IN THE COURT OF APPEAL **No. A2/2015/3763**
ON APPEAL FROM THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT
[2015] EWHC 2269 (Ch) (DAVID RICHARDS J)

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

WENTWORTH SONS SUB-DEBT SÀRL

Appellant

-and-

(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))
(6) BURLINGTON LOAN MANAGEMENT LIMITED
(7) CVI GVF (LUX) MASTER SÀRL
(8) HUTCHINSON INVESTORS LLC
(9) YORK GLOBAL FINANCE BDH LLC

Respondents

YORK'S RESPONDENT'S SKELETON
for the
WATERFALL IIA APPEAL

Introduction

1. This skeleton argument is on behalf of the Ninth Respondent, York Global Finance BDH, LLC ("**York**") in response to those parts of the skeleton argument of the Appellant ("**Wentworth**") which deal with Declaration (xiv) (paras 23-45). Declaration (xiv) concerns the date from which statutory interest is payable in respect of a contingent debt.

2. York is representative of a group of beneficial owners of very substantial admitted claims in the estate of LBIE which arose from claims that were contingent at the date of the commencement of the administration. It therefore has a particular interest in the issue of the date from which statutory interest is payable in respect of a contingent debt (Issue 7). The Judge's conclusion on Issue 7 was reflected in Declaration (xiv). As the Judge noted, the outcome of this Issue is very significant in financial terms (Judgment, para. 186).

3. In respect of the other Issues on which Wentworth has sought to appeal, York's position is likely to be materially the same as that of the Senior Creditor Group. Accordingly, in the interest of avoiding unnecessary duplication and repetition, York is not filing a separate skeleton argument in respect of these other issues. However, in the event that any argument which York considers to be material to the appeal is not advanced by any other party at the hearing of the appeals then York reserves the right to make oral submissions at the hearing.

Declaration (xiv) – Interest on contingent debts

4. The Judge held at paras 184-225 of his judgment that where a debt has not fallen due at the Date of Administration (either because it will not fall due until a certain date in the future, or because it will not fall due until some contingency which has not yet occurred), statutory interest nonetheless accrues on that debt from the Date of Administration. York's position is that the Judge's conclusions on these issues were correct.

5. Wentworth's position on this appeal is that the Judge was correct insofar as future debts are concerned, but incorrect insofar as contingent debts are concerned.

The Statutory Scheme

6. The basic function of a liquidation or an administration where the administrator has given a notice of intention of his intention to declare and distribute a dividend ("**a distributing administration**") is to collect in the insolvent debtor's assets and to distribute them amongst its creditors. For these purposes:

   (1) Creditors are entitled to submit a proof of debt in respect of any "*debt*" as defined in the legislation (see rule 13.12 of the Insolvency Rules 1986 ("**the 1986 Rules**"));

(2) The debtor's assets are then applied *pari passu* amongst the claims of creditors in respect of their debts which have been admitted to proof (see section 107 of the Insolvency Act 1986 ("**the 1986 Act**") and rule 2.69 of the 1986 Rules).

7. As the Judge correctly observed, it is a principle of insolvency law that the realisation of assets and the distribution of proceeds among creditors is treated as notionally taking place simultaneously on the date of the commencement of the liquidation or administration (Judgment para. 202). This principle is well established by a long-standing line of authority:

(1) "*I think the tree must lie as it falls; that it must be ascertained what are the debts as they exist at the date of the winding-up, and that all dividends in the case of an insolvent estate must be declared in respect of the debts so ascertained*" *–In re Humber Ironworks and Shipbuilding Co*. (1869) LR 4 Ch App 643 646-647.

(2) "*[T]he liquidation and the distribution are to be treated as notionally simultaneous*" *–In re Dynamics Corporation of America* [1976] 1 WLR 757, 762

(3) "*What the court is seeking to do in a winding up is to ascertain the liabilities of the company at a particular date and to distribute the available assets as at that date pro rata according to the amounts of those liabilities. In practice the process cannot be immediate, but notionally I think it is, and, as it seems to me, it has to be treated as if it were, although subsequent events can be taken into account in quantifying what the liabilities were at the relevant date. In the context of a liquidation, therefore, the relevant date for the ascertainment of the liability is the notional date of discharge of that liability …*" *–In re Dynamics Corporation of America* [1976] 1 WLR 757, 774.

(4) "*[T]he liquidation and distribution of the assets of the insolvent company are treated as notionally taking place simultaneously on the date of the winding up order*" *– M.S. Fashions Ltd* v *BCCI SA* [1993] Ch 425, 432.

(5) "*[T]he debts of the bankrupt are treated as having been ascertained and his assets simultaneously distributed among his creditors on the bankruptcy date*" – *Stein* v *Blake* [1996] 1 AC 243, 252.

8. It follows from the notional liquidation and distribution on the date of the commencement of the insolvency proceeding that the debts which rank for proof are ascertained as at that date. The ascertainment of the debts at a fixed date, i.e. the date of the commencement of the insolvency proceeding, enables a *pari passu* distribution to be made amongst creditors. The debts as ascertained are then entitled to rank for, and be paid, dividends accordingly.

9. Thus, for the purposes of the statutory scheme, provable debts (including contingent and future debts) become outstanding as from the date of the commencement of the insolvency proceeding which in the case of the liquidation is the date of the winding up order. This is the date on which such debts are valued and ascertained and the date on which they are notionally enforced through the collective process against the company's assets, and the date on which the creditor's entitlement to a share of those assets on the basis of his proved debt arises.

10. The same analysis applies in a distributing administration as it does in a winding up. Although a distributing administration only comes into effect on the giving of a notice by the administrator under rule 2.95 of the 1986 Rules, the statutory scheme of collective enforcement and distribution takes effect retroactively as from the date of the commencement of the administration. This can be seen from the rules governing a distributing administration:

(1) Rule 2.72(3)(b)(ii): proof to state value of claim "*as at the date on which the company entered administration*";

(2) Rule 2.86: foreign currency debts to be converted to sterling at the exchange rate prevailing on the date when the company entered administration;

(3) Rule 2.88(1): provable debts may include interest up to the date when the company entered administration;

(4) Rule 2.89: creditor may prove for a debt which was future at the date of entry into the administration;

(5) Rule 13.12(1): debts include any debt or liability to which the company was subject at the date when it went into administration.

Proved Debts

11. The debts of the company as at the date of the commencement of the winding up or administration which can be proved include debts which were contingent at that time:

(1) Under rule 13.12(1), where a company goes into winding up, debts are defined "*as any debt or liability to which the company is subject … at the date on which the company went into liquidation*".

(2) By rule 13.12(3), this expressly includes contingent debts.

(3) Rule 12.3(1) further makes clear that debts which are contingent are provable against the company.

12. In the case of administration, by rule 13.12(5), the entirety of rule 13.12 "*shall apply where a company is in administration and shall be read as if … references to going into liquidation were references to entering administration*". Accordingly, where a company is in administration, the debts of the company for the purposes of the Rules include the debts to which the company was subject at that date including any debts which were contingent at that time.

13. As noted above, the process of collecting and distributing the assets of the company amongst the creditors is deemed to take place *uno flatu* on the date of the commencement of the insolvency. For these purposes, rule 2.81 enables the administrator to place an estimate on a contingent debt in order to produce a liquidated amount which is then provable. Rule 2.81 provides:

> "The administrator shall estimate the value of any debt which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value; and he may revise any estimate previously made, if he thinks fit by reference to any change of circumstances or to information

becoming available to him. He shall inform the creditor as to his estimate and any revision of it."

14. This amount is provable alongside all other debts established as at the date of the commencement of the administration. In this way, it can be said that there is a notional "*acceleration*" of contingent debts for the purposes of proof: Professor Sir Roy Goode, *Principles of Corporate Insolvency Law* (4th ed.), 3-11.

15. Under rule 2.81, the administrator may revise any estimate previously made if he thinks fit by reference to any change of circumstances or to information becoming available to him. In particular, the court has regard to events which have occurred at the date of distribution or payment since the date of the winding up (*the hindsight principle*): *M.S. Fashions Ltd v BCCI SA* [1993] Ch 425 at pp.432-433; *Re MF Global UK Ltd* [2013] EWHC 92 at [48]-[55].

16. Accordingly, in the same way as with present debts, debts which are contingent at the date of the commencement of the winding up are provable in the administration. For these purposes, the value of such claims is ascertained as at the date of the commencement of the administration, and they are enforced against the company's assets through the collective insolvency process which notionally takes place on that date. They become entitled to a share of the assets in the insolvent estate from that date. It follows that contingent claims are also "*outstanding*" from the date of the commencement of the administration.

17. Wentworth is therefore wrong to assert that a contingent creditor is not "*kept out of its money*" from the date of the liquidation or administration or that the debt is not due from that date. Wentworth's argument confuses the creditor's underlying claim against the insolvent company with the "*debt*" which the creditor is to entitled to prove under the statutory scheme. This proved debt is a liquidated amount, ascertained as at the date of the commencement of the insolvency and, because of the principle of insolvency law that the realisation of assets and the distribution of proceeds among creditors is treated as notionally taking place simultaneously on the date of the commencement of the insolvency, is outstanding from that date.

Set-Off

18. These conclusions are supported by the way in which insolvency set-off applies in a winding up and a distributing administration.

19. Consistent with the operation of the statutory scheme, in winding up mandatory insolvency set-off applies automatically as at the date of the winding up order: *Stein v Blake*, 252; *In re Bank of Credit and Commerce International S.A. (No. 8*) [1998] AC 214, 223. It operates to produce a liquidated net balance as at the date of the winding up order. If the balance is in favour of creditor, it is that amount which is then provable by the creditor.

20. The operation of this set-off extends to debts which were contingent at the date of the commencement of the winding up. Lord Hoffmann explained the application of insolvency set-off to contingent claims as follows in *Stein* v *Blake* (at 252-253):

> "How does the law deal with the conundrum of having to set off, as of the bankruptcy date, 'sums due' which may not yet be due or which may become owing upon contingencies which have not yet occurred? It employs two techniques. The first is to take into account everything which has actually happened between the bankruptcy date and the moment when it becomes necessary to ascertain what, on that date, was the state of account between the creditor and the bankrupt. If by that time the contingency has occurred and the claim has been quantified, then that is the amount which is treated as having been due at the bankruptcy date …
>
> "But the winding up of the estate of a bankrupt or an insolvent company cannot always wait until all possible contingencies have happened and all the actual or potential liabilities which existed at the bankruptcy date have been quantified. Therefore the law adopts a second technique, which is to make an estimation of the value of the claim …"
>
> (emphasis added)

21. Thus, where a creditor has a contingent claim against the company and the company has a cross-claim, insolvency set-off operates to reduce the claim and cross-claim to a single net liquidated balance as at the date of the winding up. If the balance is in favour of the creditor, this liquidated amount is provable, and it is "*outstanding*" from the date of the winding up.

22. The position is the same in administration. The rules governing insolvency set-off provide that, for the purposes of set-off, the value of contingent claims may be

estimated: rule 2.85(5). Where the account results in a balance owed to the creditor then this is provable in the administration: rule 2.85(8). (On the other hand, where the account results in a balance owed *to* the company then to the extent that this results from a contingent or prospective debt then it is only payable if and when that debt becomes payable: *ibid* and *Re Kaupthing Singer & Friedlander Ltd* [2011] 1 BCLC 12.)

23. For these purposes, insolvency set-off is treated as having taken place on the date of commencement of the insolvency (the retroactivity principle): see *M.S. Fashions Ltd v BCCI SA* at p.432 and *In re Bank of Credit and Commerce International S.A. (No. 8)* at p.223. Accordingly, where insolvency set-off applies, and even where the creditor's claim against the insolvent company is contingent, it will result in a net liquidated balance as at the date of the commencement of the insolvency. Where the balance is in favour of the creditor, it will be provable in the same way as all other debts and will be outstanding from that date.

24. Given that where a creditor has a contingent claim against the company which is subject to insolvency set-off, this will result in a net liquidated amount which if in favour of the creditor is "*outstanding*" from the date of the commencement of the administration, it would be anomalous if a contingent claim held by a creditor which was not subject to insolvency set-off was not likewise treated as being "*outstanding*" from the date of commencement of the administration.

The Construction of Rule 2.88(7)

25. Rule 2.88(7) provides that:

> "Any surplus remaining after payment of the debts proved shall, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the relevant date."

("*Relevant Date*" is defined at rule 2.88(1) and in the present case is the Date of Administration.)

26. Wentworth's skeleton at para.31 quotes authority to the effect that in the case of a contingent debt, there is "*no debt due*" at the Date of Administration. This is

irrelevant. The correct question is whether the debt is "*outstanding*" for the purposes of the statutory scheme.

27. As the Judge correctly observed, the reference to "*those debts*" is to the debts admitted to proof, which may include contingent or future debts (Judgment, para. 208). Under the statutory scheme, the proved debts are "*outstanding*" from the date of commencement of the administration as that is when the notional liquidation and distribution of the company's assets takes place. There are also other features of rule 2.88 which indicate that interest is payable under rule 2.88(7) from the commencement of the administration (Judgment, para. 209).

28. Other provisions of the 1986 Rules also draw a clear distinction between the two terms "*due*" and "*outstanding*". In particular, rule 2.105(2), which provides the formula for discounting future debts for the purpose of calculating dividends, provides that the amount of the debt "*outstanding*" shall be discounted according to the date on which payment would otherwise be "*due*". If those two words meant the same thing, then rule 2.105 would make no sense, as there would be no amount "*outstanding*" in respect of future debts until that debt actually fell due, by which time there would be no need to discount it. In the context of rule 2.105, "*outstanding*" was clearly not used to mean "*due*".

29. Moreover, as a matter of ordinary language, "*outstanding*" is not synonymous with "*due*". It is normal to speak of "*outstanding*" principal under a loan facility which does not fall "*due*" until a future date. It is also established that "*outstanding*" is capable of including a contingent debt: see *Crystal Palace FC (2000) Ltd* v *Paterson* [2005] EWCA Civ 180 at [52]-[53]:

> "The definition of "outstanding" in the fifth edition of the Shorter Oxford Dictionary includes, "unresolved, pending; esp (of a debt etc) unsettled." In the first edition it includes, "… that stands over; that remains undetermined, unsettled, or unpaid." In these circumstances the judge was, as it seems to me, entitled to hold that an ordinary meaning of the word is wide enough to include contingent debts which had not yet become due and payable."

30. It is also noteworthy that prior to 1986 there was no doubt under the predecessor legislation that interest ran on contingent debts in bankruptcy from the date of the

receiving order. It is notable that Wentworth has been unable to point to any indication that Parliament intended to change the law in 1986. This is in spite of the large volume of pre-legislative material available, in particular, the Cork Report. Wentworth says that there is no reported case on the question of the date from which interest ran under the 1914 Act: it is respectfully suggested that this was because the position was clear under the unambiguous wording of the statute i.e. interest ran from the date of the receiving order.

Estimation and Valuation of Contingent Debts

31. Wentworth says that its argument is reinforced by the manner in which contingent claims are estimated and valued for the purposes of being admitted to proof. This is not, however, the case.

32. As the Judge noted at paragraph 215 of his judgment, it is difficult to construct a scheme which can produce a perfectly just solution in all circumstances, and whatever approach is adopted, it is always possible to devise factual scenarios which produce apparently surprising results.

33. Thus, in the case of future debts, rule 2.105 of the 1986 Rules provides that "*[w]here a creditor has proved for a debt of which payment is not due at the date of declaration of dividend*", the debt shall, for the purpose of calculating dividends, be discounted back to a present value as at the date of the commencement of the administration according to a formula set out in the rule. But where the debt has fallen due before the date of declaration of the dividend, there is no discounting. In such a case, it can be said that such a creditor receives a "*windfall*" by receiving statutory interest from the date of the administration on a future debt which only became due some time later. However, Wentworth accepts that this is the effect of the rules in relation to future debts.

34. In relation to contingent debts, Wentworth gives an example at paras. 41-42 of its skeleton argument which it says illustrates the "*perverse consequences*" of the Judge's conclusion.

35. The point being made is that on the Judge's approach the creditor receives statutory interest on his contingent claim from the date of the administration notwithstanding that the claim may in fact have only crystallised some time later. It is said that the

creditor has only been "*deprived of its money*" for the much shorter period of time since the claim crystallised. However, the complaint is misconceived, since Wentworth again confuses the creditor's underlying claim against the company with the proved debt which the creditor is entitled to assert under the statutory scheme.

36. It is on the latter, not the former, that statutory interest under rule 2.88(7) is payable. Moreover, under the statutory scheme involving, as it does, a notional liquidation and distribution on the date of commencement of the administration, such proved debt is outstanding from that date time. Accordingly, under the statutory scheme, a contingent creditor has been out of his money in respect of his proved debt since the date of the commencement of the insolvency, notwithstanding that his underlying claim may only have crystallised later. The fact that under the statutory scheme there is no discounting of contingent claims to a present value as at the date of the commencement of the insolvency, no doubt simply reflects the fact that such discounting may well not be possible to achieve in practice – as Wentworth itself accepts (para. 38 of its skeleton argument). To the extent that the application of the Insolvency Rules results in any alleged "*windfall*" this is simply part of the "*package of both benefits and burdens*" that come with any insolvency (cf. para. 54 of Wentworth's skeleton argument).

37. In any case, it is equally possible to devise examples which go in the other direction and illustrate the injustice of excluding interest on contingent debts until they fall due[1].

38. Suppose that LBIE issued a credit-linked note to X on 15 September 2006, to be repaid on or before 15 September 2010. The principal amount payable on the note can reduce (potentially to nil) as and when events of default occur on a basket of underlying securities. Any reduction in principal takes effect each quarter. The underlying securities are extremely risky, and at all material times it is uncertain whether LBIE will be obliged to repay any principal on the notes. The interest rate is 10% per annum on the principal due on the note for the time being in each quarter.

39. It is clear that X is entitled to prove for interest accruing on the note between 15 September 2006 and 15 September 2008 (rule 2.88(1)). X is not entitled to prove for

[1] See also the examples given in the second witness statement of Andrea Zambelli at paras 10-20.

interest accruing on the debt from 15 September 2008, being the date of administration (*ibid*). According to Wentworth, X is entitled to claim statutory interest accruing on the note at the contractual rate of 10% from 15 September 2010 until the note is paid in full (rule 2.88(7), (9)).

40. This example gives rise to an obvious question: what happened to the period between 15 September 2008 and 15 September 2010? On Wentworth's argument, X has no right to receive statutory interest and no right to prove for contractual interest during this two-year twilight zone. More generally, no creditor is entitled to receive statutory interest or to prove for contractual interest in respect of the period between the onset of insolvency proceedings and the time when the debt ceases to be contingent. It is difficult to imagine a plausible policy rationale for such a gap.

41. Moreover, if contingent creditors were denied statutory interest from the date of the administration, this would create a perverse incentive for officeholders to delay causing contingent claims to become crystallised into actual claims, where this lay only within the power of the insolvent estate. It is difficult to identify any reason why the creation of such an incentive would be thought desirable. Such conduct might give rise to claims that an administrator has acted in such a way so as unfairly to harm a creditor contrary to paragraph 74 of schedule B1 Insolvency Act 1986 and would place administrators under inappropriate pressure as to when, how and in what order to deal with different contingent claims that exist at the commencement of the administration without unfairly harming particular creditors.

42. More generally, if Wentworth's arguments are correct, it creates a strong incentive for creditors to seek to crystallise contingent claims immediately after any administration commences, before creditors have any way of knowing if the administration will subsequently convert to a distributing administration and/or whether a surplus will become available to pay interest. The creation of such an incentive would, however, be undesirable and at odds with the "*rescue culture*" which administration is intended to promote. Such complex and potentially conflicting incentives on administrators and creditors would unnecessarily complicate the issues that need to be dealt with at the outset of an administration.

Conclusion

43. For the reasons above, and the reasons given by the judge, the Court is invited to dismiss Wentworth's appeal.

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