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Lehman Waterfall I: The Supreme Court decision and its wider legal implications.

Executive summary

The Supreme Court today handed down a judgment in relation to a series of complex issues surrounding a surplus of approximately £8bn currently held by the administrators of Lehman Brothers International (Europe) ("**LBIE**"). Their view, which was unanimous on all but one point, was that:

> As a matter of contractual construction, subordinated loans advanced by LBIE's immediate holding company ranked behind both statutory interest and non-provable liabilities;

> Foreign currency creditors were not entitled to receive a share of the surplus to compensate them for any losses resulting from sterling's depreciation since the date on which LBIE entered administration;

> Statutory interest accrued in an administration could not, if not paid, be claimed in any subsequent liquidation;

> The obligation imposed on a shareholder in an unlimited liability company to contribute sufficient funds to pay that company's "*debts and liabilities*" if it should go into liquidation extended to the payment of any non-provable debts, but the shareholder could not be required to fund the payment of statutory interest;

> Although LBIE is an unlimited company. its administrators could not prove in the administrations of its shareholders in respect of their contingent liability to make contributions in any subsequent liquidation of LBIE; and

> LBIE could not set-off its claim for a contribution from its shareholders against proofs lodged by those shareholders in LBIE's administration. It could, however, invoke the "contributory rule" to prevent those shareholders from making any recovery as creditors of LBIE until they had discharged their contingent liability, as unlimited shareholders, to make a contribution.

While the ruling has significant financial consequences for the various LBIE stakeholders, it also has wider legal implications, providing important guidance in relation to a range of issues including the approach taken by the courts when interpreting legislation and contracts, the role of the judiciary in the future development of English insolvency law, the exercise of insolvency set-off and the validity of contractual subordination arrangements.

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The 7 key points for the Lehman insolvency

The ranking of subordinated debt

The first issue addressed by the Supreme Court was essentially one of contractual interpretation. Loans made available by LBIE's immediate holding company, LB Holdings Intermediate 2 Limited ("**LBHI2**"), were expressed to be subordinated to liabilities payable "*in the insolvency*" of LBIE. The subordinated loans were made on FSA standard terms and formed part of LBIE's regulatory capital. The parties agreed that the subordinated loans ranked behind unsecured provable debts, but disagreed as to whether they ranked ahead of, or behind, statutory interest and/or non-provable liabilities.

The Supreme Court agreed with the High Court and Court of Appeal that both statutory interest and non-provable debts were amounts payable "in the insolvency" of LBIE and that the subordinated loans would therefore only be payable once both statutory interest and non-provable liabilities had been paid in full. In doing so, they dismissed a number of technical arguments raised by the administrators of LBHI2, including the argument that the obligation to pay statutory interest contained in the Insolvency Act 1986 ("**IA 1986**") is expressed as an obligation imposed on the insolvency officeholder rather than an obligation imposed on the company itself.

In reaching this conclusion, Lord Neuberger, in the leading judgment, sought to give the contractual provisions their "*natural meaning*", while also bearing in mind the commercial purpose of the subordinated loans (as forming part of LBIE's regulatory capital). As he noted, "*the perception of the reasonable reader would be that the holders of the subordinated debt were to be at the end of the queue – and, in the event of an Insolvency, at the bottom of the waterfall*". Lord Neuberger also found support for this construction in the fact that, while there was no statutory requirement for an administrator or liquidator to pay non-provable liabilities where there was a surplus, they were in practice required to do so under a long-standing judge-made rule which continued to survive the "*increasingly full codification of insolvency law*".

The Supreme Court did, however, differ from the Court of Appeal on one technical point, upholding the earlier first instance decision of David Richards J that, given the drafting of the subordination provisions, LBHI2 could not submit a proof for its subordinated debt claim until all amounts ranking ahead of it had been paid in full (or at least until it was clear that they could be met in full).

Currency conversion claims

Rule 2.86 of the Insolvency Rules 1986 ("**IR 1986**") required debts payable in foreign currencies to be converted into sterling for the purposes of proving, using exchange rates at the date of administration. An issue arose as to whether, in the event there was a surplus (such that creditors were paid in full, together with statutory interest) creditors who were owed debts payable in foreign currencies could, where sterling had depreciated against the relevant foreign currency between the date on which LBIE went into administration and the date on which the proved debt was paid, recover from the surplus an amount equal to any resulting shortfall, the claim in question being treated as a non-provable debt. David Richards J and the Court of Appeal (by a majority) had held that there was such a claim, which became known as a currency conversion claim.

With only Lord Clarke dissenting, the remaining Supreme Court judges held that there was no room for any such claim, the payment in full in sterling of a proof (including where the proof was converted into sterling) in accordance with Rule 2.86 satisfying the underlying contractual debt. The foreign

currency creditors could not have a "*second bite*" – the conversion was a once and for all conversion. In reaching this view, the Supreme Court reversed the decisions of both lower courts.

Lord Neuberger noted that – as opposed to the position with contingent debts or the unsecured portion of a secured debt where, in each case, the legislation provided for post-proof adjustments either way – there was no statutory value adjustment mechanism dealing with the impact of currency movements. As Lord Neuberger put it, there was no room to infer a "*non-provable back-door*" for making claims in relation to shortfalls resulting from currency movements during the course of the administration where there was no "*express provable front door*".

The majority in the Supreme Court considered that this approach was consistent with the general aim of the IA 1986 to "*simplify*" the insolvency process. They also noted that if sterling were to strengthen, rather than depreciate, after the date of administration, Rule 2.86 would work in a creditor's favour. Allowing a second claim as a result of sterling's depreciation would therefore effectively give the foreign currency creditor a one-way option characterised by Lord Neuberger as a classic case of "*heads I win, tails I don't lose*".

In his dissenting judgment, Lord Clarke expressed the view that the IR 1986 were not clear enough on this point to give shareholders a windfall at the expense of creditors seeking to recover debts denominated in a foreign currency in circumstances where there was a surplus which could be used to satisfy the relevant claim.

Can a creditor claim for unpaid post administration interest in a subsequent liquidation?

The Supreme Court agreed with the High Court, overturning the Court of Appeal, that statutory interest provided for by Rule 2.88(7) during an administration could not, if the relevant company were to be put into liquidation before such statutory interest had been paid to a creditor, be claimed in any subsequent liquidation. This conclusion was, however, reached without enthusiasm, as the Supreme Court did not identify any obvious reason why a creditor of a company in administration should lose their right to receive statutory interest simply because the company moves into liquation.

In reaching this view, it held that that Rule 2.88(7) was a direction to the administrator and only to the administrator – it could not be read as a direction to a potential or actual subsequent liquidator - and that section 189(2) IA 1986, which gives a right to claim interest in a liquidation, only applies to interest which has accrued since the date of the liquidation. There was therefore no room for a creditor to claim for statutory interest which had accrued before that date during the administration process.

Lord Neuberger also dismissed the argument that a creditor's contractual right to interest for the post-administration period could somehow revive as a non-provable debt which could be paid out of any surplus. While there was historic case law to support this proposition, it was decided before the introduction of section 189 IA 86 and Rules 2.88 and 4.93, which together created a "*complete statutory code for the recovery of interest on proved debts*". There was therefore no longer any scope for a contractual right to revive, any such right having been replaced by the new legislative rules.

While Lord Neuberger recognised that this position was most likely an "*oversight*" in the drafting of the relevant legislative provisions, he was clear that this was not something which judges could correct, as doing so would "*involve a court impermissibly usurping the legislative function of Parliament*".

Scope of the liability of LBIE's members, as contributories

LBIE is an unlimited company. LBHI2 and its other shareholder, Lehman Brothers Limited ("**LBL**"), are therefore liable under section 74 IA 1986 to contribute sufficient funds to pay LBIE's "*debts and liabilities"* if it goes into liquidation. The question was whether the term "*liabilities*" included both liabilities of LBIE which were not provable in its liquidation and statutory interest which would be payable under Rule 2.88(7) out of any surplus. The Supreme Court held that:

> (agreeing with the decisions of both lower courts) while a debt might not be provable, there was nothing in the legislation to suggest that it wouldn't still be a "liability" for the purposes of section 74. LBHI2 and LBL could therefore be required to contribute sums to allow payment of non-provable claims; but

> (overturning the Court of Appeal, "*albeit without enthusiasm*") LBHI2 and LBL could not be required to contribute sums to cover statutory interest, as section 74 only requires contributories to pay "*an amount sufficient for payment of [a company's] liabilities*". It could not be invoked to create a surplus from which to pay statutory interest. If there was no surplus, the liability to pay statutory interest did not arise, with the result that there was therefore no liability for the contributory to meet.

The statutory interest point provided a neat summary of the Supreme Court's approach to statutory interpretation as, while the Court of Appeal had been willing to interpret the legislation in a manner which achieved "*a more instinctively likely result than if the actual words used in the provision are construed according to the normal principles of interpretation*", Lord Neuberger and the Supreme Court were unwilling to go down this route, giving the words contained in the statute their "*natural meaning*", even where this led to a counter-intuitive or surprising result, unless doing so resulted in an "*absurd or unworkable*" conclusion.

Issues surrounding the mechanics of making a Section 74 claim

The final three issues arose because LBIH2 and LBL were both creditors of LBIE, as well as being shareholders with a liability to contribute in relation to any debts or liabilities which remained unpaid in its liquidation. Specifically, the Supreme Court was asked to consider:

> **Issue 1**: Could LBIE, or the administrators of LBIE, prove in the administrations of LBIH2 and LBL in respect of those companies' contingent liabilities to make a contribution in any future liquidation of LBIE?

> **Issue 2**: If LBIE and the administrators could not prove, could they nevertheless set off claims for contributions against the proofs lodged by LBIH2 and LBL in LBIE's administration? and

> **Issue 3**; If not, could LBIE nevertheless invoke the "*contributory rule*" in order to avoid making any payment to LBIH2 and LBL until such time as they had fully satisfied their obligations as contributories?

Issue 1

The Supreme Court rejected the earlier High Court and Court of Appeal decision that LBIE's administrators could prove in respect of LBIH2 and LBLs' contingent liabilities to make a contribution in any future liquidation of LBIE, on the basis that any such claim would not constitute an "obligation" for the purposes of Rule 13.12. In reaching the view that this contingent liability was therefore not a provable debt, the Supreme Court applied the guidance it had given in *Re Nortel.*

The conclusion that the section 74 payment did not constitute a provable obligation was based on the propositions that (i) the right to make a call on contributories under section 74 only arises in a winding-up – not in an administration – and (ii) the liquidator is the person entitled to make that call, with any payment being made to the liquidator as an officer of the court, not to the company, in order to enable him or her to satisfy the company's debts and liabilities.

The Supreme Court was not prepared to accept that a company, which might at the relevant time be in good financial health, could still prove in the administration or liquidation of a contributory, on the basis that it might possibly, at some future date, go into liquidation. Allowing this would give rise to a number of difficulties, not least (i) the question, particularly where the relevant company was still a going concern, of how you would value the contingent claim against the contributory (if it were to go into liquidation in several years time, would it do so owing £1million or £100million?) and (ii) the prospect of a contributory having to pay out more than once, should it pay out now, only for the relevant company to go into liquidation at a later date, but with different creditors.

Issue 2

The Supreme Court held that the reasons why the LBIE administrators were not able to prove in respect of LBIH2 and LBL's contingent liabilities to make a contribution in any future liquidation of LBIE also justified it in coming to the conclusion that this contingent liability could not be set-off against LBHI2 and LBL's claims against the LBIE estate. The technical and practical difficulties connected with making a claim would be equally relevant if satisfying that claim through the exercise of set-off rights.

Interestingly, however, Lord Neuberger also stated that he could see no good reason why a non-provable debt owed to the insolvent estate should be disqualified from being set-off in administration under Rule 2.85 (or, by extension, in liquidation under Rule 4.90). In doing so, he disapproved of the Court of Appeal decision in *Re BCCI (No.8)* to the extent that it limited insolvency set-off (insofar as it applies to the claims of the insolvent company) to provable debts. Imposing such a limitation would, he considered, go against the purpose of insolvency set-off, expressed in 19th century case law as being to do "*substantial justice between the parties*".

Issue 3

The Supreme Court was, however, willing to extend the common law "*contributory rule*" applicable in a liquidation to a distributing administration, albeit with "*minor procedural modifications*" to ensure fairness. The "*contributory rule*" (which is part of the wider equitable principle sometimes known as "*the rule in Cherry v Boultbee*), provides that a claimant cannot recover any amount in its capacity as a creditor of the relevant debtor until it has discharged in full any liability which it may have as a contributory to that debtor.

While Lord Neuberger was generally reluctant elsewhere in his judgment to allow judge-made law to encroach into areas where Parliament has already legislated, he considered that it would be both appropriate and consistent with the overall purpose of the 1986 Insolvency Rules to extend the contributory rule to distributing administrations, and to allow the administrators to retain sums otherwise payable to the contributories in their capacity as creditors until such time as it became clear whether any amount would be payable by the contributories.

The wider relevance of the Supreme Court decision

While the Supreme Court's decision contains an extensive and detailed analysis of issues relating to the application of surplus assets in an insolvency estate, there are a number of points in this judgement which have a much wider legal application.

The Supreme Court's approach to statutory interpretation

Lord Neuberger's approach to statutory interpretation is instructive, particularly in relation to possible gaps and oversights in the drafting of statutes. This point may be particularly relevant when the provisions contained in the Insolvency Rules 2016, which came into force last month replacing the IR 1986, are fully tested. The scale and logistical complexity of the process involved in redrafting these rules (which contain many procedural changes and which use language and concepts which are sometimes very different from the IR 1986) may result in requests for judicial clarification as to their precise meaning.

The key points highlighted in this judgment include the following:

- When interpreting the meaning of legislation, "*judges are primarily concerned with arriving at a coherent interpretation*". While "*taking into account commerciality and reasonableness*", the court would always pay "*proper regard to the language of the provision in its context*".
- It may be unwise to rely on cases concerning previous legislation where there have been material changes to that legislation, a point which may be particularly relevant when considering how case law on the IR 1986 may be treated when considering provisions contained in the 2016 Insolvency Rules. Lord Neuberger noted that changes in legislative wording may make it "*unsafe*" to cite earlier judicial decisions or observations.
- When considering currency conversion claims, both Lord Neuberger and Lord Sumption placed reliance on the fact that two influential reports, the 1982 Cork Report and a 1981 Law Commission Working Paper, had both reached the "*clearly expressed and firmly held conclusion*" that the date on which the company was put into an insolvency process should be the once-for-all date for the conversion of every foreign currency debt. There was nothing to suggest that those drafting the IA 1986 disagreed with the conclusion contained in these reports.

The Supreme Court's approach to using common law to address areas not covered by statute

The Insolvency Act 1986 and the Insolvency Rules do not, in themselves, constitute a complete insolvency code. These statutory provisions are supplemented by a number of judge-made common law rules, many of which were developed at a time when insolvency legislation was much less developed and therefore had gaps which needed to be addressed in order to make insolvency procedures work efficiently and fairly. Such judge-made rules include the "anti-deprivation principle", the "rule against double-proof", the "contributory rule" and the much discussed rule in *Gibbs,* which can potentially have a significant impact in cross-border insolvency situations.

Lord Neuberger made it very clear in his judgment that if there is an apparent gap or oversight in a piece of legislation, there are clear limitations on a judge's ability to fill that gap using common law rules, particularly given the fact that insolvency legislation is now very extensive. In his view, "*any judge should think long and hard before extending or adapting an existing rule, and, even more, before formulating a new rule*".

Judicial reluctance to extend the existing scope of common law rules was reflected in the Supreme Court's decision in *Belmont Park,* where it refused to extend the common law anti-deprivation rule in order to impose an ipso facto rule restricting termination of contracts on insolvency grounds. Such reluctance has also been notable in the realm of cross-border judicial assistance, with the Supreme Court being unwilling in *Rubin* to exercise common law powers in order to recognise and enforce certain foreign judgments.

There will, however, be occasions, as in this case with the extension of the "contributory rule" to distributing administrations, where it would be appropriate for the common law to correct an obvious injustice, as long as doing so was consistent with the overall statutory objective. As Lord Neuberger explained: "*if justice requires extension of [this rule] to administrations, I see no good reason why it should not be permissible to add a relatively simple procedural step [retaining all or part of the sum otherwise payable to the contributories in their capacity as creditors] which is needed to give effect to that extension, provided, as I say, that it is not inconsistent with any legislative provision*".

The Supreme Court's approach to contractual interpretation

In construing the various definitions and phrases used in the subordinated loan agreements, Lord Neuberger emphasised the need to give words their "*natural meaning*". This has been something of a trend in recent years. Lord Neuberger's approach is unsurprising given similar comments in the 2015 *Arnold v Britton* case where he also gave the leading judgment.

In particular, Lord Neuberger addressed the question of how to deal with "*superfluous*" and apparently meaningless words contained in documents. He noted that, in the absence of a good reason to the contrary, it is preferable to give wording its natural meaning, even if this means that an expression used in a document has little or no effect, rather than attempting to give such wording an unnatural meaning.

The effectiveness of contractual subordination arrangements

In reaching his view on the interpretation of contractual subordination provisions, Lord Neuberger stated that he could "*see no objection to giving effect to a contractual agreement that, in the event of an insolvency, a contracting creditor's claim will rank lower than it would otherwise do in the waterfall*". While the validity of contractual subordination arrangements, which are commonly used in both a general finance and a regulatory capital context, was not seriously doubted, this statement should remove any residual concerns arising from the 19th century case of *Ex p McKay,* which could be read as questioning the validity of such arrangements.

The impact of this judgment on insolvency set-off

As noted above, Lord Neuberger stated that he could see no good reason why a non-provable debt owed to the insolvent entity (c.f. one owed by it, which must be provable) should be disqualified from being set-off in administration under Rule 2.85 (or, by extension, in liquidation under Rule 4.90). In doing so, he disapproved the Court of Appeal decision in *Re BCCI (No.8)* to the extent that it limited insolvency set-off to provable debts.

What happens next?

A number of other surplus related issues have yet to be resolved, including litigation relating to the Lehman “Waterfall II” application, where 39 outstanding issues have been divided into 3 tranches, Tranche A dealing primarily with insolvency law matters, Tranche B dealing with matters concerning the effect of release clauses in post-Administration contracts; and Tranche C dealing with cost of funding matters, principally arising in respect of claims under ISDA Master Agreements. Court of Appeal proceedings were heard in relation to Tranches A and B last month.

In the longer term, the question arises as to whether the apparent statutory oversights identified in this Supreme Court judgment should, to the extent not remedied in the revised Insolvency Rules, be addressed as part of any future initiative to ensure that the United Kingdom’s insolvency legislation retains its market leading position.

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