No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N :

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

SKELETON ARGUMENT OF THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE)

For the trial of Part A of the Waterfall III Application

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In this skeleton argument, references to the Trial Bundle are in the format: [volume/tab/page]. References to the Position Papers are in the format [party/paragraph number].

A. INTRODUCTION

1. On 4 November 2016, the Court gave directions for:

    1.1. the trial of Issues 1 to 8, the Issue 9 Preliminary Issue ("**Issue 9A**") and Issues 10 and 12 of the Waterfall III Application (the "**Part A Issues**"); and

    1.2. the separate trial of Issues 9, 11, 13 and 14 of the Waterfall III Application (the "**Part B Issues**").

2. This skeleton argument has been lodged on behalf of the administrators of Lehman Brothers International (Europe) (the "**LBIE Administrators**" and "**LBIE**" respectively) for the trial of the Part A Issues.

3. As a result of recent correspondence between the parties, it has become apparent that the parties are agreed on the answers to some of the Part A Issues (the "**Agreed Part A Issues**"). The Agreed Part A Issues are Issues 2, 4, 5, 6 and 12.

4. At the same time, there continue to be disputes in respect of the remaining Issues (the "**Disputed Part A Issues**"). The Disputed Part A Issues are Issues 1, 3, 7, 8, 9A and 10.

5. This skeleton argument addresses:

    5.1. The Disputed Part A Issues (Sections C to H below); and

    5.2. The Agreed Part A Issues (Section I Below).

6. As regards the Agreed Part A Issues, the Court will be invited to make declarations to reflect the terms of the parties' agreement. Section I of this skeleton argument is intended

to provide the Court with submissions sufficient to enable it to consider and, if thought fit, make those declarations.

7. Whilst in the non-insolvency litigation context the Court does not ordinarily make declarations in respect of matters which are not disputed, the Waterfall III Application is an application by the LBIE Administrators under paragraph 63 of Schedule B1 to the Insolvency Act 1986 seeking directions in respect of the conduct of the administrations of a number of the companies in the Lehman group. In that context it is of course common for the Court to be asked to confirm the appropriateness of a proposed course of action or approach.

B. BACKGROUND

8. A full explanation of the background to the Waterfall III Application is contained in Downs-9 [1/21]. In summary:

   8.1. Notwithstanding the size of the surplus, there is a real prospect that it will be insufficient to discharge the liabilities of LBIE in full (i.e. including statutory interest, non-provable claims and subordinated debt) (Downs-9, [10]).

   8.2. A future liquidator of LBIE may be entitled to call on LBIE's members, Lehman Brothers Limited ("**LBL**") and LB Holdings Intermediate 2 Limited ("**LBHI2**"), for a contribution, pursuant to section 74 of the Insolvency Act 1986 (the "**1986 Act**"). Since LBIE is an unlimited company, the liability of LBL and LBHI2 as contributories is unlimited (Downs-9, [8]).

   8.3. LBIE has lodged claims in the administrations of LBL and LBHI2 seeking (*inter alia*) £10 billion in respect of their contingent liabilities under section 74 (Downs-9, [23]-[24]). These claims have not been admitted.

   8.4. At the same time, LBL has lodged claims in the administrations of LBIE and Lehman Brothers Europe Limited ("**LBEL**") seeking (*inter alia*) to 'recharge' the amounts which LBIE has claimed against it (Downs-9, [26]-[29]). These proofs of debt have not been admitted.

9. The existence of these unresolved cross-claims and the related issues are among the obstacles preventing the distribution of the remaining assets within these estates.

   9.1. The surplus in LBIE's estate cannot be distributed until the remaining issues have been resolved. Given that a period of more than two years has elapsed since the payment in full of the unsecured debts (Downs-9, [35]) and the cash balances in the hands of the LBIE Administrators are currently earning minimal rates of interest (Downs-9, [19]), it is important to move forwards towards the resolution of the remaining issues in order to enable the LBIE Administrators to distribute the surplus to those entitled to it.

9.2. In addition there are substantial sums of cash and cash equivalents in the estates of LBL, LBHI2 and LBEL which cannot be distributed until the remaining issues have been resolved (Downs-9, [18]).

10. The continuation of this uncertainty prejudices stakeholders in three respects:

10.1 First, the distributions to which they are entitled are being delayed.

10.2 Secondly, whilst statutory interest was payable under Rule 2.88 of the Insolvency Rules 1986 for as long as the provable debts remained outstanding, there is no equivalent right to interest on unpaid statutory interest or any other form of compensation available to compensate creditors for any prejudice caused by the delay in the payment of statutory interest.[1]

10.3 Thirdly, the LBIE Administrators' costs of the LBIE administration are continuing to accrue, reducing the size of the surplus available for distribution. The LBIE Administrators are keen to be able to finalise matters and close the administration.

11. In an attempt to remove obstacles to the distribution of these substantial sums, the LBIE Administrators have been seeking judicial determinations of key outstanding issues:

11.1. The Waterfall I Application was issued on 14 February 2013, in anticipation of a possible surplus in LBIE's estate (Downs-9, [38]). The parties to the Waterfall I Application were the LBIE Administrators, the LBL Administrators, the administrators of LBHI2 (the "**LBHI2 Administrators**"), Lehman Brothers Holdings Inc ("**LBHI**") and Lydian Overseas Partners Master Fund Limited (Downs-9, [39]).[2]

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[1] This decision of David Richards J on this point in Waterfall II Part A is currently subject to appeal.

[2] The LBL Administrators and the LBHI2 Administrators participated in the Waterfall I Application on the basis that LBL and LBHI2 were shareholders in LBIE.

11.2. Following a trial in November 2013, David Richards J (as he then was) handed down judgment on 14 March 2014 (the "**Waterfall I Judgment**") [1/8]. Appeals were heard by the Court of Appeal during March 2015 and the Court of Appeal handed down judgment on the appeals on 14 May 2015 (the "**Waterfall I Appeal Judgment**") [1/9]. Permission to appeal to the Supreme Court was granted by the Supreme Court and the appeals were heard in the week commencing 17 October 2016. Judgment was reserved.

11.3. The LBIE Administrators' application by Application Notice dated 12 June 2014 (the "**Waterfall II Application**") was divided into three parts: Waterfall II Part A (which involved questions of insolvency law relating to statutory interest and currency conversion claims); Waterfall II Part B (which related to post-administration contracts); and Waterfall II Part C (which related to the calculation of default interest in derivatives agreements) (Downs-9, [45]).

11.4. Waterfall II Part A and Waterfall II Part B were tried in February 2015 and May 2015 by David Richards J, who handed down his judgments on 31 July 2015. Appeals against his Orders in Waterfall II Part A and Waterfall II Part B will be heard by the Court of Appeal in April 2017. Waterfall II Part C was tried in November 2015 by Hildyard J and judgment has been handed down. Permission to appeal was granted to those parties that sought it.

12. In an attempt to avoid a disorganised multiplicity of disparate proceedings, the LBIE Administrators sought to identify the relevant unresolved issues arising from the claims and cross-claims among the various Lehman estates and to seek to have them resolved in an orderly and co-ordinated way through the Waterfall III Application. As explained above, those issues have been divided into the Part A Issues and the Part B Issues.

C. **ISSUE 1**

13. Issue 1 is:

> "*Whether the obligations of* [LBHI2] *and/or* [LBL] *to contribute to the assets of* [LBIE] *pursuant to section 74 of the Insolvency Act 1986* [(the "**1986 Act**")] *include an obligation to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay* [the Sub-Debt]".

14. The LBIE Administrators submit that Issue 1 is to be answered in the affirmative. The obligations of LBHI2 and LBL to contribute do include an obligation to contribute towards the payment of the Sub-Debt, which is one of the debts and liabilities of LBIE for the purposes of section 74(1).

15. The Administrators of LBL and the Administrators of LBH say that Issue 1 is to be answered in the negative, i.e. that the obligations of LBHI2 and LBL to contribute do not include an obligation to contribute towards the payment of the Sub-Debt.

16. In support of this position, they advance two separate contentions:

    16.1. First, the Administrators of LBL and LBH say that the Sub-Debt Agreements contain either an express term or an implied term that the funds of LBIE alone are to be resorted to for the purpose of paying the Sub-Debt and/or that there is to be no recourse to the members of LBIE for that purpose [LBL/112; LBH/12(i); LBL Reply/5.2-5.9, 6]; and

    16.2. Secondly, the Administrators of LBL and LBH say that the reference in clause 5(2) of the Sub-Debt Agreements to LBIE being able to pay its Liabilities should be construed to be a reference to LBIE being able to pay its Liabilities from its own resources, without reference to any contributions which may be made by LBIE's members under section 74 [LBL/116; LBH/12(ii)].

17. The LBIE Administrators disagree. There is no express or implied term of the type for which the Administrators of LBL and LBH contend in the Sub-Debt Agreements and

clause 5(2) of the Sub-Debt Agreements is not to be construed in the manner for which the Administrators of LBL and LBH contend.

18. It is accordingly necessary to address Issue 1 in three parts:

18.1. The contention by the Administrators of LBL and LBH that there is an ***express*** term in the Sub-Debt Agreements that the funds of LBIE alone are to be resorted to for the purpose of paying the Sub-Debt and/or that there is to be no recourse to the members of LBIE for that purpose;

18.2. The contention by the Administrators of LBL and LBH that there is an ***implied*** term in the Sub-Debt Agreements to that effect; and

18.3. The contentions by the Administrators of LBL and LBH in respect of the meaning of clause 5(2) of the Sub-Debt Agreements.

(1) The Sub-Debt Agreements

19. The background to the Sub-Debt was explained in detail by David Richards J (as he then was) in the Waterfall I Judgment, *In re Lehman Bros International (Europe) (in administration) (No 4)* [2014] EWHC 704 (Ch), [2015] Ch 1(. The LBIE Administrators will refer at trial to paragraphs 27 to 52 of that judgment for the background to, and terms of, the Sub-Debt Agreements.

(2) No express term

20. It is clear that there is no express term in the Sub-Debt Agreements that the funds of LBIE alone are to be resorted to for the purpose of paying the Sub-Debt and/or that there is to be no recourse to the members of LBIE for that purpose. There is no provision in the Sub-Debt Agreements which could properly be construed to bear the meaning for which the Administrators of LBL and LBH contend.

21. In the cases on which the LBL Administrators rely in their position paper [LBL/111], the agreements in question contained very clear provisions to the relevant effect:

21.1. In *In re Athenaeum Life Assurance Company, Ex parte Prince of Wales Life Assurance Company* (1859) 3 De G&J 660, 44 ER 1423:

> "*A policy of assurance granted by the A company provided that the capital stock of £100,000, and other property of the company remaining at the time of the claim unapplied and inapplicable to prior claims, should alone be liable to pay the sum assured, and that no shareholder should be liable beyond the amount unpaid of his shares in the capital stock*".

21.2. In *In re Accidental Death Co* (1878) 7 Ch D 568, the policy contained–

> *"a proviso limiting the scope and effect of the contract thereby created, so that the capital, stock, and funds of the company should alone be liable to answer and make good all claims in respect of any such policy, and that no proprietor of the company should in any manner be personally liable or subject to any such claims or demands, or be in anywise charged by reason of such policy beyond the amount of his or her shares of such capital, stock, or funds*".

21.3. In *In re Great Britain Mutual Life Assurance Society* (1880) 16 Ch D 246, the policy provided–

> "*that no member of the Society (whether an officer of the Society or not), nor any person claiming under him or her, should be personally liable to make good, either in whole or in part, any claim or demand whatever under any policy, grant of annuity, endowment, or other assurance, issued or to be issued on behalf of the Society, but the funds or property of the Society which at the time of recovering upon any such claim or demand, policy, annuity, endowment, or other assurance, should be in the hands or power of the directors (including the guarantee fund therein-after mentioned and provided, if it should be necessary to resort thereto for the purpose), and not for the time being required to pay or satisfy any prior claims or demands-upon the Society, should alone be liable to satisfy such claim or demand, policy, annuity, endowment, or other assurance*".

21.4. In *Lathbridge v Adams, Ex parte Liquidator of the International Life Assurance Society* (1872) LR 13 Eq 547, the policy provided—

> "*the funds and property of the society, according to the deed or deeds of settlement thereof, after satisfying all assurances granted by the society*

> *previously payable, and all other prior charges on such funds and property, shall alone be answerable for the payment of the moneys assured by this policy, and that no director of the society by whom this policy is executed, nor any other proprietor of the society, shall be responsible for the payment of or contribution towards the moneys assured by this policy, or liable to any demand against the society on any pretence whatsoever, beyond the unpaid part for the time being of his or her shares or share in the subscribed capital of the society*".

22. Such provisions were a common device for limiting the liabilities of contributories in unlimited companies. They were originally developed in the era before it was possible to incorporate a company with limited liability; and, in modern terms, they take effect as limited recourse provisions. (Indeed, the fact that limited recourse is the juridical basis for the efficacy of such provisions was explained by Lord Cranworth LC in *In re The Sea Fire & Life Assurance Company* (1854) 3 De GM&G 459 at 483.)

23. It is immediately apparent that there are no such express limited recourse provisions in the Sub-Debt Agreements. There is nothing in the payment provisions of either the standard terms or the variable terms to say that LBIE's liability for the Sub-Debt will be limited to its paid-up capital or to the nominal amount of its issued capital or anything to that effect. Similarly, there is nothing to say that the lender in respect of the Sub-Debt agrees that it will not be entitled to receive the proceeds of any calls which might be made on contributories by a liquidator in the event of LBIE's liquidation.

(3) No implied term

24. In the LBIE Administrators' submission, there is no basis for any implied term in the Sub-Debt Agreements of the type for which the Administrators of LBL and LBH contend.

(i) The basis for the contentions of the Administrators of LBL and LBH

25. The argument which has been advanced by the LBL Administrators (and adopted by the LBH Administrators) is that "[it] *makes no commercial sense for there to be recourse to assets beyond those of LBIE itself* ***in this case***" [LBL/113.1] (emphasis added).

26. The two particular facts of this case on which the LBL Administrators rely are:

26.1. The fact that the borrower, LBIE, is an unlimited company; and

26.2. The fact that the lender, LBHI2, is a member of LBIE.

27. The LBL Administrators say that "[it] *would make no commercial sense for there to be rights of recourse to assets beyond those of LBIE when this simply leads back to LBHI2 (the lender in respect of the Sub-Debt)*" [LBL/113.1].

28. On this basis, the LBL Administrators contend that there is an implied term in the Sub-Debt Agreements that the funds of LBIE alone are to be resorted to for the purpose of paying the Sub-Debt and/or that there is to be no recourse to the members of LBIE for that purpose [LBL/112-113].

29. In addition, the LBL Administrators rely on the proposition that "[almost] *all of the creditors of LBL were in commercial reality persons providing services for the benefit of the Lehman Group, including LBIE*" [LBL/113.2.3.2].

30. In reliance on this proposition, they submit that "[it] *would be inimical to the objective of the regulatory capital requirements for the provider of the Sub-Debt (LBHI2) to receive payments so as to reduce that debt at the expense of such external creditors*" [LBL/113.2.3.3].

31. This point is advanced as a further or alternative basis for contending that there should be an implied term in the Sub-Debt Agreements to ensure that contribution claims may not be made against LBL for the purpose of raising monies to pay the Sub-Debt.

(ii) <u>Overview of the LBIE Administrators' response</u>

32. The LBIE Administrators' grounds for contending that there is no such implied term are, in summary, as follows:

32.1. The particular factors on which the LBL Administrators rely are specific to the circumstances of LBIE, LBHI2 and LBL. However, the Sub-Debt Agreements are standard form agreements, which must mean the same for every person who uses them. The factors on which the LBL Administrators rely are therefore not relevant to the process of interpreting the Sub-Debt Agreements.

32.2. The fact that the Sub-Debt is assignable also serves to restrict the scope for relying on factual matrix evidence.

32.3. In any event, the test for the implication of a term is not met. The Sub-Debt Agreements are effective without the implication of the term for which the LBL Administrators contend. The implied term for which they contend is therefore not necessary to give business efficacy to the Sub-Debt Agreements. Put another way, it cannot be said that the Sub-Debt Agreements lack commercial or practical coherence without it.

(iii) Irrelevance of factual matrix to standard form agreements

33. As mentioned above, the Sub-Debt Agreements are standard form agreements. As David Richards J held in Waterfall I at first instance at [60]:

> "***In approaching the issues of construction of the subordinated facility agreements, it is clearly right to have regard to their regulatory context. It is common ground that they are largely based on templates provided by the FSA and that the subordination and other provisions contained in the Standard Terms are not tailor-made to LBIE or the particular facilities into which it entered but are generally applicable to all subordinated loans which are relied on by institutions to meet their capital adequacy requirements.*** *Although subordinated loans may rank only as lower tier 2 or even tier 3 capital, they are nonetheless to be treated as part of the capital or own funds of the institution for the purposes of providing protection to those dealing with the institutions and for the purpose of absorbing losses*" (emphasis added).

34. The standard form had been prescribed by the Financial Services Authority (the "**FSA**"): INPRU (INV) 10-63(2) R (which was in force at the time when the Sub-Debt Agreements were entered into) provided that a firm could include a subordinated loan within its financial resources only "*if it is drawn up in accordance with the standard forms obtained*

from the FSA". It was therefore not the case that the parties could amend or vary the standard form: its terms were mandatory and could not be added to or changed.

35. It follows that, in the interpretation of the Sub-Debt Agreements, it is irrelevant to consider the particular factual circumstances of LBIE, LBHI2 and LBL at the time when they entered into the Sub-Debt Agreements.

36. As Lord Millett explained in *AIB Group (UK) Plc v Martin* [2002] 1 WLR 94 at 96 (in a passage quoted with approval in Lewison, *The Interpretation of Contracts*, 6th ed. [6-04]):

> "*A standard form is designed for use in a wide variety of different circumstances. It is not context-specific. Its value would be much diminished if it could not be relied upon as having the same meaning on all occasions. Accordingly the relevance of the factual background of a particular case to its interpretation is necessarily limited. The danger, of course, is that a standard form may be employed in circumstances for which it was not designed. Unless the context in a particular case shows that this has happened, however, the interpretation of the form ought not to be affected by the factual background*".

37. Similarly, in *In re Lehman Brothers International (Europe)* [2016] EWHC 2417 (Ch) ("Waterfall II Part C"), Hildyard J held at [48]:

> "*Although the relevant background, so far as common to transactions of such a varied nature and reasonably expected to be common knowledge amongst those using the ISDA Master Agreements, is to be taken into account, a standard form is not context-specific and evidence of the particular factual background or matrix has a much more limited, if any, part to play*".

38. See, for example, *SwissMarine Corp Ltd v OW Supply and Trading AS (In Bankruptcy)* [2015] EWHC 1571 (Comm) at [27] per Andrew Smith J:

> "*Ms Bingham had a broader argument about the factual matrix in which the ISDA Agreement was made: that it informs the interpretation of the jurisdiction agreement more generally, and indicates that the standard jurisdiction wording should not be interpreted in this ISDA Agreement so as to prevent OW Supply from relying on the Danish insolvency regime by bringing proceedings in Denmark. I am not persuaded of that. To my mind, when parties choose to use for a contract a standard wording such as the ISDA Master Agreement form, generally their own circumstances at the time of the contract will not affect the*

interpretation of the wording. By choosing standard wording, parties usually evince an intention that the wording as incorporated into their contract should be given its usual meaning".

39. See also:

39.1. *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] AC 749 per Lord Hoffmann:

> "*There are documents in which the need for certainty is paramount and which admissible background is restricted to avoid the possibility that the same document may have different meanings for different people according to their knowledge of the background. Documents required by bankers' commercial credits fall within this category*".

39.2. *Dairy Containers Ltd v Tasman Orient CV* [2005] 1 WLR 215 per Lord Bingham:

> "*There may reasonably be attributed to the parties to a contract such as this such general commercial knowledge as a party to such a transaction would ordinarily be expected to have, but with a printed form of contract, negotiable by one holder to another, no inference may be drawn as to the knowledge or intention of any particular party. The contract should be given the meaning it would convey to a reasonable person having all the background knowledge which is reasonably available to the person or class of persons to whom the document is addressed*".

39.3. *Greatship (India) Ltd v Oceanografia SA de CV* [2013] 2 Lloyd's Rep 359 per Gloster J:

> "*Moreover, there is real difficulty in seeking to imply a term into a detailed standard form contract … where the strong presumption is likely to be that the detailed terms of the contract are complete*".

40. The importance of not implying terms on the basis of the factual circumstances of the parties is *a fortiori* the case where the standard form has been prescribed by regulations and may not be departed from.

41. It is also relevant in this context to note that the Sub-Debt was assignable with the consent of the FSA: see the definition of "*Lender*" in clause 1(1) of the Standard Terms and the

Lender's representation not to assign the Sub-Debt without the consent of the FSA in clause 7(a) of the Standard Terms.

42. The authorities establish that terms are not lightly to be implied into assignable contracts, which must have the same meaning for future assignees: see *Dairy Containers Ltd v Tasman Orient CV* [2005] 1 WLR 215; *Phoenix Commercial Enterprises Pty Ltd v City of Canada Bay Council* [2010] NSWCA 64; and *Cherry Tree Investments Ltd v Landmain Ltd* [2012] EWCA Civ 736, [2013] Ch 305 (in particular at [124]-[125] per Lewison LJ). The assignability of the Sub-Debt therefore provides a further obstacle to the use of the parties' circumstances as the basis for the implication of a term.

43. In the present case, there is no basis for suggesting that the "*standard form* [was] *employed in circumstances for which it was not designed*" (per Lord Millett in *AIB*). On the contrary, the standard form of the Sub-Debt Agreements was designed for precisely these circumstances, as David Richards J explained in Waterfall I at first instance at [33] and [48].

44. It follows that there is no room for any implied term deriving from the commercial circumstances of the parties. The Sub-Debt Agreements are standard form agreements which must mean the same thing for everyone who uses them. The interpretation of the Sub-Debt Agreements therefore cannot be influenced by the lender's ownership of shares in the borrower or the particular form of corporate entity of the borrower.

45. Further, by choosing to use a standard wording for their contract, LBIE and LBHI2 evinced an intention to be bound by the usual meaning of the standard wording. Indeed, since the standard form was a mandatory wording prescribed by the FSA (which could not be added to or changed), the parties would have intended not to alter it through the implication of any additional terms.

(iv) The implied term is unnecessary

46. In any event, the implied term contended for does not meet the test of necessity.

47. The requirements which must be satisfied before a term is implied were summarised by Sales J (as he then was) in *Torre Asset Funding Ltd v Royal Bank of Scotland Plc* [2013] EWHC 2670 (Ch) at [152]. In summary of the key points:

    47.1. It must satisfy the test of necessity;

    47.2. It must be so obvious that it 'goes without saying';

    47.3. It is not enough to show that, had the parties foreseen the eventuality which in fact occurred they would have wished to make provision for it, unless it can be shown either that there was only one contractual solution or that one of several possible solutions would without doubt have been preferred;

    47.4. The proposed term must be reasonably certain. Where there are a number of possible terms or where a proposed term could be expressed in different ways, that may be a good indication that it is not sufficiently certain; and

    47.5. The proposed term must be capable of being defined with sufficient precision to give reasonable certainty of operation.

48. The recent decision of the Supreme Court in *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, [2016] AC 742 reiterates that a term will be implied into a contract only if it is necessary to give business efficacy to the contract or is so obvious that it goes without saying.

49. As Lord Simon explained in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 266 at 283, the test of necessity means that "*no term will be implied if the contract is effective without it*".

50. In *Marks & Spencer* at [21], Lord Neuberger agreed with Lord Sumption's reformulation of this proposition – namely, that a term can only be implied if, without the term, the contract would lack commercial or practical coherence.

51. Lord Neuberger also held at [24] that *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988 had not ushered in any "*dilution of the requirements which have to be satisfied before a term will be implied*" and that "*the law governing the circumstances in which a term will be implied into a contract remains unchanged following the Belize Telecom case*".

52. In the present case, it cannot be said that the Sub-Debt Agreements would lack commercial or practical coherence without the implied term for which the LBL Administrators contend. It works perfectly well without the implied term for which the LBL Administrators contend. It is a loan which is repayable on the occurrence of particular contingencies. When it becomes repayable, the borrower is under an obligation *in personam* to repay it. There is no commercial or practical incoherence in an ordinary subordinated loan which contains no limited recourse provisions.

53. The main point advanced by the LBL Administrators is that it would make no sense for LBHI2 to have to contribute to the payment of the Sub-Debt, in circumstances where LBHI2 is the creditor in respect of the Sub-Debt: the position would be circular and LBHI2 would have to provide monies to LBIE for the repayment of itself.

54. However, this ignores the fact that the Sub-Debt was freely assignable (with the permission of the FSA). It was therefore foreseeable that LBHI2 would not always be the creditor in respect of the Sub-Debt; and the parties would have been aware from the outset that the circularity on which the LBL Administrators now seek to rely was not necessarily a permanent feature of the commercial circumstances.

55. Similarly, there was nothing to ensure that LBHI2 and LBL would always be shareholders in LBIE . They were free to transfer their shares to any other entity and could have done so at any time (e.g. in the event of a further restructuring of the group's corporate structure). On this basis, two (or more)_different Lehman companies could have taken over from LBHI2 and LBL as the shareholders in LBIE, without any change being made to the Sub-Debt arrangements. The parties to the Sub-Debt Agreements would have been aware of the possibility of changes in share ownership and would have known on this basis also that the circularity on which the LBL Administrators seek to rely was not necessarily a permanent feature of the commercial circumstances.

56. Further, there was never any circularity in the position of LBL, which was a shareholder in LBIE at the time when the Sub-Debt agreements were entered into but not a lender in respect of the Sub-Debt. The circularity in the position of LBHI2 does not provide any basis for saying that a term should be implied to protect LBL.

57. Furthermore, it is not obvious that the parties to the Sub-Debt Agreement would have agreed to the implied term for which the LBL Administrators contend, if it had been suggested to them at the time of the making of the contract. LBHI2 in particular would have had no reason to agree to a term which would prevent recourse against LBL for the payment of the Sub-Debt and thereby impair the value of the Sub-Debt, including as an assignable asset. It would have been in the interests of LBHI2 to retain LBL's potential liability in respect of the Sub-Debt and not to exclude it in the way for which the LBL Administrators contend. It is also unlikely that LBIE would have agreed to a term which departed from the standard form mandated by the FSA.

58. The LBL Administrators' reliance on the proposition that "[almost] *all of the creditors of LBL were in commercial reality persons providing services for the benefit of the Lehman Group, including LBIE*" [LBL/113.2.3.2] is also misplaced. The relevant creditors for regulatory capital purposes were LBIE's creditors, rather than LBL's creditors or 'external' creditors of the Lehman group in any general sense.

(4) <u>Construction of clause 5(2) of the Sub-Debt Agreements</u>

59. The LBH Administrators contend that the condition of LBIE's ability to pay Liabilities in clause 5(2) of the Sub-Debt Agreements refers to payment from LBIE's own funds without reference to contributions from members under section 74 [LBL/116; LBH/12(ii)].

60. Clause 5(1) provides that the payment of the Sub-Debt is conditional on LBIE "*being 'solvent' at the time of, and immediately after, the payment*". Clause 5(2) provides that LBIE "*shall be 'solvent' if it is able to pay its Liabilities (other than the Subordinated Liabilities) in full*". The term "*Liabilities*" is defined to mean "*all present and future*

sums, liabilities and obligations payable or owing by the Borrower (whether actual or contingent, jointly or severally or otherwise howsoever)".

61. The LBH Administrators fasten upon the word "*it*" in the phrase "*if it is able to pay its Liabilities*" and contend that this is a reference to LBIE being able to pay its Liabilities (as defined) from its own assets, without recourse to its contributories [LBH/12(ii)].

62. The LBIE Administrators submit that the LBH Administrators' argument is wrong, as it produces an absurd and uncommercial result which cannot have been intended. In summary, the logical consequence of the interpretation of clause 5(2) for which the LBH Administrators contend is that:

    62.1. If the realisations in LBIE's estate (without taking into account LBIE's claims against its contributories under section 74) are £1 ***more*** than the amount required to pay the Liabilities, the Sub-Debt will fall due and payable; but

    62.2. If the realisations in LBIE's estate are £1 ***less*** than the amount of the Liabilities, so that LBIE has to make a call on its contributories for £1 to enable it to pay the Liabilities in full, the Sub-Debt will never fall due and payable (even if, following that call, LBIE does actually pay all of those prior-ranking liabilities in full).

63. Therefore, on the logic of the LBH Administrators' submission, even where the Liabilities have actually been paid in full, the Sub-Debt will never become payable at all if the sums which were used to pay those Liabilities included any amount (even if only £1) provided by LBIE's contributories under section 74 of the 1986 Act. In that eventuality, since LBIE would not have been able to pay the Liabilities in full from its own resources, but would have had to look to its contributories for assistance in paying them, the LBH Administrators' logic would mean that the condition in clause 5(2) could never be satisfied, such that the Sub-Debt would never become payable.

64. Given that the nature of the Sub-Debt is that it is intended to rank below the Liabilities and to fall due for payment when the Liabilities have been paid, the LBIE Administrators submit that there is no sensible commercial basis for any interpretation which prevents the Sub-Debt from falling due in circumstances where the Liabilities have actually been

paid in full. The fact that the Liabilities might have been paid by LBIE utilising monies which include additional funds from its contributories does not provide any sensible commercial basis for contending that the Sub-Debt should never be payable at all.

65. Further, there is no distinction in principle between: (i) the payment of Liabilities using capital provided by the shareholders ***before*** the commencement of the liquidation (e.g. at the time when the shares were originally allotted and paid up to their nominal values); and (ii) the payment of the Liabilities using capital provided by the shareholders ***after*** the commencement of the liquidation (i.e. pursuant to a call on them). In either case, the Liabilities are discharged using monies from the shareholders. The timing of the provision of those monies (and in particular whether the monies were provided by the shareholders before or after the commencement of the liquidation) provides no support for the LBH Administrators' argument. It makes no sense to say that, where the Liabilities are discharged using monies provided by the shareholders before the commencement of the liquidation, the Sub-Debt will become repayable, but, where the Liabilities are discharged using monies provided by the shareholders after the commencement of the liquidation, the Sub-Debt will never become repayable at all.

66. Notwithstanding this key point, however, the LBH Administrators advance four arguments in support of the interpretation of clause 5(2) for which they contend, as set out below. For the reasons explained below, the LBIE Administrators submit that none of the LBH Administrators' contentions provides any support for their interpretation.

67. The LBH Administrators' first argument is that:

    67.1. The liability of the contributories under section 74 arises only where the borrower is in liquidation. Where the borrower is not in liquidation, it is unable to make calls on its contributories [LBH/12(ii)(d)].

    67.2. Accordingly, in the case of a borrower which is not in liquidation, the concept of the borrower being able to pay its Liabilities must necessarily be construed as a reference to the borrower's ability to pay its Liabilities from its own assets, without any reference to its rights against its contributories under section 74.

67.3. The concept of the borrower being able to pay its Liabilities must mean the same thing whether or not the borrower is in liquidation [LBH/12(ii)(e)(1)].

67.4. Accordingly, even where the borrower is in liquidation, the concept of the borrower being able to pay its Liabilities should be construed as a reference to the borrower's ability to pay its Liabilities from its own assets, without any reference to its rights against its contributories under section 74.

68. In the LBIE Administrators' submission, this argument is misconceived.

69. It is not correct to say that LBIE cannot make a claim against its contributories under section 74 before the commencement of LBIE's liquidation. David Richards J held in Waterfall I that LBIE's contingent claim against its contributories under section 74 is a provable debt in the contributories' administrations; and the Court of Appeal agreed. Therefore, whilst LBIE is not currently in liquidation, it is (on the law as it currently stands) able to make a claim against its contributories relying on their contingent liabilities under section 74.

70. Further and in any event, the reference in clause 5(2) of the Sub-Debt Agreements to the borrower being able to pay its Liabilities is a reference to the borrower being able to pay its Liabilities with what means might be available to it at the relevant time. The LBH Administrators' submission therefore confuses the interpretation of the clause with its application to any given facts and their proposition is accordingly a *non sequitur*. In circumstances where the means available to the borrower to enable it to discharge its Liabilities do include an ability to seek a contribution from its contributories, there is no basis for excluding that right.

71. Secondly, the LBH Administrators say that 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 the Sub-Debt Agreement, LBIE was able to rely on its claims against its contributories under section 74 [LBH/12(ii)(e)(2)-(3)]. The LBH Administrators say that this would be particularly inappropriate in circumstances where the valuation of that right would be uncertain.

72. However, a claim against its contributories is in this context no different from any other asset, and considerations of solvency always depend on matters of opinion, including opinions as to the realisable values of assets. This is no different.

73. Thirdly, the LBH Administrators say that the right to make a call is not in fact the property of the company [LBH/12(ii)(e)(4)].

74. This contention is irrelevant. Clause 5(2) does not refer to the property of the company. It refers to the ability of the company to discharge its Liabilities. That is the phrase which must be construed. The source of that ability to make those payments is nothing to the point.

75. In any event, the LBH Administrators' proposition is contrary to long-standing authority. In summary:

75.1. In *Webb v Whiffin* (1872) LR 5 HL 711, Lord Cairns held at 734-735:

> "*A capital is created, sometimes limited, sometimes without a limit; but that capital is to be made good in the shape of a common fund, and that common fund it is which is to be the source of the payment of every creditor of the company ... **Now, I ask the question, are the contributions to be made by the ex-members the property of the company or are they not? Can it be contended for a moment that they are not? Whose property are they, if they are not the property of the company?***" (emphasis added).

75.2. Lord Hatherley LC agreed at 720-721:

> "***The assets of the company of course include all contributions which you are entitled to raise from the members** ... When that is done, a common fund is formed, and you find no direction in the Act whatever, except for the distribution of the common fund so formed*" (emphasis added).

75.3. Similarly, in *In re General Works Company, Gill's Case* (1879) 12 Ch D 755, Bacon V-C held at 757:

> "*The law vests in the liquidator the control of all the assets of the company, and the assets of the company in this case consist of, amongst others, a sum*

which Mr Gill undertook to contribute to the assets of the company, whatever might happen".

75.4. In Waterfall I, David Richards J held that the company's right to claim a contribution from its members is an asset of the company (see [165]); and the Court of Appeal agreed (see Briggs LJ at [197]-[198]).

76. Finally, the LBH Administrators say that a member's liability under section 74 of the 1986 Act is a liability to contribute a sum which is "*sufficient*" to pay the company's debts and liabilities and the expenses of its winding up [LBH/12(ii)(g)(7)]. They say that a member's liability under section 74 presupposes that the company is unable to pay its debts and liabilities on its own account.

77. The argument thus appears to be that the member will be liable under section 74 only where the company is unable to pay its debts and liabilities, whereas the Sub-Debt will be payable only where the company is able to pay its debts and liabilities. In other words, they appear to say that the condition precedent to the liability of the members to contribute to LBIE is the opposite of the condition precedent to the liability of LBIE to pay the Sub-Debt, so that both conditions cannot be satisfied at the same time.

78. However, the LBH Administrators' argument is wrong, because it proceeds on the assumption that the debts and liabilities within section 74 are the same as the debts and liabilities which rank ahead of the Sub-Debt. This assumption is wrong, because the debts and liabilities within section 74 include the Sub-Debt, whereas the debts and liabilities which rank ahead of the Sub-Debt (by definition) exclude the Sub-Debt itself.

79. The LBH Administrators' argument is also circular, because it presupposes that the LBH Administrators' construction of clause 5(2) is correct. If the ability of LBIE to pay its Liabilities in clause 5(2) is a reference to the ability of LBIE to pay its liabilities with whatever means might be at its disposal at the relevant time, including any claims that it may have against its contributories, the Sub-Debt will be payable.

80. For these reasons, the LBIE Administrators invite the Court to reject the contentions advanced by the Administrators of LBH and LBL and to answer Issue 1 in the affirmative.

D. ISSUE 3

81. Issue 3 is:

> "*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*".

82. The LBIE Administrators' position is that, if the realisations in LBIE's estate are insufficient to discharge the Sub-Debt in full, LBIE's contributories are liable to contribute for the payment of that part which cannot otherwise be paid. On this basis, if the realisations in LBIE's estate are insufficient to pay any part of the Sub-Debt, the Sub-Debt is to be valued in full for the purposes of the Sub-Debt Contribution Claim.

83. By contrast, the Administrators of LBL, LBHI2 and LBH contend that, if the realisations in LBIE's estate are insufficient to pay any part of the Sub-Debt, the Sub-Debt is to given a value of ***nil*** for the purpose of the Sub-Debt Contribution Claim.

(1) The waterfall in corporate insolvency proceedings

84. As Lord Neuberger held in *In re Nortel GmbH* [2014] 1 AC 209 at [39], the effect of the insolvency legislation is to produce a waterfall which governs the order of priority of distributions in liquidations and distributing administrations. As Lord Neuberger explained at [39], that order is, in summary, as follows:

> "*(1) Fixed charge creditors;*
> *(2) Expenses of the insolvency proceedings;*
> *(3) Preferential creditors;*
> *(4) Floating charge creditors;*
> *(5) Unsecured provable debts;*
> *(6) Statutory interest;*
> *(7) Non-provable liabilities; and*
> *(8) Shareholders*".

85. Nothing is payable in respect of any given level in the waterfall unless and until the prior-ranking levels have been paid in full. The payment of any particular level is thus contingent on the payment in full of the prior-ranking levels.

86. As Briggs LJ explained in *Waterfall I* at [198]:

> "*No class within the waterfall receives anything unless there is a surplus after payment in full of the prior class or classes. No-one doubts that provable debts are liabilities of the company, but they are payable only if there is a surplus after payment of floating charge creditors. Statutory interest is by the same token a liability of the company, payable only if there is a surplus after payment of provable debts*".

87. As this makes clear, after the commencement of insolvency proceedings, the question of whether the liability would have been immediately payable ***absent*** the insolvency proceedings ceases to be relevant. Instead, what matters is whether there is a liability which has become payable within the insolvency waterfall.

88. For example, a debt may have been due and payable under the terms of a contract at the moment immediately before the commencement of the debtor company's winding-up. After the commencement of the winding-up, however, the creditor will be unable to compel the debtor company to pay it. Even a judgment creditor will be unable to levy execution to obtain payment in full. A stay on proceedings and enforcement applies under the insolvency legislation. As Briggs LJ explained in *Waterfall I* at [198], the liabilities which fall within any given level of the waterfall will become payable only if there is a surplus after payment of the liabilities which fall within the preceding levels.

(2) <u>The extent of the liability of contributories</u>

89. The contributories are liable in respect of every level in the waterfall.

90. As Lewison LJ held in *Waterfall I* in the Court of Appeal at [121], "[the] *contributory's liability under section 74 extends to all the liabilities of the company at all stages of the waterfall. If (as section 74 expressly provides) that liability extends to adjusting the rights of contributories, which are at the bottom of the waterfall, the logic is inescapable that*

the contributory's liability encompasses liabilities that are higher up the waterfall". See also Briggs LJ at [203]-[204]. On this basis, the Court of Appeal held in *Waterfall I* that the liability of the contributories extends to statutory interest and non-provable liabilities within levels (6) and (7) in the waterfall.

91. However, it is important to appreciate that there is a difference between the liability of the company and the liability of the contributories. In summary:

    91.1 The company's office-holder must pay the items in the waterfall to the extent that the net realisations made by him are ***sufficient*** to meet them.

    91.2 The contributories must contribute towards payment of those items to the extent the net realisations in the company's estate are ***insufficient*** to meet them.

92. It is submitted that this distinction is clear and incontrovertible:

    92.1 The liability of the contributories to contribute towards payment of the items in the waterfall will be reduced to the extent that the other realisations in the estate are sufficient to discharge those liabilities. If the realisations are sufficient to discharge the liabilities, there will be nothing left in respect of which the contributories could be called on to contribute. The members are therefore not liable to the extent of the items in the waterfall which the company is able to pay. For instance, if the realisations in the estate are sufficient to discharge levels (1) to (3), the contributories will have no liability in respect of levels (1) to (3).

    92.2 Instead, the members will be liable to the extent of the items in the waterfall which the company is otherwise unable to pay. In this way, the liability of the contributories cannot be reduced by an insufficiency of realisations in the estate. Put another way, the contributories cannot rely on the fact that the company itself is not yet making payments at a particular level in the waterfall as a basis for restricting or eliminating their own liability in respect of the items falling within that level or any level below it. For example, as the Court of Appeal held in *Waterfall I*, the contributories are liable to contribute sufficient to meet statutory interest at level (6), even if the realisations in the company's estate are insufficient

for the payment in full of the provable debts at level (5): see, in particular, Briggs LJ at [196]-[198]. The fact that statutory interest is not yet payable by the company provides no basis for suggesting that the contributories have no liability in respect of statutory interest. The company has that liability, even if the trigger for it becoming payable is, in effect, the company becoming able to pay it.

93. For this reason, the contingency to payment by the company of any given level in the waterfall (namely, the sufficiency of realisations in the estate to discharge the prior-ranking levels) does not apply to the liability of the contributories. The contributories cannot say that, because the realisations in the estate are insufficient to trickle down to a particular level, the contributories themselves have no liability in respect of that level or any of the levels below it.

(3) <u>The position of the Sub-Debt in the waterfall</u>

94. The Court of Appeal held in *Waterfall I* that the Sub-Debt is payable after the statutory interest in level (6) and the non-provable liabilities in level (7) but that it ranks ahead of any claims by shareholders in level (8).

95. The Court of Appeal's order dated 14 May 2015 provides, at paragraph 2, that the Sub-Debt is "*subordinated to provable debts, statutory interest and non-provable liabilities and* [is] *repayable only on contingencies including payment of all such claims*".

96. According to the Court of Appeal, therefore, the effect of the subordination is to take the Sub-Debt out of level (5), where it would otherwise be located, and to move it down the waterfall so that it sits immediately below level (7).

97. The effect of the Court of Appeal's decision is thus to insert the Sub-Debt as a new level (7A) in the waterfall.

98. As is the case with every other level in the waterfall, nothing is payable in respect of this particular level unless and until the prior-ranking levels have been paid in full. As the Court of Appeal held, the payment of the Sub-Debt in level (7A) is contingent on the payment in full of the prior-ranking levels.

99. On this basis, there is no conceptual difference between the Sub-Debt in level (7A) and (say) unsecured provable debts in level (5) or statutory interest in level (6):

99.1 The payment of unsecured provable debts in level (5) is contingent on the payment in full of the four different categories of liability in levels (1) to (4).

99.2 The payment of statutory interest in level (6) is contingent on the payment in full of unsecured provable debts in level (5).

99.3 The payment of non-provable claims in level (7) depends on statutory interest in level (6) having been paid in full.

99.4 Similarly, the payment of the Sub-Debt in level (7A) is contingent on the payment in full of the non-provable liabilities in level (7).

100. In each case, the obligation to contribute extends to the full amount of each of the debts and liabilities at each of the levels in the waterfall. The only difference between the Sub-Debt and the other levels in the waterfall is that, whereas the ranking of the other levels is the result of the insolvency legislation, the introduction of the Sub-Debt as a new level (7A) is the result of the terms of the parties' contract. In summary, the Sub-Debt Agreements provide expressly for the payment of the Sub-Debt to be contingent on the payment in full of the prior-ranking items.

101. Lewison LJ explained in *Waterfall I* at [38] and [41] that the introduction of the Sub-Debt as a new level, ranking below level (7), is achieved on precisely this basis:

> "*[38] … In our case the right to repayment arises under clause 4, but that is subject to clause 5. Clause 5 imposes conditions on the right to repayment. If no insolvency process has begun then the condition in clause 5(1)(a) must be satisfied. Whether or not an insolvency process has begun, the condition in clause 5(1)(b) must also be satisfied. In my judgment clause 5(1) means that the* ***right to repayment of the subordinated debt is a contingent right, contingent on the satisfaction of clause 5(1)(b) and, if appropriate, clause 5(1)(a) as well*** " ..
> *[41] …* [The] *subordinated debt is a contingent debt****. It is contingent not because of its position in the rankings in insolvency but because the subordination agreement itself provides that repayment is not due until certain conditions***

> ***have been satisfied.*** *Mr Snowden said, correctly in my judgment, that when the proof is lodged one would expect the office holder to value it at 'nil' and then to revalue it once it becomes clear that the contingencies have been satisfied*" (emphasis added).

(4) The liability of contributories in respect of the Sub-Debt

102. Since the contributories are liable in respect of every level in the waterfall from level (1) to level (8), it follows that they are liable in respect of the Sub-Debt at level (7A).

103. This stands to reason. If the Sub-Debt had not been subordinated, the contributories would have been liable to the full extent of it as an item within level (5), whether or not the liabilities in levels (1) to (4) had been paid in full. The fact that the Sub-Debt instead ranks further down the waterfall does not alter the fact that the contributories are liable to the full extent of it. The fact that it sits at level (7A) rather than at level (5) does not mean that it ceases to be a liability for these purposes or that the contributories do not have to contribute to the deficiency to enable the company to pay it.

104. Further, on the principles set out above, the insufficiency of realisations in LBIE's estate to pay in full the prior-ranking levels cannot eliminate the liability of the contributories in respect of the Sub-Debt. On the contrary, it is precisely that insufficiency of realisations which gives rise to the liability of the contributories in respect of the Sub-Debt. The fact that the realisations are insufficient to pay the Sub-Debt gives rise to the contributories' liability to put the company in funds to pay it.

105. The contingency which applies to the payment of the Sub-Debt by LBIE (namely, the sufficiency of realisations in its estate) is therefore not a contingency which applies to the liability of the contributories in respect of the Sub-Debt. The contributories cannot say that, because the realisations in LBIE's estate are insufficient to trickle down to level (7A), the contributories themselves have no liability for level (7A) any more than they can say that the insufficiency of assets to trickle down to the unsecured creditors in level (5) absolves them from their liability to contribute sufficient to meet those liabilities.

106. In the LBIE Administrators' submission, the fact that the subordination of the Sub-Debt is achieved by contract, rather than by statute, does not provide any basis for reaching a

different conclusion in the case of the Sub-Debt. As Lewison LJ explained in his judgment in *Waterfall I*, the Sub-Debt is introduced as a new level ranking below the statutory interest and the non-provable liabilities. This is achieved by providing in the contract that payment of the Sub-Debt will be contingent on the discharge in full of the prior-ranking liabilities. Whilst the effect is achieved by contract, rather than by statute, the substance is no different from the operation of the priority waterfall at every other level – namely, payment is contingent on the discharge in full of the level above.

107. Further, according to Lewison LJ's reasoning, whilst the effect of the contractual subordination of the Sub-Debt is to transform the Sub-Debt into a contingent provable debt in the insolvency proceedings, it is a contingent provable debt of a unique kind:

107.1. First, the relevant contingencies are not external to the insolvency proceedings but consist instead of the payment of the prior-ranking levels of the waterfall within the insolvency proceedings themselves.

107.2. Secondly, unlike every other contingent provable debt, which will be valued by reference to the percentage chance of the contingency occurring, the provable value of the Sub-Debt is binary, moving from nil to 100% upon the satisfaction of the relevant contingencies. Lewison LJ explained in *Waterfall I* at 41 that "*one would expect the office holder to value it at 'nil' and then to revalue it once it becomes clear that the contingencies have been satisfied*". This is the mechanism by which the subordination has been held to take effect within the statutory insolvency code.

108. The Sub-Debt is therefore *sui generis*.

109. Further, the fact that the Sub-Debt would not be payable by LBIE ***absent*** the administration is irrelevant. As a result of the fact that LBIE is subject to a distributing administration, the distribution of LBIE's assets is now instead governed by the question of whether the liability has become payable within the waterfall. As explained above, LBIE's contributories are liable for every level in the waterfall, whether or not it has yet become payable within the waterfall. For example, statutory interest is not payable absent the administration, and the realisations may not be sufficient to pay it, but the

contributories will be liable to contribute funds sufficient to pay it. In the LBIE Administrators' submission, the position in respect of the Sub-Debt is the same.

110. Consequently, if the realisations in LBIE's estate are insufficient to pay any part of the Sub-Debt, the Sub-Debt is to be valued in full for the purposes of the Sub-Debt Contribution Claim. The members remain liable in respect of it precisely because the realisations trickling down the waterfall are insufficient to reach that level.

111. Similarly, if the realisations are sufficient to pay part of the Sub-Debt (but not all of it), the members will remain liable for the unpaid part.

112. It is only if the realisations are sufficient to pay the Sub-Debt in full that the members will have no liability in respect of it – because there will be no deficiency for them to contribute towards paying.

(5) The position of the Administrators of LBH, LBHI2 and LBL

113. The Administrators of LBH, LBHI2 and LBL take the position that, for as long as the prior-ranking liabilities remain unpaid, the Sub-Debt should be valued at nil for the purposes of the Sub-Debt Contribution Claim.

114. In summary, they say that the contingency which applies to the payment of the Sub-Debt by LBIE (namely, the sufficiency of realisations in its estate) is also a contingency to the liability of the contributories in respect of the Sub-Debt.

115. The LBIE Administrators submit that this is misconceived. The contributories are liable for the items in the waterfall if and insofar as the realisations in LBIE's estate are otherwise insufficient to pay them. The contingency to the payment of the Sub-Debt by LBIE is not applicable to the liability of the contributories in respect of the Sub-Debt.

116. If the contingency to the payment of the Sub-Debt by LBIE were applicable to the liability of the contributories in respect of the Sub-Debt, the consequences would be extraordinary. In a case where the realisations were insufficient to pay the expenses, so that the contingency to the payment of the provable debts by the company had not yet

occurred, the contributories would be able to say that the same contingency was applicable to their own liability in respect of the provable debts and that, the relevant contingency not yet having occurred, the contributories themselves had no liability in respect of the provable debts. Such a result would be illogical and absurd.

117. The flaw in the argument advanced by the Administrators of LBH, LBHI2 and LBL in their Position Papers is perhaps most clearly demonstrated by reference to the Position Paper of the LBHI2 Administrators. They accept that "*LBHI2's Sub-Debt claim against LBIE is contingent (i.e. contingent on the LBIE Administrators being able to pay all prior-ranking claims against LBIE in full)*" [LBHI2/3.3]. That accords with Lewison LJ's conclusion. However, they contend that "*LBIE cannot assert (in valuing the Sub-Debt element of any Contribution Claim) that it has a liability in respect of the Sub-Debt which it values as greater than the value it puts on that same liability when asserted against it by way of LBHI2's proof in LBIE's administration*" [LBHI2/3.5(iii)]. In support of this, they argue that "*the first contingency relevant to the valuation of any outgoing Sub-Debt Contribution Claim asserted by LBIE is the same contingency as applies to the valuation of the incoming liability for the Sub-Debt (asserted by LBHI2's proof in LBIE's administration), namely, whether LBIE will have sufficient assets to pay its prior ranking liabilities in full*" [LBHI2/3.5(iii)].

118. The LBIE Administrators submit that this is incorrect. The contingency to the payment of the Sub-Debt by LBIE (namely, "*whether LBIE will have sufficient assets to pay its prior ranking liabilities in full*") is not a contingency to the liability of the contributories. Rather, the contributories are liable for every level in the waterfall if and insofar as the realisations in LBIE's estate are otherwise insufficient to pay them.

119. Applying the reasoning advanced by the LBHI2 Administrators in their Position Paper, it could equally be said that the contingency to the payment of provable debts (namely, the sufficiency of realisations in LBIE's estate to pay in full the prior-ranking liabilities) is also a contingency to the liability of the contributories for the provable debts. Such a contention would be conceptually misconceived. The level of realisations in the liquidation or administration dictates only the extent to which the liabilities in the waterfall are capable of being discharged ***without*** requiring any contribution from the members. To the extent that those realisations are sufficient, the members will not be

required to contribute to facilitate their payment by the company. The members will remain liable only to the extent that the realisations are insufficient. But there is no logical basis for contending that the insufficiency of realisations to pay anything at a particular level will operate so as to relieve the contributories from liability for that level (or any other level which remains undischarged by payment).

120. Similarly, the LBL Administrators say in their Position Paper that, if nothing is payable by LBIE in respect of the Sub-Debt, nothing can be payable by LBIE's contributories in respect of the Sub-Debt [LBL/122]. In support of this proposition, they say that the Sub-Debt Contribution Claim "*is a more remote contingency than the Sub-Debt claim itself*" and that LBIE cannot "*make recoveries by way of the Sub-Debt Contribution Claim where presently the underlying debt is not due*" [LBL/123].

121. This is entirely back-to-front. The true position is that, to the extent that the realisations are insufficient, the contributories remain liable; and, to the extent that the realisations are sufficient – but only to that extent – the contributories' liability is reduced. It makes no sense to say that, to the extent that the realisations are insufficient, the contributories have no liability.

122. Similarly, the LBH Administrators say in their Position Paper: "*If LBIE has no liability to pay the Sub-Debt (or the value of LBHI2's claim into LBIE for the Sub-Debt is nil) then a liquidator would have no need (nor right) to make a call under section 74 in order to enable LBIE to pay the Sub-Debt*" [LBH/20(i)]. Again, that is incorrect. If the realisations in LBIE's estate are insufficient to pay the Sub-Debt, then that is precisely the situation in which a liquidator of LBIE would need (and be entitled) to make a call under section 74 in order to enable LBIE to pay the Sub-Debt.

(6) <u>Conclusion on Issue 3</u>

123. The LBIE Administrators therefore invite the Court to hold that:

123.1 if the realisations in LBIE's estate are insufficient to pay any part of the Sub-Debt, the Sub-Debt is to be valued in full for the purposes of the Sub-Debt Contribution Claim;

123.2 if the realisations are sufficient to pay part of the Sub-Debt (but not all of it), the members will remain liable for the unpaid part; and

123.3 if the realisations are sufficient to pay the Sub-Debt in full, the members will have no liability in respect of it.

E. ISSUE 7

124. Issue 7 asks:

> "*In the light of the fact that LBL owns one share of $1 in LBIE and LBHI2 owns 2 million 5% redeemable Class A preference shares of $1,000 each, 5.1 million 5% redeemable Class B shares of $1,000 each and 6,237,133,999 ordinary shares of $1 each in LBIE:*
> *(i) whether their obligations to contribute to the assets of LBIE pursuant to section 74 are joint, several, joint and several, or otherwise as against LBIE;*
> *(ii) whether they are entitled to a contribution or indemnity from one another in respect of (a) any payments made pursuant to any such obligation; and/or (b) any set-off pursuant to any such obligation, and, if so, the nature and extent of such right of contribution or indemnity;*
> *(iii) whether, in addition to or instead of any right of contribution or indemnity ... LBL or LBHI2 are liable to contribute to LBIE's assets to any amount sufficient for the adjustment of the rights of the contributories among themselves and what the effect of such adjustment is;*
> *(iv) to what extent any right of contribution or indemnity ... and/or adjustment ... is affected by any other claims which LBHI2 and LBL have against one another or any other party;*
> *(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 this decision*".

125. As may be seen, Issue 7 consists of a number of different component parts which, whilst linked by a common theme, require to be addressed separately.

(1) Paragraph (i)

126. Paragraph (i) raises the question of the nature of the liability of each contributory and in particular as to whether the contributories' obligations to contribute to LBIE's estate are joint and several, joint, several, or otherwise.

127. The Administrators of LBIE, LBH and LBHI2 agree that the liability is neither joint nor joint and several [LBIE/41(1), 42(1); LBH/32(i); LBHI2/7.1(i)]. The LBL Administrators do not assert that it is joint or joint and several.

128. However:

128.1. There is a dispute among the parties as to whether the liability of each of LBIE's contributories under section 74 in respect of LBIE's debts and liabilities is: (i) rateable by reference to the nominal value of the shares held by that contributory; or (ii) limited only by the total amount of LBIE's debts and liabilities.

128.1.1. The Administrators of LBL, LBH and LBHI2 say that the liability is rateable by reference to the nominal values of the contributories' shareholdings.

128.1.2. The LBIE Administrators say that, in an unlimited company such as LBIE, the liability of each contributory for LBIE's debts and liabilities is not rateable by reference to the nominal values of their shareholdings but is limited only by the total amount of LBIE's debts and liabilities.

128.2. Separately, the LBL Administrators contend that LBL has no liability under section 74, either: (i) on the basis that LBL held the shares as a nominee; or (ii) on the basis that LBL did not in practice enjoy any rights as a shareholder. The LBIE Administrators contend that these facts (even if true) would not provide any basis for relieving LBL from liability as a contributory. (At the Part A trial, the Court will be invited to deal with this issue as a matter of law by deciding whether or not the grounds raised by the LBL Administrators would, if true, serve to relieve LBL from liability under section 74. Whether or not they are true could then be decided during the Part B trial, to the extent that this may be necessary.)

(i) <u>The main point on paragraph (i) – the extent of the liability</u>

129. As noted above:

129.1. The Administrators of LBL, LBH and LBHI2 say that the liability is rateable by reference to the nominal values of the contributories' shareholdings [LBL/100, 101.2; LBH/32(v); LBHI2/Introduction, (iv); LBL Reply/12]; and

129.2. The LBIE Administrators say that, in an unlimited company such as LBIE, the liability of each contributory for LBIE's debts and liabilities is not rateable by reference to the nominal values of their shareholdings but is limited only by the total amount of LBIE's debts and liabilities [LBIE/42(1)(iii), 45(1)-(2)].

130. The position of the LBIE Administrators is straightforward:

130.1. In an unlimited company, the liability of each of the contributories is unlimited.

130.2. That is to say, it is not limited in amount.

130.3. Similarly, it is not limited as a percentage.

130.4. Rather, it is limited only to the total amount required to pay the company's debts and liabilities (and the expenses of the company's winding-up).

131. In the LBIE Administrators' submission, therefore, in the case of an unlimited company in liquidation with only two shareholders, holding 99 shares and 1 share respectively, each shareholder would be liable for the full amount of the debts and liabilities and the expenses of the winding-up. If the liquidator had concerns that the holder of the 99 shares would be unable to pay a sufficient amount, he would be entitled to pursue the holder of the single share for the whole of the deficiency in the winding-up.

132. Accordingly, in the present case, it does not matter that LBL holds a single share in LBIE. The sole factor of importance on this point is that LBL is a shareholder in an unlimited company. LBL's liability for the debts and liabilities of LBIE and the expenses of LBIE's winding-up would be the same if LBL held 1 or 100 or 1,000 or 1,000,000 shares in LBIE.

(a) ***The statutory provisions***

133. The extent of the liability of the company's contributories is clear from section 74(1) of the 1986 Act, which states that "*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".

134. Limits to this liability are contained in section 74(2), which provides (in the form that would be applicable in LBIE's winding-up):

> "*(2) This is subject as follows—*
> *(a) a past member is not liable to contribute if he has ceased to be a member for one year or more before the commencement of the winding up;*
> *(b) a past member is not liable to contribute in respect of any debt or liability of the company contracted after he ceased to be a member;*
> *(c) a past member is not liable to contribute, unless it appears to the court that the existing members are unable to satisfy the contributions required to be made by them in pursuance of the Companies Act and this Act;*
> *(d) in the case of a company limited by shares, no contribution is required from any member exceeding the amount (if any) unpaid on the shares in respect of which he is liable as a present or past member ...*"

135. None of these statutory criteria provides for shareholders' liabilities to be limited to their proportionate share of the losses:

    135.1. Paras (a) to (c) limit the liability of past members by reference to three statutory criteria, none of which relates to the rateable allocation of losses.

    135.2. Para (d), which applies only in the case of limited companies, limits liability to any amount unpaid on the shares, rather than to a proportionate share.

136. In any event, none of the limitations in section 74(2) is applicable in the present case. None of the contributories is a past member. Further, LBIE is an unlimited company. The liability of each of the contributories is therefore not limited.

137. The fact that liabilities of contributories are not rateable and are not limited to their proportionate shares of the losses is also apparent from two other aspects of the structure of the legislation:

    137.1. the fact that sections 74 and 150 provide expressly for the adjustment of the positions of the contributories *inter se* – a process which would be unnecessary if

contributories' liabilities to the company to which they are obliged to contribute were always limited to their proportionate shares of the losses.

137.2. the fact that section 150(2) of the 1986 Act provides: "*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*". This makes clear that the Court may rely on one contributory's impecuniosity as a basis for demanding more from the others and is therefore inconsistent with the idea of rateable liability of contributories.

138. The construction of section 74 for which the LBIE Administrators contend is the only one which is consistent with the legislative history of the liability of members of an unlimited company, explained below.

(b) *Historical development*

139. Before the introduction of joint stock companies, businessmen wishing to carry on business together usually had no choice but to do so in the form of a partnership.

140. In the case of a partnership, each partner is subject to "*unlimited liability … for the debts and obligations of the firm*" (*Lindley & Banks on Partnership*, 19th ed., [13-14]).

141. As Lord Lindley put it in an earlier edition of that work (in a passage still quoted in the current edition at [13-14]):

> "*By the common law of this country, every member of an ordinary partnership is liable to the utmost farthing of his property for the debts and engagements of the firm. The law, ignoring the firm as anything distinct from the persons composing it, treats the debts and engagements of the firm as the debts and engagements of the partners, and holds each partner liable for them accordingly. Moreover, if judgment is obtained against the firm for a debt owing by it, the judgment creditor is under no obligation to levy execution against the property of the firm before having recourse to the separate property of the partners; nor is he under any obligation to levy execution against all the partners rateably; but he may select any one or more of them and levy execution upon him or them until the judgment is satisfied, leaving all questions of contribution to be settled afterwards between the partners themselves*".

142. As De Grey CJ put it in *Abbot v Smith* (1760) Black W 947 at 949, "*Each is answerable for the whole, and not merely for his proportionate part*". Lord Cranworth LC explained the point in the following terms in *In re The Sea Fire & Life Assurance Company, Greenwood's Case* (1854) 3 De GM&G 459 at 476:

> "[The] *principle cannot ... for one moment be disputed ... that every person engaged in a partnership is liable solidarily, as they say upon the Continent, for everything. Thus A, B and C, carrying on business together, may stipulate among themselves that no one of them shall be liable for more than £1,000, yet, if in the conduct of their business they incur a debt to the extent of £10,000, every one of them would be liable for it, notwithstanding any stipulation they might have made with one another*".

143. The incorporation of joint stock companies was first permitted by the Joint Stock Companies Act 1844. However, limited liability remained unavailable. In the case of a company incorporated under the 1844 Act, therefore, each shareholder remained personally liable to the fullest extent for the debts of the corporation.

144. Section 25 of the 1844 Act confirmed that "*every ... shareholder shall ... be and continue liable as he would have been if the said company had not been incorporated*". Section 66 of that Act provided that "*every judgment and every decree or order ... against any company ... may ... be enforced, and execution thereon be issued, not only against the property and effects of such company, but also ... against the person, property and effect of any shareholder for the time being*".

145. Consequently, as Lord Cranworth explained in *Oakes v Turquand* (1867) LR 2 HL 325 at 361, "*the course which a creditor was to take in order to enforce a debt or demand was to sue the incorporated company as his debtor, and having recovered judgment against that body, he was, in the first instance, to endeavour to levy his debt by an execution against it, and if that did not produce sufficient to satisfy him, then he was entitled to issue execution against any shareholders*".

146. Having quoted sections 25 and 66 of the 1844 Act, Lord Cranworth LC confirmed in the *Sea Fire & Life Assurance* case at 479:

"*Thus it is clear that the liability to creditors is not materially affected, and the Legislature has not only not exempted the shareholders from their ordinary obligations as partners, but has expressly enacted that they shall remain liable*".

147. The position was the same under the Joint Stock Banks Act 1844, as explained by Lord Cranworth in *Oakes v Turquand* (1867) LR 2 HL 325 at 360:

> "*But concurrently with this Act* [i.e. the Joint Stock Companies Act 1844] *another Act was passed, 7 & 8 Vict. c. 113, intituled 'An Act to regulate Joint Stock Banks in England'* [i.e. the Joint Stock Banks Act 1844]. *It differed in some important particulars from the other Act. It did not incorporate any joint stock banking company, but it enabled persons desirous of forming themselves into such a company, upon complying with certain requisitions, to obtain, under the sanction of the Board of Trade, a royal charter of incorporation, subject to various statutable qualifications, and, amongst other things, that,* ***notwithstanding the incorporation, the shareholders should be liable as if they were not incorporated***" (emphasis added).

148. Consequently, in *In re The Royal Bank of Australia* (1856) 6 De GM&G 572, where the deed of incorporation provided that each shareholder would be liable for the losses of the company in proportion to his shares, Lord Cranworth LC held at 587-588 that, notwithstanding the terms of the deed, each shareholder remained liable for the full amount of the company's debts, and not merely for his proportionate share:

> "***Every shareholder, as a partner, is liable to every creditor to the full amount of his demand****, and the sum raised by the Master represents not any demand of the shareholders inter se, but the aggregate demand of all the creditors on the whole partnership.* ***The solvent shareholders are bound to make up this sum, not by virtue of any engagement contained in the deed, but because by the general rules of law every partner is liable to the whole of the demands on the partnership. To put an extreme case, if there had been but one solvent shareholder, there is no doubt a call might have been made on him for an amount equal to all the debts due from the partnership.*** *How could it be said that he was liable to pay that sum because he had been party to a deed in which it was stipulated that every shareholder should be liable to the losses of the company in proportion to his shares? If in such a case the clause in question would not be applicable, neither can it be so when there are many solvent shareholders. In the one case, as in the other, the liability is not the consequence of the stipulation in the deed, but of the general liability of the shareholder to the creditors*" (emphasis added).

149. Limited liability was first introduced by the Limited Liability Act 1855, which made it possible to limit the liability of a company's shareholders but did not alter the mode of enforcing it. Section 7 of the 1855 Act provided that the shareholders of a limited company "*shall not be liable, under any judgment, decree or order which shall be obtained against such company, or for any debt or engagement of such company, further or otherwise than is hereinafter provided*". Section 8 of the 1855 Act provided:

> "*If any execution, sequestration or other process in the nature of execution, either at law or in equity, shall have been issued against the property or effects of the company, and if there cannot be found sufficient whereon to levy or enforce such execution, sequestration or other process, then such execution, sequestration or other process may be issued against any of the shareholders to the extent of the portions of their shares respectively in the capital of the company not then paid up, but no shareholder shall be liable to pay … a greater sum than shall be equal to the portion of his shares not paid up*".

150. Thus, as Lord Chelmsford LC explained in *Oakes v Turquand* (1867) LR 2 HL 325 at 346-347, in the case of a limited company, sections 7 and 8 of the 1855 Act "*gave the same remedy, by execution against the shareholders, to the extent of the unpaid portions of their shares in the capital of the company, as creditors could use against shareholders of companies with unlimited liability, under the former Acts*".

151. The Companies Act 1862 retained the possibility of limited liability but abolished the creditors' remedy of execution against the shareholders. As Lord Cranworth explained in *Oakes v Turquand* at 362-363:

> "*There are important differences between the provisions of the Act of 1862 and the two Acts of 1844. In the first place, all the enactments contained in the previous Acts for enforcing a debt or demand by execution against a shareholder are repealed. The creditor must, as under the former Acts, proceed against the company; but if, on recovering judgment against the company, he was unable to obtain satisfaction, he has no power to proceed against any individual shareholder. He must obtain an order for winding up the affairs of the company, by causing all its assets to be called in and distributed among all the creditors rateably, as in a bankruptcy. But there is another very material distinction between the two statutes, arising from the power given by the Act of 1862, of constituting a company whose shareholders shall not, like partners at common law, or like shareholders under the* [two Acts of 1844]*, be indefinitely liable for all obligations of the partnership, but whose liability shall be limited to the extent and in the manner specified in the articles under which the incorporation takes place.*

> *Two modes of limiting the responsibility of the shareholders are provided by the Act, but we need only advert to that which is described in the Act as a limitation by shares. Any joint stock company may adopt such a limitation by making it part of its constitution that the shareholders shall be liable only to the extent of so much of their shares as has not been paid up ...*
> ***It is obvious that when the Legislature had sanctioned the principle of limited liability, the powers given by the former Acts of taking out execution against individual shareholders necessarily fell to the ground. It would be impossible for a creditor to know to what extent his right to take the shareholder's goods in execution would exist. This difficulty, indeed, would not arise under the Act of 1862 as to companies formed with unlimited liability; but experience had shown that the system of execution against individual shareholders often operated very unfairly, and the Legislature probably thought, and correctly thought, that companies with unlimited liability would be but few in number, and the remedy by winding up, which was necessarily adopted in the case of limited companies, was equally just and efficacious where there was no limit, and the same course of proceeding was therefore prescribed in both cases.***
> ***The first question then is, whether the change in the mode in which a creditor is obliged, under the Act of 1862, to seek relief, makes any difference as to who are liable to him as shareholders? I think not***" (emphasis added).

152. In this way, the remedy of individual execution against shareholders was replaced by the collective remedy of winding-up, which centralised the process of execution against shareholders by enabling the liquidator to make calls against them. But the change in the mode of enforcing the shareholders' liabilities did not alter the substance of those liabilities; rather, it merely changed the way in which they would be enforced.

153. As Lord Chelmsford LC put it in *Oakes v Turquand* at 347, the changes culminating in the 1862 Act—

> "*merely changed the remedy which the creditor previously possessed of issuing execution against the shareholder (which, as I have shown, was continued to him when companies with limited liability were first established) into a right to obtain satisfaction of his debt by means of forced contributions, either by compelling a winding up of the company, or by becoming a party to a winding-up which had been already ordered.* ***They do not appear to me to have changed the right of the creditor on the one hand or the liability of the shareholder on the other***" (emphasis added).

154. Lord Cairns summarised these legislative developments in *Webb v Whiffin* (1872) LR 5 HL 711 at 734:

> "*It was always the habit in ordinary partnerships, and it was the habit in previous Acts, or in almost all previous Acts of Parliament, to constitute more or less of a direct relation between the creditor and the debtor, between the creditor and the particular individual shareholder in the company. In some of the former Joint Stock Companies Acts, even although the process had to be taken in the first instance against the company, the creditor was afterwards allowed to take out execution under certain qualifications against an individual shareholder, and in that way, to constitute a direct relation between himself and the individual shareholder. But by the Act of 1862 that state of things is entirely swept away. A capital is created, sometimes limited, sometimes without a limit; but that capital is to be made good in the shape of a common fund, and that common fund it is which is to be the source of the payment of every creditor of the company. And* ***although it is quite true that members and ex-members of the company are placed by the Act under liability, that liability is a liability, not to make payments to creditors, but it is a liability to contribute to and make good what should be the proper amount of the common fund****. Then, having got into the common fund every sum which ought to be contributed to it by every person whomsoever, the Legislature takes possession of that common fund, and proceeds to distribute it amongst the creditors of the company*" (emphasis added).

155. In other words, the changes introduced by the 1862 Act meant that, instead of being liable to creditors directly, the shareholders would be liable to contribute to the assets of the company. However, that change in the mode of enforcement of the shareholders' liabilities did not change the extent or substance of those liabilities. Lord Cranworth explained in *Oakes v Turquand* at 363-364:

> "***The winding-up is but a mode of enforcing payment.*** *It closely resembles a bankruptcy, and a bankruptcy has been called, not improperly, a statutable execution for the benefit of all creditors. The same description may be given to a winding-up, and as in the bankruptcy of an ordinary partnership every person against whom a judgment creditor of the firm could have levied execution as a partner, would be liable to have his estate administered in the bankruptcy, just so must every person against whom a creditor might, under the Acts of 1844, have levied execution as a shareholder, be liable to have his estate dealt with under a winding-up order.* ***The change, therefore, from a right in the creditor to levy execution to a right to wind up the affairs of the company, does not seem to me to affect the question who are liable to the creditors***" (emphasis added).

156. The liability of shareholders therefore remained unchanged, as it had been before the 1862 Act, save that, rather than being vulnerable to execution by individual creditors, shareholders became liable to pay contributions to the assets of the company. The centralised mode of enforcement thus changed the means for obtaining monies from the shareholders but did not alter the extent of the shareholders' liability.

157. In the case of an unlimited company, this means that the shareholders are liable to the same extent as they would have been in a partnership, or in a joint stock company under the 1844 Act. The only difference is that, from 1862 onwards, their liability was to be enforced through the collective mechanism of the winding-up. They remain, as Lord Macnaghten put it in *Ooregum Gold Mining Company of India Ltd v Roper* [1892] AC 125 at 144, "*liable to the uttermost farthing*" – save that their liability became a liability to the company, rather than to creditors individually.

(c) <u>*The 1986 Act*</u>

158. The basic scheme of the 1986 Act is the same in this regard as the basic scheme of the 1862 Act. The shareholders are not liable to individual creditors. However, pursuant to section 74(1), the shareholders are "*liable to contribute to* [the company's] *assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up*". Since, in the case of an unlimited company, none of the limitations on liability in section 74(2) is applicable, the liability of each of the shareholders is unlimited – or, to put it another way, it is limited only to the "*amount sufficient for payment of* [the company's] *debts and liabilities, and the expenses of the winding up*".

159. There is no basis for suggesting that, in an unlimited company, the liability of the shareholders is limited to their proportionate share of the total amount of the debts and liabilities. Such a limitation is inconsistent with the basic concept of unlimited liability.

160. The existence of statutory machinery for the adjustment of the position of the contributories *inter se* is also inconsistent with the idea of rateable liability, as it presupposes that the initial contributions may not have been rateable. In other words, even if the ultimate intended outcome is rateability, the position as between the company and each of its contributories at the earlier stage need not involve rateable contributions.

161. Further, section 150(2) of the 1986 Act is inconsistent with the suggestion that contributions will be rateable. It provides: "*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*". As stated above, this makes clear that the Court may rely on one contributory's

impecuniosity as a basis for demanding more from the others and is therefore inconsistent with the idea of the liability of each contributory to the company being limited to a rateable proportion.

(d) *Conclusion*

162. The LBIE Administrators therefore invite the Court to hold that the liability of each contributory for LBIE's debts and liabilities is not rateable by reference to the nominal values of their shareholdings but is limited only by the total amount of those debts and liabilities.

(ii) The LBL Administrators' further arguments on paragraph (i)

163. As noted above, the LBL Administrators contend that LBL has no liability under section 74, either:

163.1. on the basis that LBL held a share as a nominee; or

163.2. on the basis that LBL did not in practice enjoy any rights as a shareholder.

164. The LBIE Administrators contend that these facts (even if true) would not provide any basis for relieving LBL from liability as a contributory.

(a) *Irrelevance of nominee status*

165. The authorities establish that the nominee status of a shareholder is irrelevant to the existence or extent of that shareholder's liability to the company under section 74. A registered shareholder cannot dispute his liability by contending that he holds the shares on trust. He will continue to be liable to the company, even if he is only a trustee. Separately, he may have a claim for an indemnity against the beneficiary of the trust, but that does not in any way alter or diminish his liability to the company under section 74. Indeed, the need for such an indemnity reflects the fact that the nominee is himself liable in the first place.

166. The principle was explained in *In re Imperial Mercantile Credit Association, Chapman and Barker's Case* (1867) 3 Eq 361, in which the headnote states:

> "*Shares in a company were transferred into the name of A, with his consent, to be held by him as a trustee for the company:*
> *Held, that, although a person wrongfully put upon the register would have a right to relief even as against creditors, A's name having been placed by his own consent upon the register, he was liable as a contributory, although he might have a right to be indemnified by the company for any payments made by him in respect of the shares, of which he was merely a trustee*".

167. The irrelevance of a shareholder's nominee status was confirmed in *Muir v City of Glasgow Bank* (1879) 4 App Cas 337, in which the House of Lords held (to quote the headnote) "*that the trustees, A and B, were partners of the company, and as such were personally liable for payment of all calls made on them in respect of the said stock*".

168. Lord Hatherley said at 365:

> "[The] *shares themselves are the things which regulate on the one hand the responsibility of the person who is the owner of those shares, and on the other hand the advantage and profit which the person who is the owner of that share is to acquire. Whosoever at any given time, be it for profit or be it for loss, finds his name attached to the ownership of a given number of shares, that person has to deal with those shares as provided by these articles of partnership deed, namely, to contribute to the loss and to share in the profit in proportion to the number of shares that he holds*".

169. See also *In re City of Glasgow Bank* (1879) 4 App Cas 547.

(b) <u>*Irrelevance of benefits as a shareholder*</u>

170. In the LBIE Administrators' submission, a contention by a shareholder that he never enjoyed any benefits from his shareholding will also be legally irrelevant to the shareholder's liability to the company under section 74.

171. Section 74(1) provides that "*every present and past member is liable*" to contribute to the company's assets. The qualifications to liability in section 74(2) contain nothing to limit or extinguish liability where the shareholder has received no benefit.

172. The legal basis for the LBL Administrators' contention in this regard is not presently understood and the LBIE Administrators reserve the right to file supplemental written submissions in response to that contention when it has been articulated.

(2) <u>Paragraphs (ii) and (iii)</u>

173. Paragraphs (ii) and (iii) may be taken together, as they raise the issue of the rights of shareholders *inter se* by asking:

 173.1. Whether the shareholders have any direct claims against each other for a contribution or an indemnity in respect of sums paid by them to the company under section 74; or

 173.2. Whether the position of the shareholders *inter se* is instead to be adjusted through the making of further calls and distributions in LBIE's liquidation.

174. On this point:

 174.1. The LBL Administrators appear to say that there is such a direct right of contribution or indemnity [LBL/101.3.1-101.3.2; LBL Reply/18], although the principle of law on which it is based is not identified; and

 174.2. The Administrators of LBIE, LBH and LBHI2 all say that there is no such direct right of contribution or indemnity and that adjustments are instead to be conducted through the making of further calls and distributions in LBIE's liquidation [LBIE/41(2)-(3), 42(2)-(3); LBH/32(ii)-(iii); LBHI2/7.1(ii)-(iii)].

175. In summary, the LBIE Administrators submit that:

175.1. As explained above, each of the shareholders is liable for the full amount of the company's debts and liabilities and the expenses of its winding up.

175.2. Since profits and losses are allocated per share (rather than per shareholder), the *ultimate objective* is to ensure that shareholders' contributions are rateable with the nominal amounts of the shareholdings. However, this is not achieved through the exercise by an over-paying shareholder of a right of contribution or indemnity against an under-paying shareholder.

175.3. Where there are sufficient assets remaining in the estate after the payment in full of the debts and liabilities and the expenses of the winding-up for the purposes of adjustment, it may be possible to equalise the contributions by making distributions to the over-paying shareholders.

175.4. If, however, after the payment in full of the debts and liabilities and the expenses of the winding-up, there are insufficient assets in the estate for the purposes of adjustment, it will be necessary for the liquidator to make a call on the under-paying shareholders for the purpose of adjustment. The proceeds of such a call will be distributable to the over-paying shareholders.

175.5. Therefore, as part of the statutory mechanism for winding-up, the liquidator has the power to make a call on the under-paying shareholders for the purposes of adjustment. This power is clear from sections 74(1) and 150(1) of the 1986 Act.

175.6. Whilst an over-paying shareholder will be entitled to payment from the estate for the purposes of adjustment, he does not have any direct claim against the under-paying shareholders. Rather, as explained above, as a result of the centralised mechanism of collection and distribution through the company's estate in a winding-up, the rights and liabilities of the shareholders are rights against, and liabilities to, the estate of the company itself.

175.7. Accordingly, there is no direct right of contribution or indemnity between shareholders. Such a claim would be inconsistent with the nature and extent of the statutory liability under section 74, and the collective nature of the statutory scheme, all of which require monies to be paid into and out of the estate.

175.8. For completeness, the LBIE Administrators also submit that where the liquidator considers that there are insufficient assets in the estate to meet the debts and liabilities, and the expenses of the winding up, the liquidator will be unable to make a call on a member for the adjustment of the rights of the contributories among themselves. This is because, in that scenario, the purpose of the call – being the adjustment of the rights of the contributories among themselves – would not be met. It would not be met because the fruits of the call would have to be applied in meeting the remaining debts and liabilities, and the expenses of the winding up[3]. See also *Re Shields Marine Insurance Association* (1868) 5 LR Eq 368 at 372.

(1) <u>The relevant provisions</u>

176. Section 74(1) of the 1986 Act provides that the contributories are liable not only to contribute to the company's assets to any amount sufficient for payment of its debts and liabilities and the expenses of the winding up but also "*for the adjustment of the rights of the contributories among themselves*".

177. Similarly, section 150(1) provides:

> "*The court may, at any time after making a winding-up order, and either before or after it has ascertained the sufficiency of the company's assets, make calls on all or any of the contributories for the time being settled on the list of the contributories to the extent of their liability, for payment of any money which the court considers necessary to satisfy the company's debts and liabilities, and the expenses of winding up, and for the* ***adjustment of the rights of the contributories***

[3] This would be the case even if the LBIE Administrators were wrong to submit that the liquidator would be unable to make a call on a member for the adjustment of the rights of the contributories among themselves where the liquidator considers that there are insufficient assets in the estate to meet the debts and liabilities, and the expenses of the winding up.

***among themselves**, and make an order for payment of any calls so made*" (emphasis added).

178. The existence of a centralised adjustment regime, exercisable by the court through a delegation to the liquidator under Rule 4.202, does not provide for rights of contribution at the suit of an overpaying member. Furthermore, its existence means that there is no need for an equitable right of contribution and is in any event inconsistent with, and would be undermined by, any such equitable right.

(2) The authorities

179. The authorities on the centralised nature of the winding-up process have been identified above in the context of paragraph (i) of Issue 7.

180. The further authorities identified below deal with the situation after the payment of the debts and liabilities and the expenses of the winding-up, where some shareholders have contributed more than their rateable share for the payment of those sums. These authorities make clear that the ultimate objective is the rateable allocation of the losses in accordance with the nominal values of the shareholdings and that, after the payment in full of the debts and liabilities, and the expenses of the winding up:

180.1. Where there are assets remaining in the estate after the payment of the debts and liabilities and the expenses of the winding-up, it may be possible to equalise the contributions by making distributions to the over-paying shareholders;

180.2. However, if there are insufficient assets in the estate for this purpose, it will be necessary for the liquidator to make a call on the under-paying shareholders. The proceeds of such a call will be distributable to the over-paying shareholders.

(a) Distribution of surplus assets to achieve rateable allocation of losses

181. The first line of cases deals with the situation in which (i) shareholders' contributions have not been rateable and (ii) there is a surplus remaining in the estate after the payment of the debts and liabilities and the expenses of the winding-up. These cases show that the

surplus assets should be distributed to the over-paying shareholders first, to the extent necessary to rectify their overpayment. In summary:

181.1. In *In re Hodges' Distillery Company, Ex parte Maude* (1870) 6 Ch App 51, the company had issued shares with a nominal value of £25 each. Some shareholders had paid up the full amount of £25 per share, whilst others had paid up only £20 per share. There was a surplus remaining after the payment of the debts and liabilities and the expenses of the winding-up. The Court of Appeal held (to quote the headnote) that "*in the distribution of the surplus assets of the company after winding-up, the holders of fully paid-up shares were entitled to receive £5 a share before the assets were divided*". Mellish LJ held at 55 that "*the losses of the company ought to be borne ... in proportion to the subscribed capital, whether the shares happened to be fully paid up or not*".

181.2. In *In re Weymouth & Channel Islands Steam Packet Company* [1891] 1 Ch 66, the company had issued shares with a nominal value of £10 each. Some shareholders had paid up the full amount of £10 per share, whilst others had paid up only £3 per share. There was a surplus of £25,000 remaining after the payment of the debts and liabilities and the expenses of the winding-up. North J held (to quote the headnote) that "*out of the surplus ... the sum of £7 per share must first be paid to the original shareholders and that the residue of the fund must then be divided rateably among all the shareholders*". This was affirmed on appeal.

181.3. Similarly, in *In re Scinde Punjab and Delhi Corporation* (1867) LR 6 Ch App 53 (Note), the company had issued shares with a nominal value of £10 each. Some of the shareholders had paid up the full amount of £10 per share, whilst others had paid up only £5 per share. There was a surplus of £215,000 remaining after the payment of the debts and liabilities and the expenses of the winding-up. Stuart V-C "*declared that the liquidators must apply the surplus funds in their hands, first, in repaying £5 per share to the shareholders who had paid £10 per share, and next in distributing the balance rateably amongst all the shareholders who had paid up the calls on their shares*".

181.4. The position was similar in *In re Gibson, Little & Co Limited, Ex parte James* (1880) 5 LR Ir 139, in which the company had issued shares with a nominal value of £10 each. Some of the shareholders had paid up the full amount of £10 per share, whilst others had paid up only £5 per share. There was a surplus remaining after the payment of the debts and liabilities and the expenses of the winding-up. Chatterton V-C held at 147:

> "*I am of the opinion that the fully paid-up shareholders are entitled to have the sums paid by them equalised by the repayment to them of the amount which they have paid per share in excess of the sums paid by the other shareholders. The rule of law is settled, that where there are a number of shareholders of the same class, some of whom have paid more on their shares than others, leaving an unequal amount unpaid, those who have advanced more are entitled to be repaid the difference before the distribution of the fund*".

181.5. The correctness of this approach was confirmed in *Birch v Cropper* (1889) 14 App Cas 525 and *In re Driffield Gas Light Company* [1898] 1 Ch 451.

182. As may be seen, in the cases mentioned above, there was already a surplus remaining after the payment of the debts and liabilities and the expenses of the winding-up; and the adjustment to result in a rateable distribution of losses could be achieved merely through the differential distribution of that surplus. There was, therefore, a centralised process by which part of the surplus payable to the under-paying shareholder was distributed instead to the over-paying shareholder, in order to equalise their contributions.

(b) <u>*Further call for monies sufficient to achieve a rateable allocation of losses*</u>

183. In other cases involving unequal contributions, however, there will be no surplus available in the estate for that purpose. In those cases, in order to achieve a rateable allocation of the losses, the centralised process envisaged by the legislation involves the creation of a surplus by making a call on the under-paying shareholders. A rateable distribution is thus achieved by requiring the under-paying shareholders to provide a fund for distribution to the over-paying shareholders. Cases which bear out this approach include the following:

183.1. In *Re The Lancashire Brick & Tile Company* (1865) 34 Beav 330, a holder of fully paid-up shares petitioned for a winding-up order. Sir John Romilly MR held that a holder of fully paid-up shares may be entitled to a winding up order in order to compel the other shareholders to contribute towards the payment of the debts of the concern. He explained:

> "*Thus, if the Petitioner has 100 shares which he has fully paid up, and there are debts of £1,000, the whole of which have been paid out of his contribution, while there are, perhaps, two or three hundred other shareholders who have not paid a penny on their shares, he is entitled to compel those other shareholders to contribute towards the payment of the debts of the company, and to exonerate him from all beyond his due share of the liability. The same rule would apply to an unlimited company*".

183.2. In *In re Anglesea Colliery Company* (1866) LR Eq 379, aff'd (1866) 1 Ch App 555, some of the shares in the company were fully paid-up, whilst others were only partly paid-up. After the payment in full of the debts and liabilities of the company, the liquidators made a call on the partly paid-up shareholders to adjust the rights of the contributories amongst themselves. Wood V-C held that the call was valid. This was upheld by the Court of Appeal, Turner LJ saying at 560:

> "*Now it seems to me to be clear, beyond all doubt, that* ***the purpose of the Act is, inter alia, to adjust the rights of all the members of companies which should be wound up under it. Indeed, I do not see how the rights of those members who have not paid up in full could be adjusted without the rights of those members who have paid up in full being taken into account*** *… Upon the whole case I entertain no doubt whatever that the Vice-Chancellor has arrived at the right conclusion upon the construction of the Act*" (emphasis added).

183.3. In *In re Crookhaven Mining Company* (1866) LR 3 Eq 69, a holder of fully paid-up shares petitioned the Court to have a call made on the holders on partly paid-up shares and to have the proceeds of that call applied in adjusting the rights of the contributories. After the presentation of this petition but before it could be heard by the Court, the winding-up was concluded and the company was dissolved. Counsel for one of the liquidators argued (at 72) that, the company having ceased to exist, "*the rights of the holders of paid-up shares against the other shareholders … must be enforced in some other manner, the jurisdiction of*

the Court under the Companies Act having come to an end". This argument was rejected by Lord Romilly MR, who held in favour of the petitioner, saying at 73 that "[there] *must be an order for a call upon the holders of the shares not fully paid up, for the purpose of adjusting the rights of the shareholders*".

183.4. In *In re Shields Marine Insurance Association, Lee & Moor's Case* (1868) LR 5 Eq 368, Lord Romilly MR confirmed that—

> "*in the same manner, in a company of limited liability, where there are many shares, some of which are paid up, and the rest not paid up, the persons who have paid up in full are not required to be on the list of contributories, but as soon as it is found there are assets more than sufficient to pay all the debts, then* ***calls may still be made on the persons who have not paid up in full, in order to adjust the rights of the shareholders between themselves; and persons are not discharged from all liability as shareholders because all claims against the society have been disposed of, if the society have claims against them for the purpose of setting right the contributions equally amongst the members***" (emphasis added).

183.5. In *Re The Provision Merchants' Company Limited* (1872) 26 LT 862, some of the shareholders had paid up £10 per share whilst others had paid up only £5 per share. The company went into liquidation. The assets in hand were sufficient to discharge the debts and liabilities of the company. The surplus remaining thereafter was insufficient to equalise the shares. A holder of fully paid-up shares applied to the Court for an order requiring the liquidator to make a call. Bacon V-C held that there must be a call to equalise the shares, saying at 863, col.1:

> "*The assets of the company consisted as much of unpaid calls as of the money in their own counting house, and as the shareholders had contributed unequally there must be a call to equalise the shares* inter se".

183.6. In *In re Anglo-Continental Corporation of Western Australia* [1898] 1 Ch 327, the company had issued 125,000 shares with a nominal value of £1 each of which 25,000 were fully paid-up and the remaining 100,000 were only partly paid-up to the extent of 5 shillings per share. In the winding-up of the company, after the payment of the debts and expenses, the liquidator applied to the Court for directions. Wright J held that the liquidator should make a call of 3 shillings per

share on the 100,000 partly paid-up shares, so as to make those shares paid up to the extent of 8 shillings per share; that the amount so called must be applied in repayment of 12 shillings per share to the holders of the 25,000 shares, making their shares also paid up to the extent of 8 shillings per share; and that the surplus remaining in the liquidator's hands thereafter would be divisible among the holders of the whole of the 125,000 shares *pro rata*. He said at 333-334:

> "*There is not in truth a surplus at all, but a mitigation of loss. The loss and the mitigation of it are, I think, intended to be distributed equally, but subject to equalisation of the capital account, and not irrespectively of such equalisation, and a call, actual or in account, is necessary for that equalisation which is an essential part of a winding-up ...* [The] *liquidator must proceed to make a call (either actual or imaginary, as the case may require) on the 100,000 shares sufficient to equalise the capital account. If all the shareholders are solvent the call will in this case be one of 3s. per share on the 100,000 shares, making them 8s. paid. The amount so obtained will be sufficient to repay to the holders of the 25,000 shares 12s. per share, leaving them also with 8s. paid. The assets in hand will then be divisible equally among the whole 125,000 shares, and the ultimate loss of each shareholder will be the difference between the 8s. and the dividend so paid. Assuming the monies in hand to be £25,000, then each of the holders of the 100,000 shares will as a result of the whole have received back 1s. per share, and each of the holders of the 25,000 shares 16s. per share, and every shareholder will have lost 4s. per share*".

(3) Conclusion

184. The statutory provisions and the authorities therefore make clear that, where necessary, the position of the shareholders *inter se* is to be adjusted through the making of calls in the liquidation and distributions to equalise the positions of the shareholders.

185. A contributory who has paid more than its rateable share obtains his remedy through the statutory adjustment regime, and if necessary is able to seek a direction requiring a liquidator to seek permission under Rule 4.204 to make a call for the purpose of adjustment, by making an application to the Court under section 168(5) of the 1986 Act or section 112(1) of the 1986 Act.

186. It follows that the conduct of the adjustment through section 74 renders otiose a further claim for contribution or indemnity. There can be no equity to seek a contribution where the statute expressly provides for an alternative equalisation remedy. This remains the case even if, because there are insufficient assets in the estate to meet the debts and liabilities, and the expenses of the winding up, the liquidator is unable to make a call on a member for the adjustment of the rights of the contributories among themselves (as to which, see paragraph 175.8 above). In that scenario, there can equally be no direct claim for contribution or indemnity by an overpaying contributory against an underpaying contributory because such a claim would compete with the company's primary claim under section 74(1) in respect of the deficiency in the estate as regards the debts and liabilities, and the expenses of the winding up.

187. Furthermore, the statutory regime for adjustment of the position of the shareholders *inter se* is inconsistent with the LBL Administrators' suggestion that an over-paying shareholder would have a direct claim for a contribution or indemnity against an under-paying shareholder, outside of the statutory regime. The process of adjustment through section 74 is intended to centralise any equalisation of how liabilities are ultimately borne as between the contributing members, and is inconsistent with the idea of a direct claim for a contribution or indemnity by individual members. Any such claim would introduce a remedy which cuts across that which the statute contemplates as the means for equalisation.

188. The LBL Administrators have also sought to suggest that a contribution or indemnity claim "*is not inconsistent with the adjustment mechanism contained in s.74*" on the basis that "*the contribution and indemnity claim is a corollary to and follows from that process*" [LBL Reply/18.2]. They do not, however, identify the principle or rule of law from which such right of contribution or indemnity is said to arise.

189. In the LBIE Administrators' submission, however, the suggestion is misconceived. The supposed claim for a contribution or an indemnity cannot 'follow from' the section 74 process, which results in the adjustment having been made, because there is nothing left in respect of which a contribution or indemnity could be sought.

(3) Paragraph (iv)

190. Paragraph (iv) of Issue 7 asks whether the adjustment under section 74 (or, if it exists, any right of contribution or indemnity) is affected by any other claims which LBHI2 and LBL have against one another or any other party.

191. The Administrators of LBIE, LBH and LBHI2 say that claims between contributories are not to be taken into account [LBIE/41(4), 42(4); LBH/32(iv); LBHI2/7.1(iv)].

192. In the LBIE Administrators' submission, the position is clear from *In re Alexandra Palace Company* (1883) 23 Ch D 297, in which the headnote states:

> "*Under section 109 of the Companies Act 1862, the Court has jurisdiction to adjust the rights* inter se *of contributories; it cannot enforce equities which persons who, as tortfeasors (being also contributories) have been ordered to pay money under section 165, may have against other persons, who happen also to be contributories, to compel them to make good the money so ordered to be paid*".

193. The facts were as follows

193.1. London Financial Association ("**LFA**") and Messrs Kelk and Lucas ("**K&L**") held shares in the company. The directors of the company were also shareholders.

193.2. In order to enable the company to declare and pay a dividend, LFA and K&L made loans to the company.

193.3. The company went into liquidation. LFA and K&L lodged proofs of debt in respect of their loans to the company.

193.4. The Court held that the dividends had been unlawful and that the company's directors were liable to the company for damages in tort.

193.5. The directors considered that LFA and K&L were joint tortfeasors who were liable on that basis to pay contributions to the directors in respect of the amounts which the directors had been ordered to pay to the company.

193.6. Therefore the directors applied to the Court for an order requiring the liquidator to pay to the directors the dividends that were otherwise payable to LFA and K&L in respect of their proofs of debt.

193.7. Counsel for the directors submitted that the jurisdiction to make the order sought by the directors was supplied by section 109 of the Companies Act 1862, which empowered the Court to "*adjust the rights of the contributories amongst themselves*" (LFA, K&L and the directors all being contributories).

193.8. Fry J rejected the directors' argument on the basis that the jurisdiction to adjust the rights of contributories under section 109 of the Companies Act 1862 related solely to their rights *qua* contributories and did not apply to any rights which they might have against each other in any other character. He said at 300:

> "*Now I do not find that I have any authority to make such an order for the purpose of working out such an equity between a tortfeasor to the company and creditors or contributories of the company. It was suggested that the 109th section of the Act gives me jurisdiction. That section requires that 'the Court shall adjust the rights of the contributories amongst themselves, and distribute any surplus that may remain amongst the parties entitled thereto'. It may be true, and I believe it is, that* [LFA and K&L] *and the directors are all contributories of the company, but* ***the rights which the directors now desire to enforce have nothing whatever to do with their position as contributories*** *… I have inquired whether there is any other section of the Act which enables me to adjust equities between creditors of the company and tortfeasors to the company, but none has been referred to. I have inquired whether any authority can be cited for working out such an equity in a winding-up, and it has been admitted that no such authority can be produced*" (emphasis added).

194. Accordingly, the adjustment of the position between contributories under sections 74 and 150 of the 1986 Act relates solely to their rights and obligations *qua* contributories and does not address their rights or obligations in any other character.

(4) Paragraph (v)

195. Paragraph (v) of Issue 7 seeks to identify the factors which the Court should take into account in reaching a decision as to whether or not a call should be made under section 150 of the 1986 Act and the basis on which the Court should exercise its discretion.

196. It is common ground that the Court is involved in the making of calls. In particular, whilst Rule 4.202 provides that the powers of the Court with respect to the making of calls are exercisable by the liquidator as an officer of the Court, it makes clear that the liquidator's exercise of those powers remain "*subject to the court's control*". Further, where there is no liquidation committee, the liquidator cannot make a call without the Court's permission: see section 160(2) of the 1986 Act and Rule 4.204(1). Furthermore, as an officer of the Court performing a function of the Court which has been delegated to him, the liquidator's decision-making in respect of the making of calls must be exercised in accordance with any relevant principles which would apply to the Court's exercise of discretion in respect of the making of calls.

197. Beyond this point, however, there is no agreement.

198. The Administrators of LBL and LBH say that the Court has a discretion to decline to make a call on a contributory in respect of the amount identified in section 74(1) of the 1986 Act [LBL/100.1, 102; LBH/34(iii)-(v); LBL Reply/20].

199. Further, the LBL Administrators say that the factors which the Court should take into account in the exercise of its direction will include the relative size of each contributory's shareholding and, where shares are held on trust for a third party, the nominee status of the registered shareholder [LBL/101].

200. Against this, the LBIE Administrators submit that:

200.1. The Court's power to make a call (which is delegated to the liquidator) must be exercised in the interests of the company in liquidation (and, by extension, in the interests of those who are interested in distributions from its estate);

200.2. The matters which fall to be considered in the exercise of that power do not extend to factors relating to the circumstances of the contributories or the basis on which they hold shares in the company;

200.3. In practice, therefore, where there is a need for monies for the purposes identified in section 74(1) for which the contributories are liable, the power should be exercised in favour of a call. It is not in truth a discretion at all but is rather tantamount to a duty to see that the relevant stakeholders are paid;

200.4. The amount and timing of any call will fall within the Court's discretion, although again the determinative factor will be the Court's perception of the amount that is required for the purposes identified in section 74(1).

(1) The statutory provisions

201. The relevant provisions are sections 74(1), 80 and 150(1) of the 1986 Act and in this context the LBIE Administrators emphasise the following points.

202. First, section 74(1) gives rise to a liability: it provides that "*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*" (emphasis added). The Court is given no power to relieve a contributory from this liability. Every member simply "*is liable*".

203. Secondly, section 80 provides that the liability of a contributory creates a debt accruing due from him at the time when his liability commenced, but payable at the times when calls are made for enforcing the liability. This too makes clear that the contributory is under a liability under section 74(1).

204. Thirdly, the existence of the liability is confirmed by section 150(1), which provides that the Court may make calls on the contributories "*to the extent of their liability*". The contributories are liable whether or not any call happens to be made on them. The call is simply a mechanism for enforcing the liability; it does not create it. Indeed, that is part

of the reason why there exists a provable claim in respect of such liability, even before LBIE enters liquidation.

205. Fourthly, whilst section 150(1) provides that the Court "*may*" make a call on the contributories, the Court's power (which is delegated to the liquidator) is plainly to be exercised in accordance with the statutory framework under which it has been conferred. That statutory framework provides for the contributories to be liable to pay the amounts identified in section 74(1). Accordingly, where there is a need for monies to pay the amounts identified in section 74(1), the power can properly be exercised only in one way – namely, in favour of a call. The 'discretion' is, in such case, akin to a duty.

206. Fifthly, section 150(1) makes clear that the Court may make a call "*either before or after it has ascertained the sufficiency of the company's assets*". The timing of any call is therefore flexible rather than fixed and the call on the contributories need not wait until the extent of the deficiency has been finally determined.

207. Sixthly, the amount of the call is to be the amount "*which the court considers necessary to satisfy the company's debts and liabilities, and the expenses of winding up, and for the adjustment of the rights of the contributories among themselves*". The amount of any call is therefore also within the Court's discretion (which is delegated to the liquidator), albeit such discretion is here as to the ***amount*** which is considered necessary for the stated purpose; it is not a discretion as to whether, as against a contributory (or the contributories as a whole), to call for the amount which is considered necessary.

208. Seventhly, the fact that the power is to be exercised in accordance with the interests of the company in liquidation (and, by extension, in the interests of its stakeholders) is confirmed by section 150(2) of the 1986 Act, which provides: "*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*". The objective is thus to maximise the amount of the contributions, to the extent that they are required for the purposes identified in section 74(1).

(2) <u>The authorities</u>

209. The authorities establish that the Court's power in respect of the making of calls is to be exercised in the interests of the company in liquidation (and, by extension, in the interests of those who are interested in distributions from its estate).

210. First, in *In re Barned's Banking Company Limited* (1867) 36 LJ Ch 215, Turner LJ held at 217:

> "*I desire to express my very clear and decided opinion that in this case a call ought to be made, and made immediately, and made on all the contributories whose names are upon the list of contributories of this company. This act of parliament has placed creditors in this position (it is not of course for us to judge the expediency of the act of parliament; we can judge only of its results, and its results are these), that creditors of these companies are, by the act of parliament, precluded from enforcing their claims against companies otherwise than by a proceeding under the act to have the company wound up. The creditors, then, being deprived of their legal remedies, except in the mode provided by the act,* ***it becomes, I conceive, <u>the imperative duty of this Court</u> to exercise the powers which are given by the act for the benefit of the creditors****, having regard to the position in which the legislature has placed them. I think, therefore, that, when it appears that there is a large amount of debts due from companies of this description (I think, in the present case, debts to the amount of £1,843,968, according to the evidence before us)* ***it is not consistent with justice that the Court should decline to exercise its power for the purpose of making a provision for the payment of those debts at the earliest possible period****. It seems to me, therefore, that this is a case in which undoubtedly a call ought to be made, and made at the earliest possible period*" (emphasis added).

211. Cairns LJ agreed, holding at 220:

> "***But it is not a case merely of creditors. It is a case in which the interests of other contributories have to be considered.*** *There may be, and we are told there are, many other contributories ... As to them, it must be a matter of vital consequence that any persons who are to share their burdens should not be permitted, through the medium of delay, to put themselves in a position in which they will be unable to contribute towards the burthen which they are to bear when the proper time arrives*" (emphasis added).

212. Secondly, in *In re Cordova Union Gold Company* [1891] 2 Ch 580, where the company had agreed with the shareholder that calls would be payable in instalments (an agreement which the Court held to be ineffective in the winding-up), Counsel for the shareholder

contended that the Court should nevertheless exercise its discretion by declining to make a call, in order to give effect to the terms of the parties' bargain. Kekewich J rejected this argument at 586, holding:

> "*Then Mr Rawlins' last hope was in an appeal to the discretion of the Court. He says that the Court may make a call, but will not under the present circumstances.* ***The Court is bound to see the creditors paid. The word 'may' in section 102 may not be equivalent to 'shall' but it is a near approach to it.*** *So far as discretion goes, I should not exercise it in favour of Mr. Rawlins' clients, when many persons in the same position have taken different views. It would be extremely hard on them to say that the sixteen who have fought and failed are to get off and not pay because the Court is merciful*" (emphasis added).

213. Thirdly, in *Helbert v Banner* (1871) LR 5 HL 28, the House of Lords considered the Court's discretion to make a call on contributories. Lord Hatherley LC held at 34-35:

> "*On this appeal it has been argued that, besides these requirements, it should appear to the Court not only that the assets are not sufficient for the payment of the debts, but also that there is not any probability of assets being got in sufficient for the payment of those debts.*
> *With reference to that part of the case,* ***the Court, exercising a reasonable discretion, would in no case direct calls to be made if it was clear that there were assets actually in the possession of the liquidator which were sufficient for the payment of the debts. But in the other case, of assets being outstanding, you must consider what would be reasonably required by the Court.*** *It is not pointed out specifically by the statute, but you must trust to the discretion of the Court with respect to it, and all that the Court has to be satisfied of is that there is an improbability (to say the least of it) of the assets being obtained in such a manner, and within such a reasonable time, as to be sufficient for the payment of the debts of the creditors of the company. Because the Court is not bound to allow delay for an indefinite period of time in getting in the assets.* ***The creditors are, by the statute, restrained from proceeding to enforce their ordinary remedies, and it would therefore be neither right nor just that they should be made to wait beyond the period at which the Common Law would have afforded them their remedy, or until the expiration of every possible delay consequent on getting in the assets. They ought to be paid within a reasonable time after the commencement of the process of winding up.*** *The Legislature has left this matter to the discretion of the Court, not indicating anything definite upon that head, but it does require that it shall appear satisfactorily to the Court that the existing members are not able to contribute sufficient for the purpose*" (emphasis added).

(3) Conclusion

214. For these reasons, the LBIE Administrators submit that, whilst the word "*may*" in section 150 could be taken to suggest that the making of calls is discretionary, the power to make calls must be exercised in accordance with the statutory scheme and, where monies are required for the purposes identified in section 74(1), can only be exercised in one way (namely, in favour of making a call).

215. Put another way, if it is proper to characterise it as a discretion at all, it is a discretion which must be exercised in the interests of the company in liquidation (and, by extension, in the interests of those who are interested in distributions from its estate), such that matters which can be considered by the Court do not extend to the interests of the contributories or the basis on which they hold shares in the company.

(4) Irrelevant factors

216. It follows that the matters identified by the LBL Administrators are irrelevant to the exercise of the Court's power in this regard.

217. First, the sizes of the contributories' shareholdings are irrelevant. The liabilities of contributories in an unlimited company are not limited by reference to the percentage share of the total issued share capital which they hold. The LBIE Administrators' submissions on this point have been set out in the context of paragraph (i) of Issue 7.

218. Secondly, the fact that a contributory holds the shares as a nominee for a third party will be irrelevant to the exercise of the power to make a call. The LBIE Administrators' submissions on this point have been set out above in the context of the LBL Administrators' further arguments on paragraph (i) of Issue 7.

219. Thirdly, the circumstances in which the contributory came to hold a share will be irrelevant, as will the history of the contributories' shareholding, including the question of whether any dividends which fell due were ever paid to the shareholder. (That particular matter is addressed expressly by section 74(2)(f) of the 1986 Act, which provides that "*a sum due to any member of the company (in his character of a member)*

by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves". See also *Soden v British & Commonwealth Holdings plc* [1998] AC 298.)

F. **ISSUE 8**

220. Issue 8 is:

> "*How, if at all, any claim for a contribution or indemnity ... and/or any adjustment ... would be affected by the rule against double proof in circumstances where LBIE had not yet been paid in full in respect of a Contribution Claim*".

221. Issue 8 presupposes that LBL and LBHI2 are liable to LBIE in respect of a Contribution Claim and that LBL has either:

221.1 a direct claim against LBHI2 for a contribution or indemnity; or

221.2 a right to adjustment under section 74 of the 1986 Act. The right to adjustment will only arise where the debts and liabilities, and the expenses of the winding up, have been or will be met in full: see paragraph 175.8 (including footnote 3) above.

222. The LBIE Administrators' position is that:

222.1 As explained above in the context of Issue 7, LBL has no direct claim against LBHI2 for a contribution or indemnity. However, in the event that LBL were to have a direct claim against LBHI2 for a contribution or indemnity, the rule against double proof would apply to prevent LBL's claim against LBHI2 from competing with LBIE's Contribution Claim against LBHI2.

222.2 However, the rule against double proof has no application to the process of adjustment under section 74 of the 1986 Act.

(1) **The rule against double proof**

223. The rule against double proof prevents more than one proof being lodged in the same estate in respect of what is in substance the same debt.

224. As Mellish LJ held in *In re Oriental Commercial Bank* (1871) LR 7 Ch 99 at 103, "*the true principle is, that there is only to be one dividend in respect of what is in substance the same debt*". A debt which is disqualified from proof will also be disqualified from set-off: *In re Fenton; Ex parte Fenton Textile Association Ltd* [1931] 1 Ch 85; *Secretary of State for Trade and Industry v Frid* [2004] 2 AC 506 per Lord Hoffmann at [13]. There is a full discussion of the purpose and scope of the rule in the judgment of Oliver LJ in *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] AC 626 at 636–644.

225. As Lord Walker explained in *In re Kaupthing Singer & Friedlander Ltd (in administration) (No 2)* [2011] UKSC 48, [2012] 1 AC 804 at [11]-[12]:

> "*[11] The function of the rule is not to prevent a double proof of the same debt against two separate estates (that is what insolvency practitioners call "double dip"). The rule prevents a double proof of what is in substance the same debt being made against the same estate, leading to the payment of a double dividend out of one estate. It is for that reason sometimes called the rule against double dividend. In the simplest case of suretyship (where the surety has neither given nor been provided with security, and has an unlimited liability) there is a triangle of rights and liabilities between the principal debtor (PD), the surety (S) and the creditor (C). PD has the primary obligation to C and a secondary obligation to indemnify S if and so far as S discharges PD's liability, but if PD is insolvent S may not enforce that right in competition with C. S has an obligation to C to answer for PD's liability, and the secondary right of obtaining an indemnity from PD. C can (after due notice) proceed against either or both of PD and S. If both PD and S are in insolvent liquidation, C can prove against each for 100p in the pound but may not recover more than 100p in the pound in all.*
> *[12] …* [The] *surety is also potentially a creditor of the principal debtor, because of his right to an indemnity. The effect of the rule is that so long as C has not been paid in full, S may not compete with C either directly by proving against PD for an indemnity, or indirectly by setting off his right to an indemnity against any separate debt owed by S to PD*".

226. It was pointed out by Scrutton LJ in *In re Melton* [1918] 1 Ch. 37 at 60 that in considering the rule against double proof technicalities are not to be regarded:

> "*To these two sets of legal principles I have mentioned it remains to add the fact of the debtor's bankruptcy, and in particular the rule in bankruptcy that there must not be a double proof for the same debt, with the further explanation that, in determining whether the two proofs are in respect of the same debt, regard must be had, not to technicalities, but to the substance*".

227. A helpful illustration is provided by *Steamship Enterprises of Panama Inc., Liverpool (Owners) v Ousel (Owners) (The "Liverpool") (No 2)* [1963] P 64, in which, following a collision between two vessels (the "Ousel" and the "Liverpool") in the mouth of the River Mersey (in respect of which the Liverpool was at fault), the owners of the Ousel were liable to the Mersey Docks and Harbour Board in respect of the expenses which had been incurred by the Board in clearing up a wreck of the vessels. The Board made the same claim against a fund constituted by the owners of the Liverpool. The owners of the Ousel also claimed on the fund constituted by the owners of the Liverpool for (*inter alia*) an indemnity in respect of their own liability to the Board. The Court of Appeal held that the rule against double proof was applicable to the fund constituted by the owners of the Liverpool and that the claims by the Board against that fund to recoup the Board's expenses and by the owners of the Ousel for indemnification against their own liability to pay the Board's expenses were, in substance, the same. Hodson LJ said at 85-86:

> "*The board's right against the Liverpool is the cost to which the board as owner of the port has been put as a result of the collision. The damage that flows from the Liverpool's wrongdoing is the reasonable cost of removing the obstruction ... The £10,000 for which the Ousel seeks to prove ... arises out of the proviso to section 3 (3) of the Act of 1954, and is the 'deficiency' in the amount recovered by the board from sales of salved material against 'expenses' incurred by it in exercise of its statutory powers under the section. These are the very same expenses as are claimed as damages in tort against the Liverpool ... That is, in fact, a part of the same debt, and in our judgment if both sums can be proved for, the same debt will have been proved for twice to the extent of £10,000 ...*
> *In our judgment, therefore, the fund is not to be subjected to both liabilities*".

(2) <u>The present case</u>

228. It is necessary to consider the position:

228.1 On the hypothesis that the LBL Administrators are correct to say that LBL has a direct claim against LBHI2 for a contribution or an indemnity; and

228.2 On the hypothesis that the LBL Administrators are wrong and that any adjustments *inter se* are instead to be made through section 74 of the 1986 Act.

(1) The position in the event of a direct claim for a contribution or an indemnity

229. If the LBL Administrators are (contrary to the position adopted by the other parties) correct to say that LBL has a direct claim against LBHI2 for a contribution or an indemnity, the position will be as follows.

230. Pursuant to section 74 of the 1986 Act, LBIE will have a Contribution Claim against LBHI2 and LBL in respect of the shortfall in LBIE's administration.

231. If LBL has a direct claim against LBHI2 seeking a contribution or an indemnity in respect of its liability to LBIE pursuant to section 74, LBL's claim against LBHI2 will constitute a further claim against LBHI2 in respect of the shortfall in LBIE's administration.

232. In that eventuality, the two rival claims against LBHI2 would be claims for, in substance, the same debt – namely, the shortfall in LBIE's administration; LBIE's being for the Contribution Claim itself and LBL's being for an indemnity or contribution in respect of the Contribution Claim.

233. The rule against double proof would then apply in LBHI2's administration to prevent LBL's claim against LBHI2 from competing with LBIE's claim against LBHI2.

(2) The position if adjustments are to be conducted through section 74 of the 1986 Act

234. If the correct position is that adjustments are to be conducted through section 74 of the 1986 Act, it will follow that there cannot be any claim by LBL against LBHI2 for a contribution or an indemnity.

235. Instead, there will simply be a claim by LBIE against LBHI2 under section 74 for the amount required to enable the adjustment to be made.

236. The fact that LBL would not have a claim against LBHI2 would mean that there was no competition. There would simply be a claim by LBIE against LBHI2.

237. Since there would, in that case, simply be a claim against LBHI2 by LBIE, and no rival claim by LBL, the rule against double proof could not apply. The adjustment process under section 74 (which only applies where the debts and liabilities, and the expenses of the winding up, have been met and, in any event, cannot lead to a competition between the overpaying contributory and those with claims ranking higher in the waterfall than the members (see paragraph 175.8 above)) ensures that the rule itself is not required.

(3) The positions of the other parties

238. The Administrators of LBHI2 and LBH appear to agree that, if there is a direct claim for a contribution or an indemnity, the rule against double proof would apply to prevent LBL's claim from succeeding [LBHI2/8.3; LBH/36(iii)].

239. The Administrators of LBL have not expressed a position on this point and have instead suggested that the Court should decline to answer Issue 8.

(4) Conclusion

240. For the reasons set out above, in the event of the Court holding that LBL has a direct claim against LBHI2 for a contribution or indemnity, the Court is invited to hold that the rule against double proof would apply to prevent LBL's claim against LBHI2 from competing with LBIE's Contribution Claim against LBHI2.

241. Insofar as the Court agrees with the LBIE Administrators' submissions on Issue 7 that there is no direct claim for a contribution or an indemnity between contributories and that adjustments *inter se* are instead to be made through section 74 of the 1986 Act, the Court is asked to declare that the rule against double proof has no application.

G. **<u>ISSUE 9A</u>**

242. Issue 9A is:

> "*Whether, as a matter of law, it is possible for a member of a company to enter into with that company an enforceable agreement which has the effect of enabling that member to avoid what would otherwise be its obligation to contribute to the assets of the company under section 74* [of the 1986 Act] *in the event of the company's winding up or otherwise to reverse the effect of that section (whether by claiming to be contractually entitled to reimbursement from that company in respect of such contributions or otherwise)*".

243. This issue arises in the context of Issue 9, where the LBL Administrators assert that LBL has a contractual right to be indemnified by LBIE against LBL's obligation to contribute to LBIE's estate under section 74 [LBL/78]. The LBL Administrators say that LBL's right to recharge calls to LBIE provides LBL with a defence of circuity of action to any call which may be made by a liquidator of LBIE [LBL Reply/17]. In this way, the LBL Administrators say that the effect of the contractual right for which they contend is to relieve LBL from its liability under section 74 of the 1986 Act.

244. Whilst the LBIE Administrators consider that the LBL Administrators' contention on Issue 9 is wrong as a matter of fact, they have also identified a preliminary issue, Issue 9A, which answers the LBL Administrators' contention shortly as a matter of law.

245. The LBIE Administrators submit that a contract of the type for which the LBL Administrators contend (or indeed any contract to that effect) would be unenforceable as a matter of law, because its effect would be defeat to the provisions of the statutory regime [LBIE/51-52]. The purpose or intention of the parties is irrelevant to the analysis; it is simply the *effect* of the agreement – being inconsistent with the result provided for by statute – which renders the agreement void.

246. The LBHI2 Administrators agree with the LBIE Administrators on this point [LBHI2/9A.1].

247. By contrast, the LBL Administrators say that such a contract would be valid and enforceable [LBL Reply/23]. (LBH takes no position on this point [LBH/39].)

(1) <u>Section 74</u>

248. 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*".

249. This is a mandatory statutory rule – every present and past member "*is liable*".

250. This rule is subject only to the qualifications contained in section 74(2), which include:

250.1. Qualifications in the case of past members (section 74(2)(a), (b) and (c)); and

250.2. Qualifications in the case of a limited company (section 74(2)(d)).

251. As regards the position of limited companies, section 74(2)(d) provides that "*in the case of a company limited by shares, no contribution is required from any member exceeding the amount (if any) unpaid on* [his] *shares*".

(2) <u>The relevant authorities</u>

252. In the LBIE Administrators' submission, the statutory obligation in section 74 is for the benefit and protection of the company's creditors (and other contributories) and it is not possible to 'contract out' of the liability which it imposes. Accordingly, any agreement between the company and a contributory that the contributory will have, in the company's liquidation, a liability which is less extensive than that provided for by the terms of the statute is unenforceable and of no effect.

253. The general principle was stated in *In re Paraguassu Steam Tramroad Co, Black & Co's Case* (1872) LR 8 Ch App 254, in which contractor agreed with a company to supply

steam engines at a fixed price and to take shares in the company. The terms of the agreement provided that any calls on the shares would be deferred until at least two engines had been paid for and that the contractor could set any calls off against the money that the company owed to him. The contractor took shares accordingly, and made two engines for the company, which were not taken by the company or paid for. The company went into liquidation and the liquidator made a call, which was challenged by the contractor on the basis of his agreement with the company. The Court of Appeal held that the agreement did not provide the contractor with any valid basis for disputing the calls. Lord Selborne LC held at 260-261:

> "[It] *is very difficult to understand how it can seriously be argued that a company and one of its shareholders can, by any agreement they chose to enter into between themselves, override and relieve themselves from the operation of the Act of Parliament …* [It] *is impossible to entertain the idea that … any company can, by a private contract, take a particular creditor, who is also a shareholder, out of the operation of that law*".

254. He concluded at 264:

> "*I am clearly of opinion that it is not competent for any persons whatever, by any antecedent contract, to alter the administration of the assets of the company under such a winding-up*".

255. Mellish LJ agreed at 265:

> "[It] *is quite clear that the company cannot, by making an agreement with a particular shareholder, save him from that liability which the Act of Parliament has imposed upon him*".

256. This general principle has been applied on numerous occasions.

257. The most well-known application of this principle is the line of cases holding that a limited company cannot enter into a valid agreement to issue shares at a discount. In such a case, the agreement for a discount will be invalid and the shareholders will be liable for the full unpaid nominal amount of the shares in the event of the company's liquidation, in accordance with the terms of the statute, which will override the parties' agreement in respect of the discount.

258. The leading case on this point is *Ooregum Gold Mining Company of India Ltd v Roper* [1892] AC 125, in which the House of Lords held (to quote the headnote) that "[a] *company limited by shares, formed and registered under the Act of 1862, has no power to issue shares as fully paid up, for a money consideration less than their nominal value*".

259. Lord Halsbury LC explained his reasoning at 133:

> "*My Lords, the whole structure of a limited company owes its existence to the Act of Parliament, and it is to the Act of Parliament one must refer to see what are its powers, and within what limits it is free to act. Now, confining myself for the moment to the Act of 1862, it makes one of the conditions of the limitation of liability that the memorandum of association shall contain the amount of capital with which the company proposes to be registered, divided into shares of a certain fixed amount.* ***It seems to me that the system thus created by which the shareholder's liability is to be limited by the amount unpaid upon his shares, renders it impossible for the company to depart from that requirement, and by any expedient to arrange with their shareholders that they shall not be liable for the amount unpaid on the shares, although the amount of those shares has been, in accordance with the Act of Parliament, fixed at a certain sum of money***" (emphasis added).

260. Similarly, in *Welton v Saffery* [1897] AC 299, the House of Lords held (to quote the headnote) that—

> "[it] *being ultra vires for a limited company to issue shares at a discount or by way of bonus, although authorized to do so by the articles of association, the holders of shares so issued are not thereby relieved from liability, in a winding up, to calls for the amounts unpaid on their shares for the adjustment of the rights of contributories inter se, as well as for the payment of the company's debts and the costs of winding up*".

261. Lord Halsbury LC explained at 304-305:

> "*I think the Legislature, in permitting the existence of a company limited by shares and with limited liability, created a machinery which makes it impossible by any expedient, either by company or shareholder, to act otherwise than in pursuance of the provisions of the statute. Whether for the purpose of settling the rights inter se, or for the purpose of satisfying creditors, it appears to me that the statute enforces upon company and shareholder alike conformity to the rule laid down, that a share for a fixed amount shall make the person agreeing to take that share liable for that amount ... I am unable to see how this artificial creature, limited*

> *within its sphere of action by the statute under which it is created, can do anything contrary to the provisions of the statute.* ***It is not a question for what purpose it is done. Dealing with it as I think it must be dealt with, as an artificial creation, it can only act as a company or as shareholder in either of those characters within the fetters created by the Act of Parliament***" (emphasis added).

262. As this reasoning makes clear, the purpose or intention of the agreement will be irrelevant to the analysis; it is simply the *effect* of the agreement – being inconsistent with the result provided for by statute – which renders the agreement void.

263. Lord Macnaghten agreed at 321:

> "*The articles in express terms purport to authorize the directors to issue shares at a discount. That provision, however, is in contravention of the statute of 1862, and simply void; neither the company nor the shareholders, even if they had been unanimous, could have empowered the directors to do anything of the kind*".

264. The contravention of the statute is therefore judged in terms of the *effect* of the transaction, rather than by reference to its purpose or to the intention of the parties.

265. Lindley LJ had expressed the same view in the same case in the Court of Appeal (sub nom *In re Railway Time Tables Publishing Company, Ex parte Welton* [1895] 1 Ch 255 at 266):

> "*I do not think that by any process a share can be issued at a discount so as to render the person to whom it is issued not liable to pay up the amount thereof in full. This cannot be done consistently with the Acts of Parliament*".

266. *Ooregum* and *Welton* were not isolated decisions but represented the culmination of a long line of authority to the same effect:

    266.1. In *In re Addlestone Linoleum Co* (1887) 37 Ch D 191, the company had purported to issue shares at a discount of 25 per cent. Lindley LJ held that the shareholders were nevertheless "*saddled with a liability to pay in full, a liability from which they could not escape, even by a registered contract*".

266.2. In *In re New Chile Gold Mining Co* (1888) 38 Ch D 475, the company had purported to issue shares at a discount of 15 shillings per share. North J held (to quote the headnote) "*that the issue of the shares at a discount was illegal and that the shareholders were still liable to the extent of 15 shillings per share*". He explained at 479: "*In my opinion, such a transaction is not legal and has not the effect of relieving the shareholders from liability to pay up 15s. per share*".

266.3. In *In re Almada & Tirito Co* (1888) 38 Ch D 415, the headnote states: "*A company limited by shares under the Act of 1862 has no power to issue shares at a discount so as to render the shareholder liable for a smaller sum than that fixed for the value of the shares by the memorandum of association*". Cotton LJ held at 424: "*If these shareholders were put on the list and remained on the list, they would in the event of winding-up be liable to pay not only the unpaid shilling which is now unpaid, but the whole 18 shillings which still remains unpaid, that being the only limit of their liability in accordance with section 7 and the other sections of the Act of 1862*".

266.4. In *In re Weymouth & Channel Islands Steam Packet Company* [1891] 1 Ch 66, the company issued shares with a nominal value of £10 each at a discount of £7 per share. North J held at 75: "*What, then, is the position in which* [the shareholders] *stand? They have agreed with the company that, in consideration of their paying £3 per share, they are to be the holders of fully paid-up shares; in other words, that, on the payment of £3 per share, the sum of £10 per share is to be taken to have been fully paid up. Beyond all question that is illegal*". The Court of Appeal agreed, holding that the agreement was not only unenforceable *vis-à-vis* the creditors but was also unenforceable *vis-à-vis* the shareholders. Bowen LJ held at 81: "*Such an agreement, if made, could not be enforced against present, and certainly would not bind future, shareholders*".

267. Whilst the prohibition of the issue of shares at a discount is the most well-known example of the rule that it is impossible to 'contract out' of the statutory obligation to contribute, there are other examples of cases in which this rule has been applied:

267.1. First, it has been held that it is not possible for an *unlimited* company to agree with a shareholder that the shareholder's liability should be *limited*. For instance, in *Muir v City of Glasgow Bank* (1879) 4 App Cas 337, Lord Selborne held at 384 that, in the case of an unlimited company, "[if] *any individual shareholder had proposed to the directors to take an allotment of shares upon the condition that he should in no case be liable beyond a certain specified amount … it is clear that the directors would have had no power … to agree to such a condition*".

267.2. Secondly, it has been held that a provision in the articles exempting shares from calls would not be effective in the event of the company's winding up. In *Re Sluzkin Pty Ltd* [1932] VLR 229, a sub-clause in the articles provided that certain shares should be exempt from calls. The Supreme Court of Victoria held at 234: "*If … the proper construction of the sub-clause is that the shareholder is to be exempt from all calls whether the company is a going concern or is in liquidation, then we think that the sub-clause is invalid*".

267.3. Thirdly, it has been held that a contract for the payment of calls by instalments (or subject to some other qualification not consistent with the statute) will be unenforceable in the event of the company's liquidation. For example, in *In re Cordova Union Gold Company* [1891] 2 Ch 580, the company had agreed with a shareholder that the nominal amount of certain shares would be payable in instalments. Kekewich J held that this agreement was ineffective following the commencement of the company's winding up, because the "*legislative provisions* [of the Companies Act 1862] *defeat their contract*" (at 585). Again, in *Re Irma Co-operative Co* [1925] 1 DLR 27, the headnote states: "*A contributory to an insolvent company is liable to pay the full balance owing on his shares although under the subscription contract such balance is not due, being payable by instalments. This applies to a company being wound up*". Similarly, in *In re Coed Madog Slate Co* (1877) WN 190, the articles provided that no further call should be made without the consent of the at least three-quarters by value of the shareholders at a general meeting. Sir George Jessel MR held that "*the provision in the articles against making a further call without the consent of three-fourths of the shareholders … could only operate as a limitation of the powers of the directors while the company existed, but not when it was in liquidation*".

(3) <u>The mandatory nature of the statutory insolvency code</u>

268. The court's approach to the nature of a contributory's liability under section 74 is founded on sound principle and is consistent with the court's approach to rights and obligations arising in other parts of the 1986 Act. Put in the most general terms, it is a familiar principle that the parties may not validly contract out of any provision of the statutory insolvency code, which (on its true construction) is mandatory in its terms. In this context, Lord Collins referred in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38, [2012] 1 AC 383 at [1] to "*the general principle that parties cannot contract out of the insolvency legislation*".

269. In *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785, for example, the House of Lords held that it is not possible for the parties to contract out of statutory insolvency set-off, agreeing with Lord Denning MR in *Rolls Razor Ltd v Cox* [1967] 1 QB 552 at 570 that "*the parties cannot contract out of the statute*".

270. Similarly, in *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 1 WLR 758, the majority of the House of Lords held that a clearing house arrangement between a large number of airline companies relating to debts arising as between them was ineffective as against the liquidator of one of the companies, British Eagle. All members of the House upheld the principle that contracting out of the *pari passu* provisions of what was then section 302 of the Companies Act 1948 was void. Lord Cross held at 780:

> "*But what the respondents are saying here is that the parties to the 'clearing house' arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in 'contracting out' of the provisions contained in section 302 for the payment of unsecured debts 'pari passu'. In such a context it is to my mind irrelevant that the parties to the 'clearing house' arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a 'contracting out' must, to my mind, be contrary to public policy*".

271. The ratio of that decision was accurately stated by Peter Gibson J in *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207 at 226 as being that "*where the effect of a contract is that an asset which is actually owned by a company at the commencement of its liquidation would be dealt with in a way other than in accordance with* [the statutory pari passu rule] ... *then to that extent the contract as a matter of public policy is avoided*".

272. Lord Collins explained in *Belmont* at 414-415 that considerations of intention and/or the *bona fides* of the parties will be irrelevant in such a case:

> "*[75] ...* [In] *the leading pari passu principle case, British Eagle [1975] 1 WLR 758, it was held by the majority that it did not matter that the clearing transaction was a sensible commercial arrangement not intended to circumvent the pari passu principle ...*
> *[78] ...* [There] *is an impressive body of opinion from some of the most distinguished judges that, in the case of the anti-deprivation rule, a deliberate intention to evade the insolvency laws is required. That conclusion is not affected by the decision in British Eagle [1975] 1 WLR 758.* **The pari passu rule is clear. Parties cannot contract out of it.** *That is why, by contrast with the anti-deprivation cases, Lord Cross was able to accept (p.772) that the clearing house was a commercial arrangement which was for the mutual advantage of the airlines, but that the power to go behind agreements, the result of which were repugnant to the insolvency legislation, was not confined to cases in which the dominant purpose was to evade its operation. It was irrelevant that the airlines had 'good business reasons for entering' into the arrangements and 'did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of [them]': p.780*".

273. *Belmont* therefore shows that, if the effect of the agreement is to cut across a mandatory provision of the insolvency code, it will be invalid irrespective of whether or not some form of acceptable commercial purpose is present.

274. See also *Ex parte Mackay, In re Jeavons* (1873) L.R. 8 Ch App 643, in which James LJ held at 647 that "*a man is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides*". As Lord Collins explained in *Belmont* at [11], the reference by James LJ in *Mackay* to a "*different distribution of his effects in the event of bankruptcy from that which the law provides*" is an early expression of the pari passu principle. This point was explained further by Rimer LJ in *Mayhew v King* [2011] Bus LR 1327 at [29]:

> "*The basis of the principle underlying the decision in Ex p Mackay is that a purported 'contracting out' of the insolvency legislation is contrary to public policy, as Lord Cross explained in his speech in the House of Lords (the main speech of the majority) in British Eagle International Airlines Ltd v Cie Nationale Air France [1975] 1 WLR 758, 780. British Eagle International Airlines Ltd shows that Ex p Mackay was rightly decided. That was also accepted by the minority, with Lord Morris of Borth-y-Gest delivering the main dissenting speech. The minority view was based on its assessment that the commercial arrangements in issue, unlike those in Ex p Mackay, could not be regarded as a device for defeating the bankruptcy laws. The majority's view was that a purported contracting out of the bankruptcy laws was nevertheless their effect*".

275. If it were to be the LBL Administrators' case that these well-established principles have no application because LBL has not made an express agreement with LBIE, but has only entered into recharge arrangements with it, which would cause LBIE's Contribution Claim to fail for circuity of action, any such argument would be wrong. In the LBIE Administrators' submission, where a statutory provision is mandatory, the critical question is the effect of what has been agreed, and any attempt to contract out of the statute will be unenforceable whether the evasion of the statute is direct or indirect. See, for example:

275.1. *Booth & Pollard v Bank of England* (1840) Cl & Fin 509, in which Lord Tindal CJ held at 540 that "*whatever is prohibited by law to be done directly cannot legally be effected by an indirect and circuitous contrivance*". See also *Fox v Bishop of Chester* (1824) 2 B&C 635 at 658 and 655 per Abbott CJ: "*If it be an evasion of the statute, it must be void according to general principles*" – namely, "*the well-known principle of law, that the provisions of an Act of Parliament shall not be evaded by shift or contrivance*". See also *Heydon's Case* (1584) 3 Co Rep 7a ("*the office of all the Judges is always to make such a construction as shall suppress the mischief, and advance the remedy, and to suppress subtle inventions and evasions for the continuation of the mischief*"); and

275.2. The "*very familiar principle that you cannot do that indirectly which you are prohibited from doing directly*" (*Madden v Nelson & Fort Sheppard Railway Company* [1899] AC 626 per Lord Halsbury LC at 627-628). See also *Deane v Clayton* (1817) 7 Taunt 489, in which Burrough J held at 498 that a person

"*cannot justify doing that indirectly, which he would not have been warranted in doing directly*". He added at 507: "*In support of this proposition, I need only resort to the storehouse of wisdom, the common law of England. There I find it written in plain terms, that Quando aliquid prohibetur ex directo, prohibetur et per obliquum (Wingate, 680)*". Park J agreed at 511, saying: "*I have ever thought it quite clear, that no man shall do that indirectly, which he cannot do directly*".

(4) <u>The LBL Administrators' contentions</u>

276. In response to the LBIE Administrators' position, the LBL Administrators have advanced a number of arguments.

277. First, the LBL Administrators contend that section 74 is not mandatory (LBL Reply/23.1). This contention is wrong. Section 74 is a mandatory statutory rule, as the authorities mentioned above make clear. See, in particular, *Paraguassu*, *Ooregum* and *Welton*. That is why the company and its shareholders cannot contract out of it.

278. Secondly, the LBL Administrators contend that the 1986 Act "*does not contain an express prohibition on parties seeking to exclude the nature and extent of a member's liability*" (LBL Reply/23.2). However, the authorities make clear that the statute's express provision for the extent of the member's liability has the effect of prohibiting arrangements which seek to provide for the member's liability to be less extensive than is provided for by the statute.

279. Thirdly, the LBL Administrators assert that the contract for which the LBL Administrators contend, by which LBL is said to be entitled to be indemnified by LBIE in respect of LBL's liability to contribute to LBIE's estate under section 74, was "*not effected with the intention of avoiding LBL's statutory obligations under section 74*" (LBL Reply/23.3). Even if this were right as a matter of fact (which must be at least doubtful, given the supposed terms of the contract for which the LBL Administrators contend in the context of Issue 9), it would, for the reasons explained above, be irrelevant. As Lord Halsbury LC made clear in *Welton* at 304-305, considerations of purpose and intention of the agreement are irrelevant to the analysis. Lord Collins confirmed in *Belmont* that considerations of intention and/or *bona fides* will be irrelevant in the context

of the rule against contracting out of mandatory provisions of the statutory insolvency code. The determinative question is whether the arrangement in question has the effect of producing an outcome which is inconsistent with the statutory regime.

280. Fourthly, the LBL Administrators say that the "*consequence of LBL avoiding the effect of section 74 of the Act was not foreseen and is remote*" (LBL Reply/23.4). Whether or not this is correct as a matter of fact (which is, again, doubtful, given the supposed terms of the agreement for which the LBL Administrators contend, which includes the alleged right to recharge the section 74 liability), it is, in any event, irrelevant. In the cases mentioned above holding that the issue of shares at a discount is unlawful, the likelihood or unlikelihood of the company going into liquidation at the time of that allotment was never considered to be relevant. The question is whether, in the event of the company's winding-up, the agreement in question would counteract the provisions of the statute. The contract for which the LBL Administrators contend plainly satisfies that test: they argue that, pursuant to the contract for which they contend in the context of Issue 9, LBL is entitled to be indemnified by LBIE in respect of LBL's liability to contribute to LBIE's estate under section 74. A starker case of an agreement which has an effect contrary to section 74 is difficult to imagine.

281. Fifthly, the LBL Administrators contend that "*LBIE is entitled to waive its statutory rights*" under section 74 (LBL Reply/23.5). This is wrong. The authorities make clear that the company cannot agree with its shareholders to provide for them to be liable in an amount lower than the statutory requirement. The courts have made clear repeatedly that the company is unable to waive these statutory rights. In *In re Almada & Tirito Co* (1888) C8 Ch D 415, for example, Fry LJ held at 425 that "*a release by the company will not diminish the liability – accord and satisfaction between the company and the shareholder will not diminish the liability; nothing will diminish or extinguish the liability but payment*". The case law on this point is clear.

282. Sixthly, the LBL Administrators contend that the agreement in the present case should be held to be enforceable because LBL's creditors include ordinary trade creditors, former employees and HMRC (LBL Reply/23.6). This consideration is irrelevant and has no place in the analysis.

(5) **<u>Conclusion</u>**

283. In the LBIE Administrators' submission, therefore, the Court should answer Issue 9A by holding that it is not possible as a matter of law for a member of a company to enter into an agreement with the company which has the effect of enabling the member to avoid what would otherwise be its obligation to contribute to the assets of the company under section 74 of the 1986 Act in the event of the company's winding up or otherwise to reverse the effect of that section (whether by claiming to be contractually entitled to reimbursement from that company in respect of such contributions or otherwise).

284. In the event of the Court deciding against the LBIE Administrators and in favour of the LBL Administrators on this point by holding that it is possible to enter into such an agreement, and in the event of the LBL Administrators proving that such an agreement exists, the LBIE Administrators will submit that such an agreement could not in any event be enforced in the present case, as its enforcement would be contrary to the rule against double proof. The LBIE Administrators' submissions on the rule against double proof have been set out above in the context of Issue 8. The contributory's claim to recharge its own liability for the company's debts would be the same, in substance, as those debts themselves. Therefore, in the event of the Court holding in favour of the LBL Administrators on Issue 9A, the LBIE Administrators would invite the Court to consider as part of the Part B trial whether the enforcement of the contract for which the LBL Administrators contend would be contrary to the rule against double proof.

H. <u>ISSUE 10</u>

285. Issue 10 is:

> "*If the answer to the issue at sub-paragraph 9(i) above is yes, whether LBL's recharge claim against LBIE in respect of the Sub-Debt Contribution Claim and LBHI2's claim in respect of the Sub-Debt are to be paid pari passu and, if not, in what order or priority*".

286. The "*issue at sub-paragraph 9(i) above*" is, in summary, "[whether] *and to what extent LBL is entitled … to recover from LBIE … sums paid or payable by it to LBIE in respect of a Contribution Claim*".

287. Issue 10 thus presupposes that:

287.1. LBHI2 has a claim against LBIE in respect of the Sub-Debt;

287.2. LBIE has a Sub-Debt Contribution Claim against LBHI2;

287.3. there is no set off between those two items;

287.4. LBIE therefore also has a Sub-Debt Contribution Claim against LBL; and

287.5. LBL is entitled to recharge that liability to LBIE.

288. In the LBIE Administrators' submission, Issue 10 does not arise. Among other things, LBL is not entitled to recharge any Sub-Debt Contribution Claim to LBIE.

289. However, if Issue 10 were to arise, it is the LBIE Administrators' position that the rule against double proof would apply in LBIE's administration to prevent LBL's recharge claim against LBIE in respect of the Sub-Debt from competing with LBHI2's claim against LBIE in respect of the Sub-Debt.

290. The LBIE Administrators' submissions on the law relating to the rule against double proof have been set out above in the context of Issue 8.

291. The rule against double proof would apply because:

291.1. LBHI2's claim against LBIE would be a claim in respect of the Sub-Debt; and

291.2. LBL's claim to recharge its own liability for the Sub-Debt to LBIE would also be a claim in respect of the Sub-Debt.

292. The two competing claims against LBIE would therefore be claims for, in substance, the same liability – namely, the Sub-Debt.

293. In their Position Paper, the LBIE Administrators had formulated a different answer to Issue 10, namely that LBL's recharge claim against LBIE would be a provable debt to which the Sub-Debt would be contractually subordinated [LBIE/56(6)].

294. However, on further reflection, the LBIE Administrators consider that, for as long as the Sub-Debt remained outstanding in whole or in part, the rule against double proof would prevent LBL's recharge claim against LBIE from being a provable debt and that the subordination provisions in the Sub-Debt Agreements would therefore not result in the Sub-Debt being subordinated to the recharge claim.

295. In summary, as a result of clause 5(2) of the Sub-Debt Agreements, the Sub-Debt is subordinated to Liabilities (as defined) other than "*obligations which are not payable or capable of being established or determined in the Insolvency of the Borrower*".

296. As Lord Walker explained in *Kaupthing* at [11], the effect of the rule against double proof is to ***prevent*** a proof of debt from being lodged or admitted and to mean that nothing is payable in respect of the secondary claim for the primary obligation.

297. The rule against double proof would therefore prevent LBL's recharge claim against LBIE in respect of the Sub-Debt from being "*payable or capable of being established or determined in the Insolvency of the Borrower*".

298. It follows that the Sub-Debt would not be subordinated to such a claim. Indeed, in effect, LBL's claim would be subordinated to the Sub-Debt by reason of the rule against double proof.

299. For these reasons the LBIE Administrators invite the Court to hold that the rule against double proof would apply in LBIE's administration to prevent LBL's recharge claim against LBIE in respect of the Sub-Debt from competing with LBHI2's claim against LBIE in respect of the Sub-Debt.

I. THE AGREED PART A ISSUES

(1) Issue 2

300. Issue 2 is:

> "*Whether any claim of LBIE against LBHI2 and/or LBL under section 74 (a 'Contribution Claim') in respect of the Sub-Debt (a 'Sub-Debt Contribution Claim') is to be included in the insolvency set-off account in LBIE's administration as against the provable claims of: (i) LBHI2; and/or (ii) LBL*".

301. The Administrators of LBIE, LBL, LBHI2 and LBH agree that a Sub-Debt Contribution Claim is to be included in the insolvency set-off account in LBIE's administration as against the provable claims of LBHI2 and/or LBL [LBIE/14; LBL/118; LBHI2/2.1; LBH/15]. (The LBEL Administrators have not taken a position on this Issue.) The extent of the set off that results (including the valuation of the Sub-Debt Contribution Claim) is the subject of other Issues in the application.

302. The basis on which the LBIE Administrators subscribe to the common position is that:

302.1. Insolvency set-off applies to "*mutual credits, mutual debts or other mutual dealings*" (Rule 2.85(2); Rule 4.90(1)).

302.2. David Richards J held in *Waterfall I* that a Contribution Claim by LBIE against LBHI2 or LBL is to be included in the insolvency set-off account in LBIE's administration as against the provable claims of LBHI2 and/or LBL. Declaration (ix) of his Order provided that "*the contingent liabilities of LBL and LBHI2 as contributories are the subject of mandatory insolvency set-off against such claims of LBL and LBHl2 as creditors of LBIE as are provable*". The Court of Appeal did not set aside or vary that declaration.

302.3. The only difference between declaration (ix) of David Richards J's Order and Issue 2 is that Issue 2 is dealing specifically with a Contribution Claim in respect of the Sub-Debt. However, there is no reason why the position should be

different. The Contribution Claim will be included in the set-off account in LBIE's administration, whether it relates to the Sub-Debt or to any other liability in the waterfall (e.g. statutory interest or non-provable liabilities). The Sub-Debt is simply one of the liabilities within section 74 which may be included within a Contribution Claim and it should be treated like any other component part of the members' liability under section 74.

302.4. It is not anticipated by the LBIE Administrators that the decision of the Supreme Court in *Waterfall I* will have any bearing on the position in this regard.

303. The LBIE Administrators invite the Court to declare that:

> "*A claim of LBIE against LBHI2 or LBL under section 74 (a 'Contribution Claim') in respect of the Sub-Debt (a 'Sub-Debt Contribution Claim') is included in the insolvency set-off account in LBIE's administration as against the provable claims of LBHI2 or LBL*".

(2) **Issue 4**

304. Issue 4 is:

> "*To the extent that insolvency set-off has already taken effect in the administration of LBIE between LBHI2's claim in respect of the Sub-Debt and LBIE's Sub-Debt Contribution Claim (if any) against LBHI2, what effect (if any) such set-off has on LBIE's ability to make a Sub-Debt Contribution Claim against LBL*".

305. The Administrators of LBIE, LBL, LBHI2 and LBH are agreed that insolvency set-off takes effect in the administration of LBIE between LBHI2's claim in respect of the Sub-Debt and LBIE's Sub-Debt Contribution Claim against LBHI2, such set-off extinguishing, to the extent of that set-off, LBIE's Sub-Debt Contribution Claim against LBL [LBL/126-127; LBIE/28-29; LBHI2/4.3; LBH/23; and LBL Reply/2, 11]. (The LBEL Administrators have not taken a position on this Issue.)

306. The basis on which the LBIE Administrators subscribe to the common position is that:

306.1. According to Lewison LJ's judgment in *Waterfall I*, if and when the debts ranking prior to the Sub-Debt are discharged in full, the Sub-Debt will be revalued in its full amount, on the basis of the hindsight principle.

306.2. The set-off account in LBIE's administration will then be adjusted to include LBHI2's claim against LBIE in respect of the Sub-Debt: see Issue 2 above.

306.3. It should be noted that the parties are not agreed as to whether the effect of such set-off would be to extinguish all or only part of LBHI2's claim against LBIE:

306.3.1. The LBIE Administrators contend that LBIE's Sub-Debt Contribution Claim against LBHI2 will always be equal to the full amount of the Sub-Debt (to the extent that the Sub-Debt has not been discharged by payment): see the LBIE Administrators' submissions on Issue 3.

306.3.2. The LBHI2 Administrators contend that LBIE's Sub-Debt Contribution Claim against LBHI2 must be discounted to reflect contingencies and may therefore be for a sum which is less than the full amount of the Sub-Debt [LBHI2/3.4-3.7]. (The valuation of such a claim and the quantum of any discount (e.g. to reflect the chance of LBIE not going into liquidation) fall outside the scope of this application.)

306.4. It is, however, common ground that the result of the set-off would be to discharge all or at least part of LBHI2's claim against LBIE for the Sub-Debt.

306.5. If and when the Sub-Debt or any part of it came to be extinguished by insolvency set-off in LBIE's administration, LBL would cease to be liable to LBIE under section 74 in respect of the Sub-Debt or that part of it.

306.6. This is because LBL's liability to contribute to the payment of the Sub-Debt depends on the continued existence of the Sub-Debt as a liability of LBIE. If the

Sub-Debt (or part of it) ceases to exist, LBL will cease to be liable to contribute to the payment of the Sub-Debt (or that part of it).

306.7. At the same time, however, LBL will become liable to contribute to LBIE's assets under section 74 for the purposes of adjustment:

306.7.1. The setting off of the Sub-Debt against LBHI2's liability under section 74 will represent a contribution by LBHI2 to LBIE's assets.

306.7.2. As a result of that contribution, the respective contributions of LBHI2 and LBL to the assets of LBIE would be unequal: LBHI2 would have contributed towards the payment in full of the Sub-Debt, whilst LBL would have made no contribution at all to the payment of the Sub-Debt.

306.7.3. LBIE's liquidator would be entitled to make a call on LBL for the purposes of adjustment. However, given the relative size of the shareholdings, the quantum of any such adjustment would only ever be *de minimis*.

307. To reflect the agreed position, the LBIE Administrators invite the Court to declare that:

"*Insolvency set-off in the administration of LBIE between LBHI2's claim in respect of the Sub-Debt and LBIE's Sub-Debt Contribution Claim against LBHI2 has the effect of extinguishing, to the extent of the set-off, LBIE's Sub-Debt Contribution Claim against LBL*".

(3) <u>Issue 5</u>

308. Issue 5 is:

"*In circumstances where insolvency set-off in LBIE's administration took effect on 4 December 2009, whether insolvency set-off in a subsequent distributing administration or liquidation of LBHI2 and/or LBL is of any application in respect of those companies' claims against, and liabilities to, LBIE*".

309. The Administrators of LBIE, LBL, LBHI2 and LBH agree that:

309.1. In circumstances where insolvency set-off in LBIE's administration took effect on 4 December 2009, insolvency set-off in a subsequent distributing administration or liquidation of LBHI2 or LBL is of no application in respect of those companies' claims against, or liabilities to, LBIE which went into the set-off account in LBIE's administration [LBIE/32-33; LBHI2/5.1; LBH/27-28; LBL Reply/2.5].

309.2. This is without prejudice to the ability to re-draw the balances in the set-off account in LBIE's administration on the basis of the hindsight principle [LBL/131-1-131.2; LBIE/35; LBHI2/3.5, 5.1; LBH/27-28; LBL Reply/2.5].

310. The LBEL Administrators have not taken a position on this Issue, although they have provided the same answer in the context of Issue 6, which asks the same question by reference to the position of LBEL rather than LBIE [LBEL/23, 26].

311. The basis on which the LBIE Administrators subscribe to the common position is that:

311.1. Insolvency set-off in LBIE's administration is automatic and self-executing, leaving only a net balance: see *Stein v Blake* [1996] AC 243.

311.2. Because there is only a net balance, in the members' administrations there can only be a proof by LBIE for the net balance. In the event of insolvency set-off taking effect in the members' administrations or liquidations, there would be nothing to set off against the net balance, as all mutual dealings between the companies will have already been taken into account in the set-off in LBIE's administration so as to give rise to the net balance for which the proof is made.

311.3. However, the hindsight principle could result in the re-drawing of balances in the set-off account in LBIE's administration, such that the single net balance might be adjusted as a result: *Wight v Eckhardt Marine GmbH* [2004] 1 AC 147; and *In re MF Global UK Ltd (in special administration) (No 2)* [2013] EWHC 92 (Ch), [2013] Bus LR 1030 (particularly at [49] to [51] per David Richards J).

312. To reflect the agreed position, the LBIE Administrators invite the Court to declare that:

> "*In circumstances where insolvency set-off in LBIE's administration took effect on 4 December 2009, insolvency set-off in a distributing administration or liquidation of LBHI2 and/or LBL is of no application in respect of those companies' claims against, and liabilities to, LBIE which went into the set-off account in LBIE's administration. This is without prejudice to the ability to re-draw the balances in the set-off account in LBIE's administration on the basis of the hindsight principle*".

(4) <u>Issue 6</u>

313. Issue 6 is:

> "*In circumstances where insolvency set-off in the administration of* [LBEL] *took effect on 11 July 2012, whether insolvency set-off in a subsequent distributing administration or liquidation of LBL is of any application in respect of LBL's claims against, and liabilities to, LBEL*".

314. The parties are agreed that the answer to Issue 5 applies *mutatis mutandis* to Issue 6.

315. To reflect the agreed position, the LBIE Administrators invite the Court to declare that:

> "*In circumstances where insolvency set-off in the administration of LBEL took effect on 11 July 2012, insolvency set-off in a distributing administration or liquidation of LBL is of no application in respect of LBL's claims against, and liabilities to, LBEL which went into the set-off account in LBEL's administration. This is without prejudice to the ability to re-draw the balances in the set-off account in LBEL's administration on the basis of the hindsight principle*".

(5) <u>Issue 12</u>

316. Issue 12 is:

> "*If the answer to the question set out at paragraph 11(i), 11(ii) or 11(iii) above would otherwise be in the affirmative, is it impacted (and if so, to what extent) by any set-off occurring in LBIE's administration as between (i) the Contribution Claim and (ii) provable claims of LBL against LBIE*".

317. The Administrators of LBL, LBH and LBEL agree that any set-off occurring in LBIE's estate is irrelevant to LBEL's liability to LBIE [LBL/140; LBEL/27-32; LBH/43-44; LBH Reply/2.8].

318. Neither the LBIE Administrators nor the LBHI2 Administrators have adopted a position on this Issue.

319. The LBIE Administrators intend to leave it to the parties who have adopted a position on this Issue to explain the basis for their agreement.

320. However, to reflect the agreed position, the Court is invited to declare that:

> "*Insolvency set-off occurring in LBIE's administration between (i) any Contribution Claim by LBIE against LBL and (ii) any provable claim by LBL against LBIE, is irrelevant to any liability of LBEL to LBL*".

J. CONCLUSION

321. On the Disputed Part A Issues, the LBIE Administrators invite the Court to hold that:

321.1. On Issue 1, the obligations of LBHI2 and LBL to contribute to the assets of LBIE pursuant to section 74 of the 1986 Act do include an obligation to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay the Sub-Debt, because: (i) the Sub-Debt is one of the debts and liabilities of LBIE for the purposes of section 74(1); (ii) there is no express or implied term in the Sub-Debt Agreements in the terms for which the Administrators of LBL and LBH contend; and (iii) clause 5(2) of the Sub-Debt Agreements is not to be construed in the manner for which the Administrators of LBL and LBH contend.

321.2. On Issue 3, if the realisations in LBIE's estate are insufficient to discharge the Sub-Debt in full, LBIE's contributories are liable to contribute for the payment of that part which cannot otherwise be paid. Consequently: (i) if the realisations in LBIE's estate are insufficient to pay any part of the Sub-Debt, the Sub-Debt is to be valued in full for the purposes of the Sub-Debt Contribution Claim; (ii) if the realisations are sufficient to pay part of the Sub-Debt but not all of it, the members will be liable for the unpaid part; and (iii) if the realisations are sufficient to pay the Sub-Debt in full, the members will have no liability in respect of it.

321.3. On Issue 7:

321.3.1. As to paragraph (i) of Issue 7, the obligations of LBHI2 and LBL to contribute to the assets of LBIE pursuant to section 74 are neither joint nor joint and several, and the liability of each of LBIE's contributories under section 74 in respect of LBIE's debts and liabilities is not rateable by reference to the nominal value of the shares held by that contributory but is limited only by the total amount required for the purposes of section 74. Further, LBL's liability would not be reduced: (i) if it were proved that LBL held the shares as a nominee; or (ii) if it were proved that LBL did not in practice enjoy any rights as a shareholder.

321.3.2. As to paragraphs (ii) and (iii) of Issue 7, LBL and LBHI2 do not have any direct claims against each other for a contribution or an indemnity in respect of sums paid by them to the company under section 74. Rather, the position of the shareholders *inter se* is to be adjusted through the mechanism of making of calls and distributions in LBIE's liquidation. Accordingly, once the debts and liabilities, and the expenses of the winding up, have been or will be met in full, each of the contributories is liable to contribute to LBIE's assets in such amount as may be required for the purpose of the adjustment of the rights of the contributories among themselves.

321.3.3. As to paragraph (iv) of Issue 7, the position of LBHI2 and LBL *inter se* will not be affected by any other claims which LBHI2 and LBL have against one another or any other party.

321.3.4. As to paragraph (v) of Issue 7, the LBIE Administrators should not be directed to assert less than 100% of the Contribution Claim against LBL and/or LBHI2, because the power to make a call must be exercised in the interests of the company (and, by extension, in the interests of those who are interested in distributions from its estate). In practice, therefore, where there is a need for monies for the purposes identified in section 74(1) for which the contributories are liable, the power should be exercised in favour of a call. It is not in truth a discretion at all but is rather tantamount to a duty to see that the relevant stakeholders are paid. There is therefore no discretion to decline to make a call on a contributory in respect of the amount identified in section 74(1) of the 1986 Act. Further, the matters which fall to be considered in the exercise of that power do not extend to factors relating to the circumstances of the contributories or the basis on which they hold shares in the company.

321.4. On Issue 8, in the event that LBL were to have a direct claim against LBHI2 for a contribution or indemnity, the rule against double proof would apply to prevent LBL's claim against LBHI2 from competing with LBIE's Contribution Claim

against LBHI2. However, the rule against double proof has no application to the process of adjustment under section 74 of the 1986 Act.

321.5. On Issue 9A, it is not possible as a matter of law for a member of a company to enter into an enforceable agreement with that company which has the effect of enabling that member to avoid what would otherwise be its obligation to contribute to the assets of the company under section 74 in the event of the company's winding up or otherwise to reverse the effect of that section (whether by claiming to be contractually entitled to reimbursement from that company in respect of such contributions or otherwise). Therefore a contract of the type for which the LBL Administrators contend (or any contract to that effect) would be unenforceable, because its effect would be to defeat the provisions of the statutory regime. The purpose or intention of the parties is irrelevant to the analysis; it is simply the effect of such an agreement – being inconsistent with the result provided for by statute – which renders the agreement void.

321.6. On Issue 10, in the event of LBHI2 having a claim against LBIE in respect of the Sub-Debt and LBL being entitled to recharge to LBIE its liability to contribute to LBIE's assets in respect of the Sub-Debt, the rule against double proof would apply in LBIE's administration to prevent LBL's claim against LBIE in respect of the Sub-Debt from competing with LBHI2's claim against LBIE in respect of the Sub-Debt.

322. On the Agreed Part A Issues, the Court is invited to hold that:

322.1. On Issue 2, a Sub-Debt Contribution Claim by LBIE against LBHI2 or LBL under section 74 is included in the insolvency set-off account in LBIE's administration as against the provable claims of LBHI2 or LBL.

322.2. On Issue 4, insolvency set-off in the administration of LBIE between LBHI2's claim in respect of the Sub-Debt and LBIE's Sub-Debt Contribution Claim against LBHI2 has the effect of extinguishing, to the extent of the set-off, LBIE's Sub-Debt Contribution Claim against LBL.

322.3. On Issue 5, in circumstances where insolvency set-off in LBIE's administration took effect on 4 December 2009, insolvency set-off in a distributing administration or liquidation of LBHI2 and/or LBL is of no application in respect of those companies' claims against, and liabilities to, LBIE which went into the set-off account in LBIE's administration. This is without prejudice to the ability to re-draw the balances in the set-off account in LBIE's administration on the basis of the hindsight principle.

322.4. On Issue 6, in circumstances where insolvency set-off in the administration of LBEL took effect on 11 July 2012, insolvency set-off in a distributing administration or liquidation of LBL is of no application in respect of LBL's claims against, and liabilities to, LBEL which went into the set-off account in LBEL's administration. This is without prejudice to the ability to re-draw the balances in the set-off account in LBEL's administration on the basis of the hindsight principle.

322.5. On Issue 12, insolvency set-off occurring in LBIE's administration between (i) any Contribution Claim by LBIE against LBL and (ii) any provable claim by LBL against LBIE, is irrelevant to any liability of LBEL to LBL.

William Trower QC
Daniel Bayfield QC
Stephen Robins

South Square
Gray's Inn
London WC1R 5HP
Tel: 020 7696 9900
williamtrower@southsquare.com
danielbayfield@southsquare.com
stephenrobins@southsquare.com

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