to pay such liabilities from its own assets and without reliance upon the actual or potential proceeds of a possible call under section 74 should LBIE enter liquidation in the future.

27. The LBIE Administrators' position is not yet known but it is assumed that they will oppose this construction.

28. It is submitted that there are (at least) four reasons why LBH's construction of clause 5 is correct:

    i) It is the ordinary meaning of clause 5;

    ii) It is consistent with the nature of a liability under section 74;

    iii) It is consistent with the way in which LBIE's assets and hence its ability to pay would be identified when considering the solvency or otherwise of a company for the purposes of IA 1986 and more generally; and

    iv) It leads to a result that is consistent with the regulatory background to the Sub-Debt Agreements.

29. First, LBH's straightforward approach to clause 5 follows the ordinary meaning of the words used by the parties to the Sub-Debt Agreements.

30. As set out by Lord Neuberger in *Arnold v Britton* [2015] UKSC 36 at paragraph [15], the Court should first consider the natural and ordinary meaning of the wording of clause 5:

> *"When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to 'what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean', to quote Lord Hoffmann in Chartbrook Ltd v Persimmon Homes Ltd [2009] UKHL 38, [2009] 1 AC 1101, para 14. And it does so by [focusing] on the meaning of the relevant words … in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions."*

31. Lord Neuberger continued at paragraph [18]:

> *"When it comes to considering the centrally relevant words to be interpreted, I accept that the less clear they are, or, to put it another way, the worse their drafting, the more ready the court can properly be to depart from their natural meaning. That is simply the obverse of the sensible proposition that the clearer the natural meaning the more difficult it is to justify departing from it. However, that does not justify the court embarking on an exercise of searching for, let alone constructing, drafting infelicities in order to facilitate a departure from the natural meaning".*

32. Applying Lord Neuberger's guidance, the Court should be slow to facilitate a departure from the natural and ordinary meaning of words:

    i) The natural meaning of the solvency requirement that LBIE ("*it*") is to be "*able to pay its Liabilities…in full*" means that LBIE itself must have sufficient existing of its own assets to pay its own liabilities, *i.e.* without recourse to the assets of its shareholders, through calls under section 74 or otherwise;

    ii) The question whether or not LBIE is "*solvent*" is to be tested at the date on which it is being considered whether or not the Sub-Debt is payable or can be paid. The question must be whether, at that point in time, one can consider that LBIE possesses the financial wherewithal to pay its prior-ranking liabilities;

    iii) There is no ambiguity in clause 5(2) indicating that LBIE should be entitled to look to the assets of other Lehman Group companies (in particular its shareholders) to satisfy the requirement that "*it*" alone is already "*able to pay its Liabilities…in full*" without recourse to other entities; and

    iv) This is all the more so since the directors of an unlimited company have no powers to make a call on members. The members' liability (if any) under section 74 only crystallises after the company enters liquidation.

33. Secondly, if the Court has any doubt about what the LBH Administrators contend is the natural and ordinary construction of clause 5, it is submitted that the nature of a liability for a call under section 74 makes it highly unlikely that the parties to the Sub-Debt Agreements intended the requirement in clause 5(2) that LBIE be "*able to pay its Liabilities…in full*" should encompass a call for contributions from its membership under section 74:

i) A call under section 74(1) is for a contribution of, "*any amount sufficient for payment of [the company's] debts and liabilities*". Hence, a call under section 74 is in fact premised upon LBIE being unable to pay its liabilities in full. It makes little sense to say that LBIE is able to pay its debts in full by relying on the fruits of a call that could only be made in circumstances where LBIE was unable to do just that, *i.e.* pay its debts;

ii) Further, the prospective or contingent ability to make a call under section 74 cannot sensibly be said to be an asset of LBIE. The very terms of section 74(1) clarify that a right to make a call is the mechanism by which members are required to "*contribute to its [i.e. LBIE's] assets*". The right to make a call is a method of augmenting LBIE's assets rather than itself constituting an asset of LBIE, at least for the purposes of section 74;

iii) Lewison LJ was therefore correct in the Waterfall I Court of Appeal Judgment (at paragraph [113]) to have doubted the proposition that the right to make a call is the property of a company. He described the right to make a call (correctly, it is submitted) as a power of the Court, "*to call upon contributories to contribute to the assets of the company*". He doubted that such a power is itself (and it follows the proceeds realised by the exercise of such a power) ought properly to be characterised as property of the company;

iv) Although the LBIE Administrators contend, at paragraph 12(1)(ii) of their position paper, that the Waterfall I Court of Appeal Judgment establishes that the liability of LBIE's members to contribute is one of LBIE's assets, that contention represents a mischaracterisation of the decision:

a) Only one of the three judges took the view that the contingent right to make a call was an asset of the company, namely Briggs LJ. As set out above, Lewison LJ took the contrary view and Moore-Bick LJ did not address the point. Instead, he agreed with the conclusions of both Briggs and Lewison LJJ (see paragraph [246]); and

b) In any event, Briggs LJ's reasoning on this point was directed at whether LBIE was eligible to prove for a contingent section 74 liability in its members' administration or liquidation. His Lordship was not determining, let alone purporting to determine, the question whether, as a matter of contractual interpretation, when clause 5(2) of the Sub-Debt Agreements speaks of LBIE

being able to pay "*its Liabilities ... in full*" this wording was intended to allow such ability to be established by taking into account a call that a liquidator could make upon a member if LBIE were in liquidation (despite it not being in liquidation).

34. Thirdly, the LBH Administrators' construction is consistent with the way that LBIE's assets and hence its ability to pay would be identified when considering the solvency or otherwise of a company for the purposes of IA 1986 and more generally. The highest it could be put would be to say that if the future right of a future liquidator of LBIE to make a call under section 74, or any call made by the LBIE Administrators, was to be treated as an asset (which is not accepted), it could only be considered to be a contingent asset. Yet such assets do not ordinarily form part of the assessment of whether or not a company is solvent: see *Re Rococo Developments Ltd (in liquidation)* [2016] EWCA Civ 660 at paragraph [19] and *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2013] UKSC 28. It would be peculiar if the parties had, in so far as the assets of the company were concerned, intended the concept of solvency/insolvency in clause 5 of the Sub-Debt Agreements to differ so materially from the concept of solvency as contained in the IA 1986 or as a matter of general law.

35. Fourthly, the LBH Administrators' construction of clause 5 of the Sub-Debt Agreements is also the one most in keeping with the regulatory background that underpins the facility agreements:

    i) The form of the Sub-Debt Agreements is based upon templates provided by the Financial Services Authority (LBIE's regulator at the applicable time) for institutions that wished to rely upon subordinated loans to meet their capital adequacy requirements - *per* David Richards J (as he then was) at paragraph [60] in the first instance decision of Waterfall I ([2014] EWHC 704 (Ch)). The "*concept*" is that "*subordinated loan capital qualifying as part of the institution's regulatory capital is, as against creditors, to be treated as part of the 'capital' of the institution*" (paragraph [63]);

    ii) Clause 5(2)(b) of the Sub-Debt Agreements (and the definition of "*solvency*") applies both when the borrower is in a formal insolvency process and prior to that when the borrower is considering making a payment in respect of the Sub-Debt. The clause should bear the same meaning whether or not the borrower is in liquidation. It is thus appropriate to consider how the clause operates in a pre-insolvency situation;

    iii) It would be contrary to the regulatory context underpinning the Sub-Debt Agreements if, in deciding whether it could legitimately make a payment to the lender under such

agreements pre-liquidation, LBIE, as the borrower, were able to rely upon and treat as an asset its contingent entitlement to make a call under section 74 were LBIE to enter liquidation. This is especially the case where doing so would require the estimation of: (a) the contingency; and (b) the ability or otherwise of LBIE's members (who will themselves have fluctuating assets) to meet such a call. Yet further, as section 74 makes clear, a call is to be used to pay the expenses of the liquidation as well as the debts of the company. The expenses of the liquidation cannot be known. It is thus impossible to ascertain (in a pre-insolvency situation) what amount would be available from LBIE's members actually to pay the company's liabilities. The parties and the regulator cannot be taken to have intended this level of uncertainty, and cannot therefore have intended such hypothesising to form a legitimate part of the enquiry into LBIE's "*solvency*"; and

iv) If clause 5(2) of the Sub-Debt Agreements were intended to include such a possibility, it would make the protection intended to be afforded by the Sub-Debt Agreements of significantly less value. A borrower would, in effect, be able to treat its possible future ability to recover from a member pursuant to section 74 as part of its "*capital*", therefore making it "*solvent*". Such a proposition is untenable.

36. It is therefore submitted that, on the true construction of clause 5 of the Sub-Debt Agreements, LBIE has no liability to pay the Sub-Debt (making a Sub-Debt Contribution Claim impossible) unless LBIE's own assets – excluding any possible right to make a future call under section 74 – are sufficient to pay all prior ranking claims.

## D. ISSUE 3

37. Issue 3 concerns the proper valuation to be put upon a contingent claim by LBIE's Administrators against LBIE's shareholders for a section 74 contribution to pay the Sub-Debt. Issue 3 is formulated as follows:

> **Whether the value of the Sub-Debt Contribution Claim, for the purposes of proof and set-off, is:**
>
> **(i) for the full amount of the Sub-Debt;**
>
> **(ii) limited to the estimated value that is applied to LBHI2's claim for the Sub-Debt for the purposes of proof; or**
>
> **(iii) some other value.**

38. The LBH Administrators' position is as follows:

i) The value of LBIE's Sub-Debt Contribution Claim for the purposes of proof in its members' administrations (or subsequent liquidations) and set-off (in LBIE's administration) cannot exceed the estimated value that is applied to the Sub-Debt Claim;

ii) At the present moment in time, the value of both the LBIE Administrators' Sub-Debt Contribution Claim and the value of LBHI2's claim for repayment of the Sub-Debt is nil. Either that, or LBHI2's claim for repayment is (arguably) less contingent than the Sub-Debt Contribution Claim, allowing a slightly higher value (arguably) to be placed on the latter than the former[5]; and

iii) The value of LBIE's Sub-Debt Contribution Claim as against LBL or LBH (if it is assumed to be a registered shareholder of LBIE) for the purposes of proof in LBL's or LBH's respective administrations (or subsequent liquidations) and set-off (in LBIE's administration) must also be nil.

39. As noted above, the LBIE Administrators accept that, if and when the Sub-Debt Claim is re-valued upwards, it would extinguish any Sub-Debt Contribution Claim by reason of the operation of set-off against LBHI2. However, it appears that the LBIE Administrators are saying that LBIE is in a better position if the value of the contingent Sub-Debt remains as nil since they appear to contend that in such circumstances LBIE's Sub-Debt Contribution Claim should still be valued at the full amount of the (non-payable) Sub-Debt.

**The value of the Sub-Debt Contribution Claim**

40. The contention that the contingent Sub-Debt Contribution Claim falls to be valued at the full amount of the Sub-Debt irrespective of whether or not the conditions necessary for the repayment of the Sub-Debt are met, is erroneous.

41. This is because:

[5] For the reasons suggested below any such difference cannot have any material consequence.

i) The outcome of the Waterfall I Court of Appeal Judgment is that the Sub-Debt is only repayable if LBIE has paid all its prior-ranking liabilities in full. The Court of Appeal declared that:

> *"[T]he claims of LBHI2 under its subordinated loan agreements with LBIE are provable in the administration or liquidation of LBIE, but are subordinated to provable debts, statutory interest and non-provable liabilities and are repayable only on contingencies including payment of all such claims".* **[1/12/p.2]**
>
> [Emphasis added.]

ii) As explained by Lewison LJ, "*the subordinated agreement itself provides that repayment is not due until certain contingencies have been satisfied*" and that the relevant contingencies depend "*on the meaning of clause 5*" (paragraph [41]);

iii) His Lordship identified the relevant contingencies in paragraph [62], in which he held that "*the subordinated debt is repayable on contingencies which include* (*a) payment of statutory interest and (b) payment of non-provable liabilities*" (emphasis added). This is the basis for the Court of Appeal's declaration that prior-ranking liabilities require "*payment*" in order for the Sub-Debt to become due and payable[6];

iv) Lewison LJ stated further, at paragraph [41], that any proof lodged in respect of the Sub-Debt, being a contingent liability, would be expected to be valued at "*nil*" and then to be re-valued, "*once it becomes clear that the contingencies have been satisfied*" (*i.e.* the payment of, or the ability to pay, all prior-ranking liabilities);

v) It follows that unless and until LBIE has in fact paid all its prior-ranking liabilities in full or LBIE is capable of paying all its prior-ranking liabilities in full, the Sub-Debt is not repayable and there can be no basis for revaluing LBHI2's contingent proof in LBIE's administration upwards from nil by application of the hindsight principle;

[6] It is submitted by the LBH Administrators that Lewison LJ's formulation of the contingencies is unduly prescriptive (albeit this arguably makes no difference to the outcome). Clause 5 of the Sub-Debt Agreements specifically permits re-payment of the Sub-Debt even if there are extant "*Liabilities*" provided that LBIE is capable of paying its "*Liabilities*" and still remaining "*solvent*". Therefore, it would appear that the relevant contingency is not limited to actual payment of the "*Liabilities*". The LBHI2 Administrators appear to agree with this since they suggest that the Sub-Debt Claim is contingent upon the LBIE Administrators "*being able to pay*" all prior-ranking claims in full (albeit that they cross-refer to the passage in Lewison LJ's judgment in which reference was made to "*payment*") **[1/17/p.6/paragraph 3.3]**. See also **1/17/p.7/paragraph 3.5(iii)** in which the LBHI2 Administrators refer to the contingencies being satisfied upon the officeholder having sufficient assets so "*that he can pay the prior-ranking claims in full".*

vi) Notwithstanding the reasoning of Lewison LJ (that the Sub-Debt claim should be valued at "*nil*" until the contingences "*have been satisfied*"), the LBIE Administrators contend that LBHI2's proof for the Sub-Debt will also fall to be re-valued upwards even absent actual payment in full of statutory interest and non-provable liabilities in LBIE's administration, "*if it becomes clear that the relevant contingency will inevitably be satisfied, i.e. where it is clear that statutory interest and non-provable liabilities in LBIE's administration will be paid in full in any event*" **[1/16/p.10/paragraph 23]**. This is correct as a matter of principle (*i.e.* in terms of how to value a contingent debt) as well as on the basis (intimated in footnote 5 above) that the relevant contingency is not limited to actual payment, but is in fact, or at least includes, LBIE having the ability to pay its prior-ranking liabilities;

vii) A member's liability under section 74 is for the amount that is necessary to pay the company's liabilities and the expenses of the winding up. If the Sub-Debt would not be one of the liabilities for which a contribution would be needed, then it would be incapable of being the subject of a call by a liquidator under section 74. Contrary to the argument advanced by the LBIE Administrators, if LBIE has no liability to repay the Sub-Debt, then a liquidator of LBIE would have no need (nor right) to make a call under section 74 in order to enable LBIE to pay the Sub-Debt;

viii) Accordingly, the ability of the LBIE Administrators to make a Sub-Debt Contribution Claim depends upon the existence of an obligation on the part of LBIE to repay the Sub-Debt. It follows that if LBIE has no liability to repay the Sub-Debt (or the value of LBHI2's contingent claim into LBIE for re-payment of the Sub-Debt is nil) then, a Sub-Debt Contribution Claim is incapable of being made by the LBIE Administrators (or to the same effect, the contingent Sub-Debt Contribution Claim must also be valued at nil and is therefore insignificant).

42. The fallacy in the LBIE Administrators' position is thrown into sharp relief if one considers the logical consequences of their position. They accept that, if the Sub-Debt is due, LBIE's corresponding contingent claim for a Sub-Debt Contribution would be extinguished by set-off. However, it follows from their position on Issue 3 that they wish to say that if the Sub-Debt <u>is not and would not be due</u>, LBIE nevertheless still has a Sub-Debt Contribution Claim for the full amount of the Sub-Debt, but that claim would not then be extinguished by being set-off against the Sub-Debt itself. Thus it is said that LBIE is better off and able to prove in its members' administrations (in effect) for payment of the Sub-Debt even though it does not have to pay the Sub-Debt. Such a conclusion is logically unsustainable.

**Insolvency set-off**

43. In an administration, Rule 2.85(1) IR 1986 provides that insolvency set-off comes into play where the administrator has (with authority to do so) given notice, pursuant to Rule 2.95 IR 1986, that he/she proposes to make a distribution.

44. Rule 2.85(3) IR 1986 provides that:

> *(3) An account shall be taken as at the date of the notice referred to in paragraph (1) of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other.*

45. As in both personal insolvency and corporate liquidation, insolvency set-off in an administration context is automatic and self-executing. It affects the substantive rights of the parties by extinguishing their claims. It replaces those claims with a new claim in favour of the party with the larger claim. The effect is that the competing claims (which are choses in action) are extinguished and replaced with a new chose in action representing the net balance in favour of whichever party had the larger claim (*Stein v Blake* [1995] 2 All ER 96 at 250 to 255)[7].

46. In a distributing administration, insolvency set-off applies even where the creditor's claim and where the company's cross-claim are both contingent obligations (Rule 2.85(4) IR 1986).

47. Further, Rule 2.85(5) IR 1986 provides that, for the purposes of the set-off account, contingent obligations on both sides of the account are to be estimated in accordance with Rule 2.81 IR 1986.

48. Rule 2.81 IR 1986 in turn provides that:

> ***2.81.— Estimate of quantum***
>
> *(1) The administrator shall estimate the value of any debt which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value; and he may revise any estimate previously made, if he thinks fit by reference to any change of circumstances or to information becoming available to him. He shall inform the creditor as to his estimate and any revision of it.*

[7] Which analysis also applies to insolvency set-off in administration – see *In re Kaupthing Singer & Friedlander Limited (in administration)* [2010] EWCA Civ 518 at paragraph [24].

*(2) Where the value of a debt is estimated under this Rule, the amount provable in the administration in the case of that debt is that of the estimate for the time being.*

**Set-off in the present case**

49. LBH has no claim against LBIE. As a consequence, no insolvency set-off can be effected in LBIE's administration as between LBIE and LBH. This is so, even assuming that LBH were the registered holder of a single share in LBIE.

50. However, insolvency set-off has, automatically, been effected in LBIE's administration, as between LBHI2 and LBIE:

i) LBHI2's claim in LBIE's administration for re-payment of the Sub-Debt is a contingent liability as explained in the Waterfall I Court of Appeal Judgment;

ii) LBIE's Sub-Debt Contribution Claim as against LBHI2 is also contingent. It is contingent upon at least: (a) LBHI2 having a claim for the Sub-Debt (*i.e.* satisfaction of the pre-conditions to re-payment as contained in the Sub-Debt Agreements); (b) LBIE entering liquidation; and (c) LBIE's liquidator making a call under section 74 as against LBHI2;

iii) Since insolvency set-off under Rule 2.85 IR 1986 took effect automatically in LBIE's administration on 4 December 2009, there has already been a netting-off in respect of the (contingent) Sub-Debt Contribution Claim of the LBIE Administrators as against LBHI2's (contingent) cross-claim for repayment of the Sub-Debt;

iv) As a consequence, LBHI2's liability in respect of the Sub-Debt Contribution Claim has been extinguished. This is because, if the conditions for repayment of the Sub-Debt have been met (or will inevitably be met) so that the value of the contingent claim for the Sub-Debt is re-valued upwards, it necessarily follows that LBIE's Sub-Debt Contribution Claim against LBHI2 will be estimated at an equivalent or near equivalent amount. The only reason for there being any difference between the two claims would be because of the possibilities that LBIE might not enter liquidation and that a liquidator of LBIE might not make a call under section 74. Though theoretical possibilities, it is impossible to contend that these matters should have any material impact upon the estimated value of the Sub-Debt Contribution Claim. As the LBIE Administrators say, were it necessary for

LBIE to move into liquidation to make a call against its contributories "*the LBIE Administrators [would] cause LBIE to go into liquidation*" **[1/16/p.11/paragraph 25(4)]**. Were there a liquidation, the liquidator would almost certainly make a call under section 74[8]; and

v) LBIE's liability for repayment of the Sub-Debt will thus have been satisfied.

51. The foregoing is unaffected by the application of the hindsight principle to the re-valuing of the set-off account. If, in view of changed circumstances, LBHI2's contingent claim for the Sub-Debt in LBIE's administration were re-valued upwards as at the set-off date, the value of LBIE's Sub-Debt Contribution Claim against LBHI2 would also be increased to a similar extent.

52. Any liability on the part of LBIE for the Sub-Debt will therefore have been satisfied (and that will be the case irrespective of any revaluation of LBIE and LBHI2's Sub-Debt-based cross-claims in accordance with the hindsight principle). There is consequently no basis upon which a liquidator of LBIE could make a call upon LBL or LBH (on the assumption that either entity were the registered holder of a single share in LBIE) for the purposes of enabling LBIE to repay the Sub-Debt. The Sub-Debt will have been discharged through set-off as between LBIE and LBHI2.

53. The separate question whether a liquidator of LBIE might make a call under section 74 for the purposes of adjusting the rights of the members between themselves arises in the context of Issue 7.

## E. ISSUE 7(V)

54. Issue 7(v) concerns the ability (or otherwise) of the Court to direct the LBIE Administrators in the manner in which they should pursue a Contribution Claim and is in the following terms:

> **Whether the LBIE Administrators should be directed to assert less than 100% of the Contribution Claim against LBL and/or LBHI2 and, if so, by how much the Contribution Claim should be reduced as against LBL**

[8] Insofar as there might be a (theoretical) difference between the value of the contingent Sub-Debt Claim and the contingent Sub-Debt Contribution Claim (by reason of the former being given a slightly higher value than the latter), the result would simply be the creation of a notional (theoretical) balance being due and owing by LBIE to LBHI2. Any such notional (theoretical) liability on the part of LBIE to LBHI2 could, of course, simply be the subject of a higher call or an additional (notional) call for a contribution as against LBHI2 and/or LBL/LBH.

**and/or LBHI2 and what factors should the Court take into account in reaching its decision.**

55. The LBH Administrators submit that the Court can direct the LBIE Administrators to assert less than 100% of the Contribution Claim as against any shareholder (*i.e.* a claim for less than that which a liquidator of LBIE would require in order to pay LBIE's debts and the expenses of the liquidation).

56. Furthermore, in the present case:

i) Neither LBL nor LBH (assuming LBH to be the registered holder of a single share in LBIE) can or should be the subject of a Sub-Debt Contribution Claim (that is, a contingent proof for the entirety of the sums that would be necessary for a liquidator of LBIE to pay the Sub-Debt). This is because the Sub-Debt Contribution Claim and the Sub-Debt Claim are either to be valued at nil or else both claims would be discharged by operation of set-off as against LBHI2;

ii) In the latter case, the only claim that might be asserted by reference to the Sub-Debt is a claim by way of adjustment as between LBL / LBH and LBHI2. Whilst the LBIE Administrators might, in principle, assert a claim against LBH (assuming it to be the registered holder of a single share in LBIE) in respect of the (contingent) liability of LBH to a call by a liquidator of LBIE under section 74 for the purposes of adjusting the rights of LBHI2 and LBH between themselves, such a call is subject to the Court's discretion. It is submitted that, any such claim would take as a starting point the principle that members of companies should make contributions under section 74 in proportion to their shareholding. The relevant proportion in the present case would be based upon the number of $1 ordinary shares held by each shareholder (LBHI2 holding 6,237,113,999 shares and LBH being assumed on this hypothesis to hold only 1 such share); and

iii) As a consequence any adjustment would be for a trivial amount and, in the circumstances where LBHI2 does not seek any such adjustment[9], it would be irrational for such a call to be made. Hence, the Court could and should direct the LBIE Administrators not to assert any such claim.

[9] See LBHI2's position paper at **[1/17/p.3/paragraph (iv)]**.

**The Court's power to give directions to the LBIE Administrators**

57. The position of the LBIE Administrators appears to be that the Court has no power to direct them as administrators in relation to the claims that LBIE ought to lodge in the administrations of LBIE's shareholders **[1/16/p.21/paragraphs 42(ii) to (v)]**. As a matter of principle, that is plainly incorrect. The LBIE Administrators are officers of the Court and subject to its supervisory jurisdiction[10].

58. Furthermore, in asserting such a claim, the LBIE Administrators would be making a claim for a contingent liability to meet a call by a subsequently-appointed liquidator. The key point is that the ability or power of a liquidator to make a call (whether for the purposes of contribution or adjustment) is itself subject to the overriding control of the Court. As explained below, this is the case irrespective of whether the company enters compulsory or voluntary liquidation (and so it matters not which form of liquidation were to follow LBIE's administration). Since the Court can control the exercise of a call by a liquidator, it must follow that the Court supervising a prior administration can direct the administrators then holding office to act in a way which would be consistent with the way that the power would be exercisable, or directed by the Court to be exercisable, in a liquidation.

59. As to the position in a compulsory liquidation:

    i) The Court "*may*", at any time after making a winding up order, make calls for the payment of any money "*which the court considers necessary*" to satisfy the debts and liabilities of the company and the expenses of the winding up (section 150(1) IA 1986). This is, plainly, a discretionary power;

    ii) Additionally, in making a call, the Court, "*may take into consideration the probability that some of the contributories may partly or wholly fail to pay it*" (section 150(2) IA 1986);

    iii) The Court's power to make a call under section 150 IA 1986 has been delegated to the liquidator (in accordance with section 160(1)(d) IA 1986). In making a call, the

[10] See, paragraph 5 of Schedule B1 to IA 1986 and *Re Atlantic Computer Systems Plc (in Administration)* [1992] Ch 505, at 529; see also the rule in *Ex parte James* as discussed by David Richards J (as he then was) in the context of LBIE's administration in *Lomas and Others v Burlington Loan Management and Others* [2015] EWHC 2270 (Ch) at paragraphs [174] to [183].

liquidator acts "*as an officer of the court subject to the court's control*" (Rule 4.202 IR 1986);

iv) As such, the liquidator when making a call is exercising the Court's discretionary power and, moreover, is doing so under the Court's supervision;

v) Further, in the event that a liquidator made such a call but it was unpaid, the Court in deciding whether to make an order to enforce the payment of such a call pursuant to Rule 4.205(2) IR 1986 would have a further discretion as to whether or not to do so. Hence, there is another discretion vested in the Court at this stage;

vi) It follows that the Court can, in appropriate circumstances, direct the liquidator in a compulsory liquidation not to make a call or to make a call for a specific amount. Furthermore, since enforcement of a call requires the exercise by the Court of its powers to order payment by a member, the efficacy of a call is dependent upon the Court's discretion; and

vii) Accordingly, a member might be ordered to pay less than the sum that would be necessary to pay 100% of the debts and liabilities of the company and the expenses of a compulsory winding up.

60. The same is true in the case of a voluntary liquidation:

i) In order to give effect to a member's liability to make a contribution under section 74, the liquidator may apply to the Court, "*to exercise as respects the enforcing of calls or any other matter, all or any of the powers which the court might exercise if the company were being wound up by the court*" (section 112(1) IA 1986). Accordingly, in a voluntary liquidation, the Court can make such orders for calls or for their enforcement as it could make in relation to a compulsory liquidation;

ii) The Court's power to make a call in a voluntary liquidation has again been delegated to the liquidator (see the Waterfall I Court of Appeal Judgment, at paragraph [177]). Although a voluntary liquidator is not an officer of the Court, it is submitted that he is to be treated as a Court officer in circumstances where he is exercising a power of the Court that has been delegated to him. In any event, the delegated power to make a call is subject to the Court's supervision;

iii) The Court, if satisfied that, "*the required exercise of power will be just and beneficial, may accede wholly or partially to the application on such terms and conditions as it thinks fit, or may make such other order on the application as it thinks just*" (section 112(2) IA 1986). Thus, the Court in deciding the extent to which to order a member to contribute to the assets of the company would be exercising a discretion and could decide to order a contribution of such sum as it thought fit; and

iv) Accordingly, a member might be required to pay less than the sum that would be necessary to pay 100% of the debts and liabilities of the company and the expenses of the voluntary winding up.

61. It follows that since LBIE is in administration and the LBIE Administrators are officers of the Court, the Court supervising the administration can give directions to the LBIE Administrators as to whether and to what extent (*i.e.* in what amount and against whom) they should assert a Contribution Claim (whether for the purposes of contribution or adjustment) as against LBIE's members. If the Court would direct a liquidator to call for less than 100% from each shareholder, then the administrators' contingent claim must reflect that.

**The exercise of the Court's discretion to give directions to the LBIE Administrators**

62. In deciding what directions to give to the LBIE Administrators (if any), the Court should have regard to all the circumstances, including:

i) The way that a liquidator would be entitled to exercise the power to make a call under section 74. If a liquidator would not be entitled to, or would be directed by the Court not to, make a call for a particular sum or against a particular party, the prior administrators should be directed to act in a consistent manner since the administrators' contingent contribution claim should not exceed that which a liquidator could actually claim;

ii) The manner in which the Sub-Debt and the Sub-Debt Contribution Claim would be dealt with in the course of a liquidation;

iii) The directions that are necessary in order to ensure that the relevant liabilities of LBIE are discharged (taking into account, for example, the solvency and ability to pay of the respective members) – see in particular sections 150(1) and (2) IA 1986;

iv) The prospects of achieving the ultimate objective (whether a liquidator makes a call for the purposes of meeting the debts and liabilities of the company and the costs of the winding up, or for the purposes of adjusting the rights of the members between themselves) of ensuring that members contribute to the assets of the company in proportion to their respective shareholdings; and

v) When considering whether to give directions only for the purposes of adjustment, the Court should have regard to the views of the shareholder who would ultimately benefit from such an adjustment. This is particularly pertinent in the present case where, as would appear, the LBHI2 Administrators do not press for any adjustment since any such adjustment would be *de minimis* and "*can properly be ignored*" **[1/17/p.3/paragraph (iv)]**.

## F. CONCLUSION

63. The Court is accordingly and respectfully requested to make appropriate declarations in respect of the agreed Part A Issues, and to make declarations in relation to Issues 1, 3 and 7(v) on the basis of the arguments set out above on behalf of the LBH Administrators.

**STEPHEN ATHERTON Q.C.**

**TONY BESWTHERICK**

20 Essex Street

23 January 2017

**Counsel for the LBH Administrators**