IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

No. 7942 of 2008

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

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR
(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

Applicants

-and-

(1) BURLINGTON LOAN MANAGEMENT LIMITED
(2) CVI GVF (LUX) MASTER SÀRL
(3) HUTCHINSON INVESTORS LLC
(4) WENTWORTH SONS SUB-DEBT SÀRL
(5) YORK GLOBAL FINANCE BDH LLC

Respondents

REPLY SUBMISSIONS OF YORK GLOBAL FINANCE BDH LLC ON SUPPLEMENTAL ISSUES ARISING FROM THE WATERFALL II PART A JUDGMENT

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1. These reply submissions are made on behalf of York Global Finance BDH LLC ("**York**") in relation to Supplemental Issues 1(b) and 2 arising from the Waterfall II Part A Judgment.

2. As with York's initial submissions on these issues, Issue 2 is addressed first, with Issue 1(b) following. York does not make any reply submissions in relation to Issue 1(c).

Issue 2

3. Contrary to York's position (and that of the SCG), the Administrators and Wentworth both submit that a Currency Conversion Claim cannot arise from the operation of set-off pursuant to rule 2.85(3).

4. The basis of the Administrators' position is that they seek to draw a distinction between what they term "*substantive*" and "*non-substantive*" parts of the insolvency code. In particular:

    (1) they say that insolvency set-off is "*substantive*" in nature and that in this respect it is to be distinguished from the process of payment of dividends pursuant to the statutory scheme of *pari passu* distribution which is said to be "*non-substantive*" in nature;

    (2) they say that it follows that the conversion of a foreign currency claim into sterling for the purposes of set-off has "*substantive*" effect whereas conversion of a foreign currency claim into sterling for the purposes of proving, and payment of a dividend, does not do so; and

    (3) they say that it further follows that, because in the case of set-off the conversion to sterling is "*substantive*" in nature, then there is no basis for a Currency Conversion Claim as there are no remaining foreign currency rights to which the creditor can be remitted.

5. This analysis is flawed as it is founded on a false distinction between the effect of set-off and the effect of the process of proof and payment of a dividend in liquidation or a distributing administration.

6. As to this:

(1) it is common ground that insolvency set-off has a substantive effect in discharging *pro tanto* the sterling value of the claim of the creditor in the taking of the balance of the account required by set-off to the extent of the sterling value of the liability set off in that taking of the sterling-based account;

(2) however, payment of a dividend has exactly the same effect – it discharges and extinguishes *pro tanto* the sterling value of the creditor's provable claim to the extent of the sterling dividend paid and received by the creditor;

(3) the suggestion made by the Administrators that "*the payment of a dividend in corporate insolvency proceedings is not substantive*" (para. 59) is remarkable and wrong – if a creditor has a claim in the liquidation of £100 and receives dividends to the value of £50 then of course his claim is discharged and extinguished to the extent of the £50 which he has actually received, and in that respect the payment of the dividend has substantive effect.

7. The Administrators seek to rely on authority to the effect that the process of winding-up does not affect the rights of creditors and does not create new substantive rights in the creditors or destroy old ones. It is entirely correct that the process of winding up does not by itself affect the rights of creditors. However, the process of paying dividends on a creditor's claim will do so. This is clear from that part of the statement of Lord Hoffmann in Wight v Eckhardt [2004] 1 AC 147 at [27] which the Administrators have omitted from their citations:

> "27 The winding up leaves the debts of the creditors untouched. It only affects the way in which they can be enforced. When the order is made, ordinary proceedings against the company are stayed (although the stay can be enforced only against creditors subject to the personal jurisdiction of the court). The creditors are confined to a collective enforcement procedure that results in pari passu distribution of the company's assets. The winding up does not either create new substantive rights in the creditors or destroy the old ones. Their debts, if they are owing, remain debts throughout. They are discharged by the winding up only to the extent that they are paid out of dividends. But when the process of distribution is complete, there are no further assets against which they can be enforced. There is no equivalent of the discharge of a personal bankrupt which extinguishes his debts. When the company is

dissolved, there is no longer an entity which the creditor can sue. But even then, discovery of an asset can result in the company being restored for the process to continue."

(emphasis added)

8. Accordingly, to the extent that sterling dividends are paid on a creditor's sterling provable claim, then his claim will be extinguished and discharged, and his rights affected substantively, to that extent. The Administrators are therefore wrong to claim that payment of a dividend in corporate insolvency is not substantive. And the distinction which they seek to make between the payment of dividends and the operation of set-off in this respect is misplaced – both payment of a dividend and the operation of set-off will have a substantive effect on the underlying claim.

9. The question which arises is why should the conversion of a debt to sterling for the purposes of proof (and receipt of a dividend) have any different effect to the conversion of a debt to sterling for the purposes of set-off. There is no reason in principle why there should be any difference in this respect, and this is not the effect of the rules.

10. In particular, in relation to the operation of insolvency set-off:

(1) pursuant to rule 2.85, the operation of set-off takes place in sterling and both the debts due to and from the company are converted into sterling for these purposes;

(2) in relation to the debt owed *to* the company, pursuant to rule 2.85(6)(a), rule 2.86 applies to "*any sums due to the company ... which are payable in any currency other than sterling*";

(3) rule 2.85 does not itself make express provision for the conversion to sterling of debts owed *by* the company. However, as Norris J explained in Re Kaupthing Singer & Friedlander Ltd (In Administration) [2009] EWHC 2308 (Ch), [2010] 1 BCLC 222 at [20][1]:

"In my judgment, although IR 2.85(6) does not expressly apply to sums "due to or from the company" the effect of the Rules read as a whole is to make

[1] This point was not the subject of the appeal to the Court of Appeal.

> the same valuation principles apply on each side of the account. In order for the provisions of IR 2.85 to be brought into play at all there must be "[a] creditor of the company proving or claiming to prove for a debt in the administration", and in that event an account is taken of mutual credits, mutual debts or other mutual dealings between himself and the company. But a creditor proving for a debt incurred or payable in a currency other than sterling can only prove in accordance with IR 2.86 or 2.87 : he cannot seek to recover anything else from the company. The company, however, is not "proving" anything in the administration and absent IR 2.85(6) would be able to value its debt for the purposes of set-off at any advantageous date it chose. The purpose of IR 2.85(6) is to subject the company to the same valuation rules as those to which the creditor is already subject. That is why it is confined to sums due to the company."

11. Contrary to the Administrators' submissions, there is no basis for considering that this process of converting foreign currency claims into sterling for the purposes of set-off has itself any different effect to the process of converting foreign currency debts into sterling for the purposes of proving. Indeed, as Norris J pointed out, so far as a debt owed by the company is concerned, it is exactly the same rule – rule 2.86 – which applies to convert the foreign currency debt to sterling for the purposes of both set-off and proving.

12. Accordingly, the Administrators' attempts to draw distinctions between the effects of set-off and the payment of a dividend and between the process of converting foreign currency debts to sterling for each purpose are incorrect and flawed.

13. In its submissions, Wentworth seeks to make a different point. It argues that the effect of set-off is to lead to the "*permanent extinction*" of the creditor's contractual rights so that there is no longer any contractual right to which the creditor can be remitted. It says that the "*essential foundation*" of a Currency Conversion Claim is then missing (para. 28).

14. However,

> Wentworth's submissions make no attempt to explain the difference which arises on its argument between the effect of set-off and the effect of dividend payments. This is despite the fact that, as explained above, both set-off and dividends have the same substantive effect of discharging *pro tanto* the creditor's rights to the extent of the payment or set-off.

Moreover, it is submitted that Wentworth's submissions mischaracterise the way in which insolvency set-off operates, as explained by the Court of Appeal in Re Kaupthing Singer & Friedlander Ltd [2011] 1 BCLC 12. In particular

(1) The Court of Appeal in Kaupthing held that insolvency set-off only takes effect to the extent necessary to discharge the relevant liabilities. Thus it was held that discounting pursuant to rule 2.105 only took effect to the extent necessary for the purposes of set-off, and that any outstanding balance due to the company after the operation of set-off would not be so discounted: see [34].

(2) Similarly, the Court of Appeal approved the decision of the Judge at first instance that where insolvency set-off resulted in a balance owing to the company then that balance would continue to attract interest at the contractual rate: see [37]. This was on the footing that the original contractual liability remained intact except to the extent discharged by the set-off. In a case where the original contractual liability was in a foreign currency it would remain intact, except to the extent actually discharged by the set-off, in that currency.

(3) The Court of Appeal explicitly rejected the relevance of Stein v Blake, since the question of the extent of the operation of discounting and currency conversion for the purposes of insolvency set-off is a matter of statutory construction: see [36].

(4) Accordingly, in relation to both set-off and payment of a dividend, the correct analysis is that the creditor retains his existing contractual rights to payment in the original foreign currency except to the extent actually discharged by the sterling value received (valued in that foreign currency at the date of receipt) in the set-off or by way of dividend, as the case may be.

(5) Thus where a creditor has a claim for £100 pursuant to a contract and receives value of £50 in the liquidation, then the effect is the same whether that value is received by way of cash payment or set-off – the creditor will be left with a residual claim of £50 on the relevant contractual terms.

15. The position is precisely the same where the creditor's claim is in a foreign currency. Thus a creditor with a claim for US$100 who receives value of £50 in the liquidation is in the same position whether that value is received by way of dividend or set-off. In either case, he retains his residual contractual rights except to the extent actually discharged by the dividend/set-off. This means that he has a residual claim, on the contractual terms, to US$100 less the US$ value of the £50 value in fact received.

16. Wentworth's submissions appear to assume that the effect of set-off is to replace and discharge the *entirety* of the creditor's rights, not merely to the extent of the set-off. Thus, on the above example, Wentworth would seem to say that the creditor is left with some kind of statutory claim for the net balance in sterling, i.e. the sterling equivalent of US$100 less £50, in replacement of the entirety of the creditor's previously existing contractual rights. However, there is no support for this approach, either as a matter of principle or as a matter of authority.

17. Wentworth places reliance on the statement of Briggs LJ in the Waterfall I appeal [2015] 3 WLR 1205 at [152]. That paragraph, in full, reads as follows:

> "There is to my mind no logical reason why a provision for conversion into sterling of a foreign currency amount by reference to a historical date should necessarily operate as a substantive permanent alteration of the creditor's contractual rights, except only to the extent that set-off is involved. No injustice is involved in its permanent effect for that purpose because set-off is self-executing at the moment of the conversion, when the foreign currency amount is worth exactly the same as the sterling equivalent. The creditor's foreign currency debt is treated as paid in whole or in part by any sterling debt which it owes the company, or a debt in any currency for that matter, converted to sterling for that purpose. Again, the application of currency conversion to set-off is necessary, if statutory set-off is to work."

18. The point being made here is simply that, where set-off takes effect, this will have a substantive effect on the creditor's original foreign currency rights to the extent of the sterling-based set-off. As explained above, that is correct and is not controversial. However, contrary to Wentworth's submissions, Briggs LJ was not holding that the effect of set-off is to remove the *entirety* of the creditor's existing contractual rights (including those not the subject of the sterling-based set-off) and to replace them with some kind of alternative statutory claim in sterling to a net balance.

19. Finally, Wentworth says that if its conclusion was wrong then the logical corollary is that a Currency Conversion Claim would also lie in the other direction in favour of the company, but that it is not said that such a claim in fact exists (para. 33). However, a similar point applies in relation to payment by dividend where sterling then appreciates against the foreign currency. The Court of Appeal simply held that it is part and parcel of the statutory scheme that the creditor gets to keep the ensuing benefit and this does not itself mean that no Currency Conversion Claim can exist: see Waterfall I at [159] per Briggs LJ.

Issue 1(b)

20. This issue is highly material to the respective division of the surplus between ISDA creditors and Prime Brokerage ("**PB**") creditors. On the basis of the information disclosed by the Administrators (that ISDA claims are about £4.4 billion and that USD-based ISDA claims represent about 66% of those claims, and Currency Conversion Claims on the US$5.2 billion of such USD claims could be about 12% of the face value of those claims) those USD-based ISDA claims may have Currency Conversion Claims of about US$625 million. Non-provable interest on such Currency Conversion Claims could be running at rates of up to 18% per annum subject to daily compounding from the date when such ISDA default interest started running until such time as the Currency Conversion Claims are paid in full. Contractual interest entitlements on just the USD ISDA-based Currency Conversion Claims could therefore, over the nine years from 2008 to 2017, be well over a billion dollars. In contrast, as things stand, statutory interest on provable debts stopped running on the payment of 100% dividends in April 2014 and currency losses (in the original claim currency) were fixed by reference to exchange rates up to that time.

21. If ISDA creditors obtain such rates of interest for such period and PB creditors obtain nothing (as is the position being taken by all other parties), there will be a very substantial diversion of the surplus available to pay non-provable debts away from PB creditors. This is because the Currency Conversion Claims on PB claims will be fixed by reference to currency losses during the period up to payment of the 100% dividend whereas Currency Conversion Claims on ISDA claims will continue to accrete as a result of substantial interest accruals on an open running balance in the foreign currency.

22. The concept of non-provable interest depends on a remission to contractual or other rights to interest. The question is what "contractual or other rights" are relevant for these purposes?

23. As explained in its initial submissions, York's primary position is that the same approach should be adopted for these purposes as applies in relation to statutory interest for the purposes of rule 2.88(9). That rule directs an inquiry as to the "*rate applicable to the debt apart from the administration*". Such a rate does not include a rate which would only be applicable if certain steps were taken by the creditor, but were not in fact taken as at the date of the commencement of the administration (Part A Judgment [178]-[181]). Such an approach would also provide a simple answer to the question of what rights are relevant.

24. On York's secondary position, it is difficult to see any reason of logic or policy why, when looking at the rights of a creditor in the context of non-provable claims, it is legitimate to take account only of such rights to obtain interest that the creditor did in fact exercise during the period of the administration.

25. As a matter of principle, if a creditor was prevented from exercising a right to obtain interest because of the effect of the administration (e.g. the statutory moratorium) then it is very difficult to see why he should be prejudiced, and precluded from claiming the benefit of that right, simply because he, in effect, complied with the statutory insolvency scheme and pursued his claim solely within the insolvency.

26. If the position was otherwise then it would provide a material incentive for creditors to exercise rights post-insolvency and (for example) to seek to obtain post-administration judgments. One has to ask why, as a matter of policy, English insolvency law would provide incentives for creditors to have to spend time and money (and to cause an insolvent company to spend time and money dealing with the creditors) seeking leave to obtain judgments and going through the process of obtaining judgments (in the context of currency conversion claims often in courts outside England) so as not to be prejudiced years later if there turns out to be a surplus available to pay non-provable interest.

27. Furthermore, if the Administrators, the SCG and Wentworth are correct that non-provable interest runs from such time when the rights to interest actually arose under the applicable contract, then this will have the practical consequence that the Administrators will have to determine in each and every case when such rights in fact arose. This is likely to be time-consuming and expensive. In this respect, it is wrong to suggest (as the Administrators do several times, such as in para. 8(6) of their submissions) that in the case of an ISDA claim such interest runs simply from the delivery of a close-out notice. A close out payment under an ISDA only becomes payable upon delivery of an effective calculation statement and that such a statement is only effective if its form and content in fact complies with all the requirements of the applicable master agreement.

28. It is also noteworthy that, if the submissions made by the Administrators and the other Respondents are right, then it will follow that (1) for statutory interest purposes obtaining a judgment after the date of administration makes no difference to interest entitlements but (2) for non-provable interest entitlements, obtaining a judgment after the date of administration does make a difference to interest entitlements and will be taken into account in the calculation of the non-provable claim.

29. Finally, contrary to the SCG's submissions, Declaration (vi) is irrelevant to this question. That declaration deals only with the period of time over which interest may accrue, not the rate at which such interest may accrue.

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