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CASE REVIEW SECTION

Re MF Global UK Limited [2015] EWHC 2319 (Ch) (David Richards J, 31 July 2015)

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Introduction

In a reserved decision handed down on 31 July 2015 in *Re MF Global UK Limited* [2015] EWHC 2319 (Ch), following three days of adversarial argument, David Richards J (as he then was) decided that section 236 of the Insolvency Act 1986 ('IA86') does not have extra-territorial effect. In *Re Omni Trustees Limited* [2015] EWHC 2697 (Ch), HHJ Hodge QC (sitting as a Judge of the High Court) decided, on an unopposed application and giving an extemporary judgment, not to follow David Richards J's judgment in *Re MF Global*, finding that section 236(3) IA86 does have extra-territorial effect.

Accordingly, there are now divergent rulings at first instance as to whether an order may be made under section 236(3) IA86 against a person with no presence in England. It would be helpful to have the Court of Appeal's ruling on the question so as to dispel any doubt as to the correct legal position, and to clarify the territorial scope of section 236 IA86 generally (and not just section 236(3) IA86).

A. The statutory provisions

Section 236(2) IA 1986 provides that the Court may, on an application by an officeholder, summon before it:

> '(a) any officer of the company; (b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or (c) any person whom the court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company'

By section 236(3) IA86, the Court may require any such person to submit to the Court an account of his dealings with the company, or to produce any books, papers or other records in his possession or under his control relating to the company or the matters mentioned in section 236(2)(c) IA86.

The Court's powers under sections 236 and 237 IA86 to summon persons for examination apply to liquidation (and provisional liquidation), administration and administrative receivership, and materially identical provisions applicable to personal insolvency are found at sections 366 and 367 IA86.

B. David Richards J's judgment in *MF Global*

In *Re MF Global*, the joint special administrators applied for an order under section 236(3) IA86 against two companies, one of which was a French entity, seeking the production of documents and a full description by way of witness statement of the sales or auction processes by which they had closed out MF Global's open positions very shortly after the appointment of the special administrators. The French entity argued that the Court had no jurisdiction to make such an order against it under section 236(3) IA86.

In deciding that he had no jurisdiction to grant an order under section 236(3) IA86 against the French entity, the Judge considered that he was bound to do so by the Court of Appeal's decision in *Re Tucker (a Bankrupt)* [1990] Ch. 148.

In *Re Tucker*, a decision on section 25 of the Bankruptcy Act 1914 ('BA14'), which provided at section 25(6) that: 'The court may, if it thinks fit, order that any person who if in England would be liable to be brought before it under this section shall be examined in Scotland or Ireland, or in any other place out of England.' The Respondent in *Re Tucker* was resident in Belgium. Dillon LJ, giving the Court of Appeal's judgment, referred to the rule of construction that, unless the contrary is expressly enacted or plainly implied, United Kingdom legislation is applicable only to British subjects or to others who by coming to the United Kingdom, whether for a short or a long time, have made themselves subject to British jurisdiction; and held, applying this rule and taking into account various other matters, that section 25(6) BA14 had no extra-territorial effect.

David Richards J noted that where a statutory provision (such as section 25 BA14) is re-enacted in substantially the same terms (in section 236 IA86), it is a principle of construction that the re-enactment is intended to carry the same meaning as its predecessor. Notwithstanding submissions to the contrary, the Judge could see no reason why that principle should be abrogated from in the present case. In particular, leading

counsel for the special administrators submitted that the decision in *Re Tucker* should not be followed because it was *per incuriam*, alternatively because it suffered from a fundamental logical flaw. However, the Judge concluded that, quite apart from the difficulty of a first instance Court finding that a Court of Appeal decision was *per incuriam*, the Court of Appeal's decision was not flawed; and that the argument of illogicality was misconceived.

On this basis, the Judge held that the Court had no jurisdiction under section 236(3) IA86 to grant an order against the French entity.

C. HHJ Hodge QC's decision in *Re Omni Trustees Limited*

In *Re Omni Trustees Limited*, the Judge heard an application under section 236(3) IA86 by the Official Receiver ('OR'), in his capacity as liquidator of Omni Trustees Limited, against Mr Norriss, a Hong Kong resident. The application was unopposed, the respondent being unrepresented and not himself in attendance.

Counsel for the OR took the Court to *British and Commonwealth Holdings plc v Spicer & Oppenheim* [1993] AC 426, the classic statement of the test for making an order under section 236 IA86, where Lord Slynn made it clear that the powers conferred by what is now section 236 IA86 are powers directed to enabling the court to help a liquidator to discover the truth of the circumstances in connection with the affairs of the company, information of trading, dealings and so forth, in order that the liquidator may be able, as effectively as possible, and with as little expense as possible, to complete his function as liquidator, to put the affairs of the company in order, and to carry out the liquidation in all its various aspects, including the getting in of any assets of the company available in the liquidation. On this basis the Judge was satisfied that this was an appropriate case to make a section 236 IA86 order, subject to the difficulty arising from the respondent being resident in Hong Kong.

In this regard, the Judge carefully considered David Richards J's decision in *MF Global*, handed down just two months previously, that section 236(3) IA86 does not have extra-territorial effect. With evident reluctance, given in particular David Richards J's authority in the field of insolvency law, the Judge declined to follow the decision in *MF Global* on the basis that he had failed properly to distinguish between, on the one hand, requiring a respondent to attend to be examined on oath and, on the other, requiring a respondent to give an account of dealings or to produce documents. David Richards J had failed to make that distinction because: (a) his attention had not been drawn to the structural difference between the statutory provision (section 25 BA14) considered by the Court of Appeal in *Re Tucker* and sections 236(2) and (3) IA86; and (b) he was not referred to the helpful guidance given in the Court of Appeal's decision in *Re Mid East Trading Ltd* [1998] 1 BCLC 240.

As to (a), the critical structural difference between the old and new statutory regimes was that, whereas under section 25 BA14 the power of the court to order the production of documents was ancillary to, and dependent upon, the principal power conferred on the Court under that section which was to summon a respondent to attend for examination before the Court, by contrast under section 236(2) IA86 the Court may summon certain categories of person to appear before it and, separately, under section 236(3), the Court may require any such person to submit to the Court an account of his dealings with the company, and so on. HHJ Hodge QC noted that the starting point of Dillon LJ's analysis in *Re Tucker* was that section 25 BA14 was concerned with summoning people to appear before an English Court to be examined on oath and to produce documents, and his conclusion was that the Court will not compel someone to come to this jurisdiction to be examined on oath and to produce documents. The reasoning of the Court of Appeal in relation to section 25 BA14 in *Re Tucker* is, therefore, distinguishable insofar as the Court's stand-alone jurisdiction under section 236(3) IA86 is concerned.

As to (b), the Court of Appeal in *Re Mid East Trading* unanimously endorsed the following analysis of section 236IA86, namely that (p256E-F) 'the making of an order under Section 236 ... in respect of documents which are not in the jurisdiction does not involve an exercise in sovereignty; alternatively, that it is an assertion of sovereignty which the legislature must be taken to have intended the courts to make'.

On this basis HHJ Hodge QC held that section 236(3) IA86 does have extra-territorial effect and granted the relief sought by the OR.

Conclusion

The present state of the law on the territorial scope of section 236 IA86 is plainly unsatisfactory, given the divergent decisions at first instance on this aspect of section 236(3) IA86. In particular, whilst the reasoning of HHJ Hodge QC in *Re Omni Trustees Limited* is attractive, its authority is significantly weakened by that decision having been uncontested. Accordingly, the Court of Appeal's clarification of the territorial scope of section 236 IA86 is an obvious desideratum. Indeed, even if HHJ Hodge QC's decision on section 236(3) IA86 in *Re Omni Trustees Limited* becomes established as correct at first instance, it plainly sits somewhat uneasily with the Court of Appeal's decision in *Re Tucker*, which is presumably still decisive as regards the territorial scope of section 236(2) IA86. Accordingly, the Court of Appeal will need to consider the relationship between sections 236(2) and 236(3) IA86, and the territorial scope of each of those provisions, before it will be able to conclude whether *Re MF Global* or *Re Omni Trustees Limited* is good law insofar as section 236(3) is concerned.

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ARTICLE

Contingent Assets and Balance Sheet Insolvency: *Evans v Jones* [2016] EWCA Civ 660

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Introduction

Is it permissible to take into account a contingent asset for the purposes of determining balance sheet insolvency under section 123 (2) of the IA 1986?

The answer would seem fairly straightforward: only present assets can be considered for the purposes of the balance sheet insolvency test. However, the 'very peculiar facts' in *Evans v Jones* [2016] EWCA Civ 660, to use Lewison LJ's expression at [22], illustrate how the dividing line between present and contingent assets is far from being clear-cut in every case. Approaching the distinction between the two, the Court of Appeal reiterated that the statutory test under section 123 (2) IA 1986 ought not to be applied mechanistically but in accordance with commercial reality.

The facts

In *Evans v Jones*, the question of balance sheet solvency arose in the context of a claim by liquidators that a series of payments made by a company constituted 'preferences' for the purposes of section 239 to 241 of the IA 1986.

Rococo Developments Ltd ('the Company') had two directors, Mr and Mrs Jones, who were its only shareholders. Mr and Mrs Jones had made various loans to the Company. The Company entered into a building contract with a company called WJG Evans Ltd ('Evans'). As units on the sites being developed by the Company and Evans were sold, the Company made a series of five payments between 2010 and 2011 totalling GBP 450 000 odd in repayment of the debts owed to Mr and Mrs Jones. The fifth payment came just a month before the Company went into creditors' voluntary liquidation in April 2011. In addition, on 1 June 2010, prior to making the first of the five payments, the Company had paid a dividend to Mr and Mrs Jones in the sum of GBP 75 000.

The proximate cause of the Company's entry into liquidation was an adjudication award made in March 2011 in favour of Evans. Evans had referred to adjudication a dispute surrounding the final account for building works it had conducted, and sought to include a number of 'headline items', which Evans claimed created a balance in its favour of some GBP 191 000. Eventually, the adjudicator awarded Evans a total of GBP 82 000 odd, including legal costs, which the Company was unable to pay, having made no provision whatever in its accounts for the Evans claim.

Subsequently, the Company's liquidators decided to pursue a preference claim under section 239 of the IA 1986 against Mr and Mrs Jones. Following their investigations, they also sought to recover the GBP 75 000 dividend, which they considered to have been paid unlawfully, given that there had been insufficient distributable profits in June 2010.

First Instance

Shortly before trial, having previously denied the unlawfulness of the dividend, Mr and Mrs Jones accepted that it had indeed been paid unlawfully. Accordingly, the preference claim alone fell to be determined at first instance before HHJ Jarman QC. It appears to have been agreed by the parties that the payments were preferences within the meaning of the IA 1986, and that they had been made within two years of the onset of the Company's insolvency. The principal area of disagreement between the parties was whether the payments had been made at a time when the Company had been unable to pay its debts within the meaning of section 123 of the IA 1986, or had become unable to pay its debts as a consequence of the payments, pursuant to section 240 (2) IA 1986.

A single joint expert had been instructed before trial to prepare a report on the Company's solvency at the date of the each of the payments. By reconstructing the Company's accounts the expert formed the view that the minimum provision the Company should have made for the Evans claim was GBP 20 000. On that basis, the company would have been insolvent on all but one of the relevant dates. Crucially, however, the expert went on to state that the dividend paid in June 2010 had been unlawful, and that for accounting purposes it was properly considered void, such that at each of the relevant dates the Company's assets were swelled by GBP 75 000. The effect of the expert's analysis was

to return the Company (notionally) to solvency on each of the dates at which the payments had been made. It was apparently in light of the expert's report that Mr and Mrs Jones admitted the dividend had been unlawfully paid, offering to repay it to the Company in full.

The judge accepted the expert's conclusion that provision should have been made for the Evans claim, but found the minimum figure to be GBP 68 000, on the basis of information Mr Jones himself had provided his accountants in December 2010. The effect of this finding was to make the Company balance sheet insolvent on the date of each of the payments. However, the judge then went on to note that it had been common ground before him that the unlawful dividend had at all times been held on constructive trust for the Company, and thus, 'The amount of the unlawful dividend was…at the time of each of the payments, an asset of the company'.

The judge treated the unlawful dividend as a present asset of the Company at each of the relevant dates. At the same time, HHJ Jarman QC refused to take into account the full amount that the adjudicator had awarded in respect of the Evans claim. The judge's basis for so doing was that it was impermissible to use hindsight to determine whether the Company was unable to pay its debts on the relevant dates, relying on *Deiulemar Shipping SpA v Transfield ER Futures Ltd* [2012] EWHC 928 (Comm). As a result, the judge found the Company to have been solvent at the time of each of the loan repayments, such that the liquidators' preference claim was not made out.

Submissions before the Court of Appeal

Before the Court of Appeal, the liquidators challenged: (i) the judge's treatment of the unlawful dividend as a present asset of the Company at the relevant time and (ii) the judge's attribution to the dividend of its full value by the application of hindsight.

Counsel for the liquidators made two principal arguments. First, it was contended that Mr and Mrs Jones' liability to repay the unlawful dividend was unknown when the payments were made: but for the insolvency and the subsequent appointment of the liquidators, there would have been no cause for investigation of the dividend. Second, it was argued that the judge's reasoning suffered from a logical inconsistency insofar as he had, in effect, relied on hindsight in his treatment of the unlawful dividend but had declined to so with regard to the value of the Evans claim.

The Respondents contended that Mr and Mrs Jones' liability was simply an application of the law to the facts as they were, and that those facts were all in existence at each of the relevant dates. Further, it was said that the judge was entitled to deploy hindsight where appropriate. Further, counsel questioned whether the judgment in *Deiulemar Shipping* was necessarily the final word, given that for the purposes of establishing insolvency under a preference claim, the court is necessarily in engaged in a retrospective exercise. Thus counsel accepted that, in principle, hindsight could be applied to both contingent assets and contingent liabilities, but disputed a very late amendment to the Appellants' grounds of appeal which challenged the trial judge's refusal to include the debt to Evans at the amount subsequently awarded by the adjudicator. In any event, the Appellants were refused permission to amend their grounds of appeal.

Balance sheet insolvency

The Court of Appeal's judgment was given by Lewison LJ, with whom Christopher Clark LJ and Laws LJ agreed. His Lordship's starting point was the proper approach to section 123 (2) of the IA 1986, in respect of which the various judgments in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* now provided authoritative guidance.

Lewison LJ approved Morritt C's statement at first instance in *BNY v Eurosail* [2010] EWHC 2005 (Ch) at [30], that for the purposes of the balance sheet insolvency test 'the assets to be valued are the present assets of the company. There is no question of taking into account any contingent or prospective assets'. Lewison LJ accepted at [20] the proposition of law that 'contingent assets cannot be taken into account', continuing 'If there is a present asset consisting of a chose in action (such as a claim in liquidation) it can be given a value, and what it fetches in a market is good evidence of that value.' Relying on the wording of section 123 (2) to support this conclusion, his Lordship continued, 'Bearing in mind that section 123 (2) explicitly refers to contingent and prospective liabilities, but not to contingent or prospective assets, I consider that that proposition is correct.'

Present or contingent asset?

The critical issue before the Court of Appeal was whether the unlawful dividend represented a present asset of the Company or a contingent one at the relevant time. Lewison LJ allowed the appeal, holding that the dividend claim was not a present asset at the relevant dates and the judge should not have taken into it account. The Company was thus returned to notional insolvency at the relevant time such that the liquidators' preference claim succeeded.

His Lordship stressed a number of factors which led him to conclude that the dividend was a contingent asset of the Company. First, Mr and Mrs Jones believed that the dividend was lawful, and had no idea that there was any possible claim in respect of the dividend. Second, there was no reason for anyone to investigate the existence of the claim, nor would there have been

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unless and until the Company became insolvent. In reality, therefore, the discovery of the claim in respect of the unlawful dividend depended on a series of contingencies: (i) it being discovered; (ii) it being pursued (which was unlikely while Mr and Mrs Jones controlled the Company); and (iii) the Company's entry in formal insolvency proceedings.

By way of illustration, Lewison LJ noted a qualitative difference between the Evans claim and the Company's putative claim in respect of the unlawful dividend. As regards the former, what was uncertain was whether it would succeed and to what extent, but it was certain that it existed, it having been served on the Company. Relying on Donald Rumsfeld's now celebrated epistemic excursus to describe the difference between the two claims, Lewison LJ opined that:

> 'To borrow Mr Donald Rumsfeld's well-known distinction, the eventual amount of the company's liability to Evans was a "known unknown"; but the claim against Mr and Mrs Jones was an "unknown unknown". The judge should not have taken it into account'.

Lewison LJ's treatment of the Evans claim and the Company's dividend claim suggests that for a claim to constitute a present asset it should, at a minimum, be known to the company or at least be capable of being known: the company's discovery of the claim cannot be contingent on some future occurrence. Yet it is not a necessary condition for a claim to be characterised as a present asset that its value must already have been established by the courts, or admitted by a liquidator.[1]

Commercial reality

The requirement that a company be at least cognisant of a claim's existence is consonant with the Court of Appeal's emphasis on the role of commercial reality in the application of the statutory test.

Lewison LJ recalled the view of Briggs J in *Re Cheyne Finance plc* [2007] EWHC 2402 (Ch) as regards the cash flow insolvency test, and in particular the comment that even though a company may continue to pay its debts it may yet be 'on any commercial view insolvent'. As regards balance sheet insolvency, Lewison LJ cited Lord Neuberger MR's comment in the Court of Appeal in *BNY v Eurosail* [2011] EWCA Civ 227 that the statutory section 123 test must not be applied mechanistically but in a way that has regard to commercial reality.

In light of these statements, Lewison LJ observed that the judge's treatment of the unlawful dividend as a present asset of the Company at the relevant dates simply did not accord with commercial reality.

Hindsight

The issue of hindsight was thrown into relief because, as noted by the Respondents, the exercise of determining whether a company subject to formal insolvency proceedings was insolvent at the time of making a historic transaction is necessarily a retrospective one.[2]

The Court of Appeal appeared to leave the door open to the application of hindsight in this context. Lewison LJ indicated this was the case by observing that 'however liberal an approach to the use of hindsight is permissible' before continuing 'what is not permissible in my judgment is to rewrite history', suggesting that, to some degree, deploying hindsight is permissible.

His Lordship criticised the trial judge's approach to the dividend claim as having strayed into the territory of re-writing history. The judge treated the claim as a present asset of the Company at the relevant time on the basis of certain counter-factual assumptions made with the benefit of hindsight. Further, the judge had been wrong to attribute to the dividend claim its full value, as this involved the assumptions that the dividend would have been recoverable from Mr and Mrs Jones without cost, and that they would not have defended the claim.

Conclusion

The Court of Appeal's vindication of commercial reality as central to the determination of balance sheet insolvency under section 123 (2) IA 1986 provides further confirmation of the courts' approach towards the application of the statutory test. However, the Court of Appeal's emphasis on commercial reality is not entirely devoid of difficulty.

In *Evans v Jones*, the parties agreed that the unlawful dividend was held on constructive trust for the Company and that Mr and Mrs Jones were under a duty to convey it as directed by the Company. The Court of Appeal did not, however, appear to dissect what the constructive trustee label denoted in the case before them. If, on the one hand, the constructive trustee label denoted Mr and Mrs Jones' personal liability as knowing recipients (the suggestion by counsel for the liquidators at [17]), a liability recently described by Lord Sumption as 'purely remedial',[3] then it is difficult to see how as a matter of law the beneficial interest in

Notes

1 As regards the latter, see Morritt C's comments in *BNY v Eurosail* [2010] EWHC 2005 (Ch) at [34].
2 Unlike the question of a company's solvency upon the hearing of a winding up petition, which is a prospective exercise.
3 *Williams v Central Bank of Nigeria* [2014] UKSC 10 at [9].

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the dividend did not vest in Mr and Mrs Jones. But if, on the other hand, what arose by operation of law was an institutional constructive trust over the dividend at the moment it was paid, such that it remained beneficially the property of the Company (as suggested by the trial judge's treatment of the dividend recorded at [14]), the argument that at the relevant dates the dividend was always the Company's property in *law*, would arguably have been stronger.[4]

Despite the element of tension between the commercial and legal analysis of the Company's dividend claim, what is quite clear from Lewison LJ's judgment is that the Court of Appeal was not overly concerned with arguments about either the legal characterisation of the Company's right in respect of the dividend or the constructive trust which arose over it – in the circumstances, it was simply commercially unreal to consider a claim the discovery and prosecution of which depended on multiple contingencies and counter-factual assumptions to be a present asset of the Company.

Notes

4 For the possibility of such a constructive trust arising in the context of an unlawful payment of a dividend see the remarks of Nourse LJ in *Heinl v Jyske Bank (Gibraltar) Ltd* [1999] Lloyds Rep. Bank. 511, 521.

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ARTICLE

The Joint Administrators of Lehman Brothers International (Europe) (In Administration) v Burlington Loan Management Limited and Others [2016] EWHC 2417 (Ch) (Known as 'Waterfall IIC')

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On 5 October 2016 Mr Justice Hildyard handed down judgment in the third tranche of the second of three major applications concerning the proper distribution of funds in the solvent administration of Lehman Brothers International (Europe) ('LBIE'), known as the Waterfall applications. This judgment deals with the application of statutory interest pursuant to r. 2.88 of the Insolvency Rules 1986 (the '1986 Rules') on debts under the 1992 and 2002 ISDA (International Swaps and Derivatives Association, Inc) Master Agreements (the 'ISDA MAs', the most commonly used standard-form documents used to govern over-the-counter financial derivatives transactions), and under another master agreement governed by German law (the 'GMA') proved in the administration of Lehman Brothers International (Europe) ('LBIE').

A. Background to the judgment: the collapse of Lehman Brothers and the Waterfall litigation

LBIE was the UK subsidiary of Lehman Brothers Holdings Inc., the fourth largest investment bank in the United States, which filed for Chapter 11 bankruptcy protection on 15 September 2008. Following its US parent's collapse, LBIE was put into administration, also on 15 September 2008. However, the English bank had never been balance sheet insolvent and its administrators eventually found themselves charged with a surplus of around GBP 7 billion. As Hildyard J laconically put it in the introduction to his judgment, '[s]uch a situation is unusual' ([3]).

The excess of funds available for distribution generated argument over novel legal points concerning precisely how the surplus should be dealt with. The Waterfall litigation is the result of applications by the administrators of LBIE (the 'Administrators') to the court for guidance as to the correct interpretation of the rules governing the distribution of the surplus.

The first application, which came to be known as Waterfall I, concerned the order of payment of certain non-provable claims and ancillary issues regarding these. This application was dealt with by David Richards J at first instance, but aspects of his judgment were considered by the Court of Appeal and then the Supreme Court, whose judgment is pending.

David Richards J also initially had carriage of the Administrators' second set of questions, the Waterfall II litigation. This he divided into three tranches. Waterfall IIA dealt with creditors' entitlement to interest on their debts for periods after the commencement of the administration. Waterfall IIB, which, like IIA, was heard at first instance by David Richards J, dealt with the construction and effect of agreements entered into by LBIE and its creditors after the bank entered administration.

David Richards J was elevated to the Court of Appeal in July 2015. Tranche C of Waterfall II, with which this article is concerned, was therefore heard by Hildyard J.

B. Waterfall IIC: issues and parties

Waterfall IIC is concerned with the correct interpretation and application of terms regarding interest in standard form agreements entered into by LBIE before the administration with various counter-parties. Around GBP 4.4 bn of LBIE's total admitted claims arose under the 1992 and 2002 ISDA MAs and around GBP 311m is claimed under the GMA. Hildyard J also noted that the ISDA MA, which governs over-the-counter derivatives transactions, is one of the most widely used forms of agreement in the world, and that as at the end of December 2014 it is thought that the total notional amount of over-the-counter derivatives in existence was USD 630 trillion.

Because of the importance to international finance of the ISDA MAs compared to the GMA, and because the issues regarding the GMA were decided by reference to points of German law on which expert evidence was heard, this summary deals with the part of the judgment covering the ISDA MAs and deals with the German law points only in brief summary.

The English law issues in Waterfall IIC are largely concerned with r. 2.88 of the Insolvency Rules 1986 which

deals with interest on claims provable in an insolvency. Rule 2.88(7) provides that in a surplus situation interest on these claims is payable for the period for which they were outstanding before the administration:

> '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 date on which the company entered administration or liquidation].'

The rate of such interest is said at r. 2.88(9) to be:

> 'whichever is the greatest of [the rate specified in section 17 of the Judgments Act 1838 on the relevant date] and the rate applicable to the debt apart from the administration.'

The Administrators' task would therefore seem to be rather easy: simply identify the amounts outstanding before the administration, ascertain the rate of interest payable on such amounts under the relevant master agreement, and award interest at the higher of this rate and 8% p.a. (the Judgments Act rate).

However, problems arise when it comes to considering the rate payable under the relevant master agreement.

Under Section 6 of both the ISDA MAs, if an 'Event of Default' (which includes entry into administration) with respect to a party (the 'Defaulting Party') has occurred and is continuing, the other party (the 'Non-defaulting Party') may designate an 'Early Termination Date' in respect of all outstanding transactions. Additionally, some parties elected to have termination occur automatically when an Event of Default should arise.

On Early Termination, all transactions entered into pursuant to the ISDA MA are terminated and the non-defaulting party is entitled to determine the amount to be paid, in accordance with sections 6(d) and (e), with the intended effect that the parties will be left in the position they would have been in if there had been no Event of Default or Early termination. An amount may be payable from either party to the other, depending on which is 'in the money.'

Section 6(d)(ii) provides for interest to be paid on the sum calculated as being due from one party to the other under Section 6(e). Under both ISDA MAs, interest is to be paid on a sum due from the defaulting party at the 'Default Rate' in certain prescribed circumstances.

The Default Rate was defined as follows:

> 'a rate per annum equal to the cost (without proof or evidence of the actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1 per cent per annum.'

The Waterfall IIC application concerned the interest due under r. 2.88 on amounts owed by LBIE, as the Defaulting Party, to its counter-parties following the Early Termination Date of the derivatives transactions terminated following LBIE's entry into administration. Hildyard J's task was to interpret the definition of default rate so that the Administrators could properly calculate the sums due to creditors under r. 2.88. Given the value of the claims under the ISDA MAs, his answer was to have significant implications for the creditors bringing the claims.

The interpretation of the 'default rate' was challenged at a number of points:

(1) Who is the 'relevant payee': LBIE's original counter-party, or an assignee of that counter-party's entitlement, if the contractual right to interest can be transferred under the ISDA MAs? (Issues 10 and 18; the Issue numbers reflect a list pared down by the parties before trial rather than the issues to be determined at by the judge, so do not reflect the number of issues actually decided in the judgment);

(2) What does 'cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount' mean, and in particular what types of funding are permissible in the meaning of the clause? (Issues 11 and 12);

(3) Should the 'cost … to fund or of funding the relevant amount' be calculated as at a particular time or on a fluctuating basis? (Issue 13);

(4) Questions related to the certification to be provided by the relevant payee (Issue 14, 15, 16).

(5) Are the answers to any of the above questions affected by whether the MA was governed by New York rather than English law? (Issue 19).

As to the GMA, he considered whether and in what circumstances, following LBIE's administration, a creditor would be entitled to make a 'damages interest claim' within the meaning of section 288(4) of the German Civil Code on certain compensation claims arising under the German Master Agreement, and if so whether this interest could be 'the rate applicable to the debt apart from the administration' for the purposes of r. 2.88(9) (Issue 20) and if so how this rate was to be determined (Issue 21).

He also considered a supplemental issue (Supplemental Issue 1(a)): whether the rate mentioned in r. 2.88(9) incudes a contractual rate of interest on a close-out sum which began to accrue only after the close-out sum became due and payable because of action taken by the creditor after the commencement of the administration.

The Administrators were the Applicants; however the true contest was between the first to third Respondents, on the one hand, collectively called the Senior Creditors Group or 'SCG', supported by the Goldman Sachs International ('GSI'), and on the other hand, the fourth Respondent, Wentworth Sons Sub-Debt S.A.R.L. ('Wentworth').

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C. The approach to construction ([46]–[49])

Most of the issues are questions of contractual construction. Hildyard J therefore identified the principles of contractual construction on which he relied. He cited the Supreme Court's judgment in *Rainy Sky SA v Kookmin Bank* [2011] 1 WLR 2900, in which it was held that construction is the unitary exercise of ascertaining what a person with all the background knowledge available to the parties at the time of contracting and having regard to all relevant surrounding circumstances would have understood the contract to mean. Regard is to be had to 'business common sense' only where there are two possible constructions.

He also considered a number of principles relevant to the interpretation of the ISDA MAs drawn from various cases. The ISDA MAs must be interpreted in a way that gives certainty and predictability, given that they govern relations between large numbers of parties. Being standard form documents, the particular factual matrix has a much more limited part to play than in other contexts and more than ever the focus is on the words used, which should be taken to have been selected after considerable thought and with the benefit of knowledge of the market. Since the ISDA MAs are designed to be used in various different contexts, an overly rigid construction is inappropriate. The drafting is also intended to obviate the risk of litigation over its construction, and this is also a reason that it should be interpreted flexibly subject to reasonableness and good faith.

D. Issue 11 ([50]–[163]): the cost of funding

By Issue 11 the Court was asked to identify the essential characteristics of the contractual term ' cost ... if it were to fund or of funding the relevant amount.'

Wentworth argued that 'funding' means borrowing the relevant amount and 'cost' means the price required to be paid in transacting to borrow the relevant amount for the period it is required. The SCG argued that the phrase 'cost of funding' should be given a broad meaning and not 'read down' to exclude any losses or costs which arise in the legitimate and usual course of obtaining funding. The sort of losses that can be claimed for on this view are constrained only by good faith and rationality. GSI similarly contended that the phrase should include the cost of raising equity funds to maintain a required debt to equity ratio.

Hildyard J concluded that 'cost' in this context means the transactional cost, the price to be paid in return for funding over the period required. Borrowing is the only kind of funding which is obtained in return for such transactional costs. Thus the cost of funding is the actual cost where the relevant payee has actually gone to the market to borrow the relevant amount, or a hypothetical cost where it has not. The broader range of costs proposed by the SCG and GSI were not intended to be recoverable.

He found that this more limited reading was necessary to be consistent with the objective of expressing the cost of funding as a *per annum* interest rate. Interest is the cost of the use of money over time. A share is a bundle of rights, and although a fixed percentage dividend may mimic an interest rate it is conceptually distinct, being a limited right to participate in profit. Thus, the cost of equity funding is not properly expressed as an interest rate.

The limitation of funding to borrowing is also necessary to be consistent with the cost of funding language wherever it appears in the ISDA MAs and to limit the matters which are subject only to the control of good faith and rationality.

Hybrid debt/equity instruments pose a challenge to this definition of 'cost', but Hildyard J found that part of the cost of a hybrid instrument could theoretically be within the cost of borrowing language where it is possible to disentangle the interest rate element payable from other costs (in particular, any equity element cost, or some cost not referable to the relevant period during which the relevant amount is outstanding).

E. Issue 12 ([165]–[180]): the cost of borrowing

Issue 12 concerns a situation where the cost of funding includes the cost of borrowing (as Hildyard J decided it does). It asks how the cost of borrowing is to be measured: should such borrowing be assumed to have recourse solely to the relevant payee's claim against LBIE or to the rest of the relevant payee's unencumbered assets (Issue 12(1))? If the cost of borrowing is to be assessed having regard to all the relevant payee's unencumbered assets, should the cost of funding include the incremental cost to the relevant payee of incurring additional debt against its existing asset base or should it include the weighted average cost on all of its borrowings (Issue 12(2))? Should such cost include any impact on the cost of the relevant payee's equity capital attributable to such borrowing (Issues 12(3))? And is the cost to be calculated based on obtaining overnight funding, term funding to match the duration of the claim to be funded or funding for some other duration (Issue 12(4))?

Both the SCG and GSI argued that this cost was capable of including the incremental cost of funding a particular amount calculated by reference to the weighted average cost of all its borrowing or capital, and also by reference to the additional costs associated with increased leverages, given that these would be affected by the borrowing of the particular amount. Wentworth again argued for a narrower reading and argued that the incremental increase in a weighted average cost of borrowing was outwith the relevant contractual wording and that the relevant cost was

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the price the relevant payee would pay on the market to borrow the sum required taking into account all relevant considerations.

Again, Hildyard J preferred Wentworth's construction of the contractual wording. The weighted average cost of funding reflects equity funding as well as debt funding, and is also produced from the compilation of historic transactions. These cannot be regarded as constituting the cost of the instant transaction, even where a consequence of the transaction is to increase the cost of equity capital.

However, the parties were in substantial agreement, and Hildyard J also agreed, that there should be no restrictions on the tenor of funding – whether overnight or term funding. The appropriateness of certifying the cost based on a particular tenor of funding was controlled by the criteria of good faith and rationality.

F. Issue 13 ([181]–[190]): Whether the cost of funding should be calculated as at a particular time or on a fluctuating basis

Issue 13 asked whether 'cost' should be certified as at a particular date or on a fluctuating basis as over a period of time. The Administrators considered this would be of most practical importance where the certification was on the hypothetical basis.

Wentworth took the view that cost should be sought as at the date at which payment is sought, and the calculation should take into account fluctuating market conditions between then and the termination date. The SCG pointed out that a cost which took into account the fall in interest rates would be lower than otherwise, since interest rates fell after Lehman's collapse, and suggested that Wentworth wanted to take advantage of this lower rate without any support for so doing in the contractual wording.

The SCG, supported by GSI, argued that it depends on what the relevant payee would have done. If a relevant payee's habitual mode of borrowing was on the fixed basis, fluctuations in the market should be ignored. If it would have borrowed on a floating rate basis, changes in the market would in reality have determined the cost to the relevant payee.

Hildyard J accepted the latter view: 'Let's see what you say you did, or let's see what you say you would have done, and let's assess that' ([190]).

G. Issues 14 ([192]-208]), 15 ([209]–[211]), 16 ([212]–[214]) and 18 ([215]–[217]): Questions related to the certification to be provided by the relevant payee

Issues 14, 15, 16 and 18 were largely agreed but Hildyard J addressed each for 'clarity and comprehensiveness.' Under Issue 14 it was agreed by the parties that the relevant payee's certification is conclusive as to its cost of funding within the meaning of that phrase, except in certain circumstances, including where the certification was irrational or made otherwise than in good faith. There was a dispute as to whether a certification could also be challenged on the ground of 'manifest error', and also as to whether a misconstruction of the concept of 'default rate' itself could be challenged otherwise than on the ground of irrationality and good faith.

Hildyard J held that there should be no basis for challenging a certification on the ground of manifest error insofar as this is an error of fact that is not caught by the requirements of rationality and good faith. Allowing such challenges would undermine the purpose of the certification process, which is to promote a certainty that is fundamental to the architecture of the ISDA MAs as a whole. However, it is also 'inconceivable' that the draftsmen intended to preclude challenge where a certificate is founded on a manifest numerical or mathematical error, and so to the extent that this is not caught by the requirements of rationality and good faith, a separate ground of challenge is available for this.

The following matters were agreed by the parties:

- Where a relevant payee's certificate is challenged, it is the defaulting party that bears the burden of proving, on the balance of probabilities, that the relevant payee's certification has not met the relevant requirements (Issue 15);
- The relevant payee and anyone expressly or impliedly authorised by the relevant payee can provide certification of the cost of funding and where such certification is not possible, the Court will put itself in the shoes of the relevant payee to determine what decision it would have made had it determined its cost of funding properly (Issue 16); and
- Section 7(b) of the 1992 Form, which enables a party to transfer any amount payable to it from a Defaulting Party under Section 6(e) without the prior written consent of that party, does include the power to transfer any contractual right to interest under that agreement (Issue 18).

H. Issue 10 ([218]–[263]): the identity of the relevant payee

Many of the claims proved in the administration were brought by assignees of the ISDA agreements. Therefore, it was necessary to consider whether the 'cost to the relevant payee' in the definition of Default Rate was the cost to the original party who had entered the agreement, or the assignee.

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Section 7 of both versions of the ISDA MA contains a general prohibition on transfer of any interest or obligation under the relevant agreement, with certain exceptions. It is slightly differently worded in the 1992 and 2002 ISDA MAs but in each case provides that one of the exceptions is that a party may transfer its entitlement to payment of certain amounts from a defaulting party to another. As we have seen, under Issue 18 the parties agreed that the entitlement to the Default Rate was capable of being transferred under this section.

The question under Issue 10 is who the 'relevant payee' is when such a transfer has been effected. Does it refer to the original contractual counterparty, as the Administrators and Wentworth contended, so that the assignee must certify the cost of funding for the assignor, or to whoever is entitled to receive the amount, as the SCG contended?

The question is one of contractual construction: what was transferred, the right to have an entitlement calculated by reference to the position of the transferee, or simply a right to payment on terms already determined by the transferor's position?

The parties agreed that the difference in wording between the 1992 and 2002 ISDA MAs did not make a difference to what was transferred. However, they sought to rely on differences in one version could assist in the interpretation of the other.

Hildyard J concluded that section 7 restricted the right to payment of the amount that would have been due to the original counterparty: 'the transferee is entitled to the tree planted by the transferor and such fruit as had grown and would grow on it when transferred, and not to fruit of a different variety or quantity which might have grown had the transferee planted the tree' ([261]).

He concluded this on the ground that it was the more natural meaning of the wording of the sections. The term relevant payee should be construed as having the same meaning wherever it appears, and construing it as meaning which of the parties to the original agreement is entitled to payment achieves this. Further, where assignment occurs after the early termination date on which interest starts running, there will be two 'relevant payees' one before and one after transfer: this construction would require 'more substantial rewriting of the agreements than is warranted.'

The purpose of restrictions on the right of transfer is to protect against unknown credit risks: this is undermined if the defaulting party is liable to pay an amount calculated by reference to the circumstances of an unknown third party.

This construction also follows the usual principle that the transferee cannot usually recover more than the transferor could have recovered.

I. Issue 19 ([264]–[282]): New York law

Finally, under Issue 19, Hildyard J concluded that issues 10 to 18, the parties' agreed position that the answers to the questions of interpretation posed would be the same in New York law as he had concluded they are under English law is correct.

J. Issues 20 ([320]–[417]) and 21 ([420]–[451]): the German Master Agreement

Hildyard J had two issues to decide in respect of the GMA: the basis on and the time from which creditors are entitled under German law to compensation for delayed payment of a compensation claim arising under the GMA following automatic termination of the agreement by reason or in consequence of the administration application in respect of LBIE (Issue 20) and the nature and limitations imposed on such a claim as a matter of German law where there has been an assignment or transfer of the entitlement to a third party (Issue 21).

On Issue 20 Hildyard J concluded that:

– A creditor is not entitled to make a damages interest claim in the meaning of section 288(4) of the German Civil Code (BGB) on any sum which is payable pursuant to clauses 7 to 9 of the German Master Agreement (Issue 20(i) [320]–[407]).

– If he was wrong about Issue 20(i), such a damages interest claim could not at any rate constitute part of 'the rate applicable to the debt apart from the administration' for the purpose of Rule 2.88(9) ([408]–[417]).

On Issue 21 Hildyard J concluded that:

– A claim for 'further damages' under German law by an assignee of a claim against LBIE under the GMA since the date of administration cannot be treated as part of the ' rate applicable to the debt part from the administration ' for the purpose of Rule 2.88(9) (Issue 21(i), [420]–[427])

– A debtor's protection is limited to its 'legal position', and that this does not extend to the factual consequences of a change in the identity of the person asserting the same legal rights, meaning that there is no cap or limitation on the amount of further damage that an assignee may claim (Issue 21(ii) [428]–[442])

– When calculating damages for late payment of a default debt banks are entitled to perform the calculation on what was called the 'abstract' method, based on an average profit from its overall business activities. However, this method of quantification is not available to other investors (Issue 21(iii) [443]–[451]).

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K. Supplemental Issue 1(A) ([453]–[529]): sums which became due after LBIE's entry into administration

Under Supplemental Issue 1(A) Hildyard J considered whether the 'rate applicable to the debt apart from the administration' in r. 2.88(9) of the 1986 Rules includes a contractual rate of interest which was applied only after the close-out sum became due following action by the creditor after the administration.

He held that the rule did include such rates. The question was whether the rate was applied pursuant to contractual rights which were in existence at the date of the administration. If so, then the rate due on the exercise of those rights was the rate applicable for the purposes of r. 2.88(9), even if the right had not accrued before the date of the administration.

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CASE REVIEW SECTION

GSO Credit – A Partners LP & Ors v Barclays Bank Plc [2016] EWHC 146 (Comm)

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Introduction

This case arose from a dispute over the settlement amount payable following the sale of a position under a surety bonds facility by an insurance company ('HCC') to a number of funds (together, 'GSO') via an intermediary bank: Barclays Bank Plc ('Barclays'). The sale was conducted under the Loan Market Association Standard Terms and Conditions for Par and Distressed Trade Transactions dated 14 May 2012 (the 'LMA Terms').

Factual background

Codere manages various gambling ventures, including casinos, horse racing tracks and gaming machines, in Latin America, Italy and Spain. To raise finance for its business, Codere entered into a senior facilities agreement dated 19 October 2007 (the 'SFA'). Under the SFA, Codere and certain of its subsidiaries were provided with:

(1) a revolving credit facility;

(2) a letter of credit facility; and

(3) a surety bonds facility (the 'Surety Bonds Facility').

Codere needed the Surety Bonds Facility because various municipal authorities in Spain and Italy required Codere to issue surety bonds to them as guarantees for Codere's payment obligations under the gaming licences granted to it. HCC was the lender under the Surety Bonds Facility and had agreed to issue surety bonds up to the sum of €40 million at the request of the various borrowers under the SFA.

As at 7 June 2013, HCC had issued surety bonds to third parties with a face value (i.e. a potential exposure) of €23,790,371.45 (the 'Issued Surety Bonds'). Under the SFA, Codere indemnified HCC for any monies it paid under the Issued Surety Bonds and HCC's right to reimbursement was a secured obligation of Codere. As at 10 June 2013, no demands had been made under the Issued Surety Bonds and consequently no cash had actually been paid out by HCC.

In around April/May 2013 various efforts were being made to achieve a restructuring of the SFA, which was due to mature on 15 June 2013. It was in this context that GSO, which already had some exposure to Codere, considered acquiring HCC's position under the Surety Bonds Facility.

Discussions regarding the acquisition of HCC's position under the Surety Bonds Facility took place between GSO and HCC. The commercial deal which was settled on was that GSO would purchase HCC's position under the Surety Bonds Facility at a price of 76 cents /€1.

Due to the need to complete the transaction before the termination of the SFA on 15 June 2013 and the fact that GSO could not trade with HCC without completing various regulatory checks, it was agreed that Barclays would act as an intermediary and that the transaction would be effected by back-to-back trades entered into between HCC and Barclays and between Barclays and GSO respectively.

On 7 June 2013, GSO agreed to buy and Barclays agreed to sell in total a €23,790,371.45 portion of the commitment under the Surety Bonds Facility at a price of 77.125 cents/€1 (the 'GSO Trades').

Also on 7 June 2013, a corresponding agreement was reached whereby Barclays agreed to buy HCC's position under the Surety Bonds Facility at a price of 76 cents/€1 (the 'HCC Trade'). The difference in price between the GSO Trades and the HCC Trade represented Barclays' commission for acting as intermediary.

The HCC Trade was documented in an LMA trade confirmation executed by Barclays and HCC on 10 June 2013 and the GSO Trades were similarly documented in LMA trade confirmations dated 11 June 2013.

The dispute

The trades never settled because a dispute arose between GSO and HCC over the settlement amount payable. GSO's position was that in purchasing HCC's commitment under the Surety Bonds Facility, it was acquiring a contingent obligation to meet any demands made under the Issued Surety Bonds. Under the LMA Terms, this meant that the traded asset was 'unfunded' and therefore a settlement amount of €5,442,047.47 was due to GSO from Barclays, with a similar sum due to Barclays from HCC.

HCC contended that for regulatory and contractual reasons it was unable to divest itself of its obligations under the Issued Surety Bonds and that what it had sold to GSO, via Barclays, was its voting rights and its contingent right to reimbursement under the SFA but not its contingent obligations under the Issued Surety Bonds. Accordingly, HCC maintained that it was owed a settlement amount of €18,080,682.30 from Barclays.

Barclays' position was simply that the GSO Trades and the HCC Trades should be interpreted consistently.

The LMA Terms

Condition 2(a) of the LMA Terms provides:

> 'A binding contract for the sale or participation by the Seller to the Buyer of the Purchased Assets shall come into effect between the Seller and the Buyer upon oral or, in the absence of such oral agreement, written agreement of the terms on the Trade Date and shall be documented and completed in accordance with these Conditions.'

'Purchased Assets' are in turn defined as:

> 'any and all of the Seller's rights, title and interest in and to:
>
> (a) the commitment, advances, other utilisations (including letters of credit), claims and other rights of the Seller (including to any Non-Cash Distributions other than Non-Cash Distributions which are to be held by the Buyer as agent for the Seller pursuant to Condition 14.2 (Settled without accrued interest)) included in the Traded Portion of the Seller's participation under or in respect of the Credit Documentation together with any and all corresponding rights and benefits under any ancillary guarantee or security relating to the Traded Portion;
>
> (b) in the case of a Claims Trade, the Claim; and
>
> (c) the Ancillary Rights and Claims,
>
> provided that the Purchased Assets shall not include any of the Seller's rights that are attributable to the Seller's rights in any capacity other than as a Lender.'

Condition 13.1 sets out the mechanism for the calculation of the Settlement Amount:

> 'The amount payable for the Purchased Assets shall be determined for:
>
> (a) each currency in which the principal amount of the Purchased Assets has been funded;
>
> (b) the base currency of any portion of the Purchased Assets which is unfunded as of the Settlement Date;
>
> …
>
> and shall be equal to the Purchase Rate multiplied by the principal amount of the Purchased Assets funded in the same currency as of the Settlement Date less:
>
> – (100% minus the Purchase Rate) multiplied by the unfunded portion of the Purchased Assets as of the Settlement Date, where the base currency of such unfunded portion is the same currency as the principal amount of the funded portion of the Purchased Assets;
>
> – (100% minus the Purchase Rate) multiplied by any Permanent Reductions (as defined in Condition 12 (Permanent Reduction)) made in the same currency as the principal amount of the funded portion of the Purchased Assets and which occur in respect of the Purchased Assets on or after the Trade Date and on or before the Settlement Date …'

Condition 13.2 then provides:

> 'If the amount payable in respect of any currency is positive it shall be payable by the Buyer to the Seller; if negative the absolute value of the amount in the relevant currency shall be payable by the Seller to the Buyer.'

It follows from Condition 13.1 that, in order to calculate the Settlement Amount, it is necessary to determine whether or not the Purchased Assets are 'funded' or 'unfunded'.

The decision

HCC argued that because the term 'Purchased Assets' was defined separately from 'Purchased Obligations' it excluded the latter. It used this argument to support its position that all that it had agreed ultimately to transfer to GSO was its rights under the SFA and not its obligations under the Issued Surety Bonds. It further argued that the terms 'funded' and 'unfunded' were concerned with whether or not a facility had been utilized, and since the Issued Surety Bonds represented a utilization of the Surety Bonds Facility, then the rights transferred to GSO were 'funded' for the purposes of Condition 13.1.

GSO maintained that on the proper construction of the LMA Terms and the relevant trade confirmations, the term 'Purchased Assets' was broad enough to include HCC's obligations under the Issued Surety Bonds. GSO also argued that the terms 'funded' and 'unfunded' related to whether or not sums had been paid pursuant to the Issued Surety Bonds; since none had, these were 'unfunded'.

Following a careful analysis of the LMA Terms and the LMA trade confirmations Mr Justice Knowles rejected HCC's arguments and found in favour of GSO.

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He also dealt with HCC's argument that it was not able to divest itself of its obligations under the Issued Surety Bonds by holding that it was not actually required to do so: GSO could effectively take on HCC's obligations by providing cash cover or a letter of credit to HCC that would take the latter off risk.

Recognizing the importance of there being certainty as to the meaning of the LMA terms, which are widely used in the secondary debt market, Mr Justice Knowles drew the following general conclusions:

> '[F]or a trade on the 2012 LMA Terms in respect of a surety bonds facility:
>
> (a) the trade will, generally speaking, include the economic burden of the seller's obligations under issued surety bonds;
>
> (b) the "Purchased Assets" are, generally speaking, "funded" to the extent that money has been paid by the seller under issued surety bonds, rather than to the extent by which the facility has been drawn by the mere issue of surety bonds.'

Conclusion

Mr Justice Knowles's decision gave the LMA Terms a commercially sensible construction and provided welcome certainty as to their effect. The case also underlined the importance of paying proper attention to transaction documentation and, where a trade is made on standard terms and conditions, taking the time to understand what those terms and conditions actually mean.

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ARTICLE

The Proposed EU Directive on Preventive Restructuring Frameworks

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Introduction

In November 2016, the European Commission issued a proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge (the 'Proposed Directive'). This article seeks to (i) explain the policy aims underlying the Proposed Directive; (ii) summarise the Proposed Directive's key elements, in particular, the proposals for restructuring frameworks across Member States to share certain core elements and minimum standards; (iii) consider the areas in which the Proposed Directive may require some further work; and (iv) consider the likely impact of the Proposed Directive on the UK both in terms of its obligations as an EU Member State (for the time being) and, following the UK's exit from the EU and implementation of the Proposed Directive by the remaining Member States, on the UK's prospects of remaining a global restructuring hub.

The UK may well never have to implement the Proposed Directive due to the legislative steps which still need to be completed. However, the UK is nevertheless still likely to face increased pressures to reform its own restructuring frameworks, particularly the creditors' voluntary arrangement and the scheme of arrangement jurisdiction, the latter of which has stood largely unchanged for over a century.

Pressures for reform do not stem solely from the EU's latest proposals. The Proposed Directive should be seen in its international context, in which a number of jurisdictions have already made moves to overhaul their existing restructuring regimes. Recently (and most notably) Singapore enacted the Companies (Amendment) Act 2017 which, in addition to incorporating the UNCITRAL Model Law on Cross-Border Insolvency, has made extensive amendments to the Singaporean scheme of arrangement jurisdiction under Part VII of the Companies Act (Cap 50 of the 2006 Revised Edition)(the 'Revised SCA').[1]

To some degree, the UK has already responded to these international developments which potentially threaten to wrest its crown as a global centre of choice for the restructuring of corporate debts. The Insolvency Service launched a consultation in May 2016, entitled 'A Review of the Corporate Insolvency Framework' (the 'Consultation') in which feedback was sought on many of the same elements which now make up the restructuring framework set out under the Proposed Directive. Responses to the Consultation were published in September 2016 (the 'Response to the Consultation') but have not, as yet, been acted upon.

Structure of the Proposed Directive

The Proposed Directive is structured as follows:

a. Common principles and elements for restructuring frameworks across the Member States (Title II);

b. Second chance for entrepreneurs, putting in place minimum provisions on discharge for entrepreneurs (Title III);

c. A series of ancillary measures to raise the efficiency of restructuring, insolvency and second chance across Member States (Title IV).

Title III imposes a maximum period of three years within which entrepreneurs should be fully discharged from their debts, save for in the exceptional circumstances set out at Article 22, which include the entrepreneur acting dishonestly or in bad faith, or for failing to adhere to a repayment plan. Member States are conferred a discretion by Article 1(3) to apply the above discharge period to other natural persons in addition to entrepreneurs should they wish to.

The focus of this article, however, will be on the provisions of Title II, and the ancillary provisions bolstering the proposed restructuring framework under Title IV.

Policy rationale

The key elements of the restructuring framework set out in Title II of the Proposed Directive are intended to enhance rescue culture in the EU.[2] A strong rescue

Notes

1 Certain important provisions of the Revised SCA have not yet entered into force at the time of writing.
2 Page 6 of the explanatory memorandum to the Proposed Directive (the 'Explanatory Memorandum').

culture helps businesses that are still viable to continue operating and to continue paying their debts, while channelling enterprises with no chance of survival towards swift liquidation. The statistics appear to support this approach. Recovery rates generally tend to be higher in economies where restructuring is the most common insolvency proceeding.[3]

The need to increase recovery rates for creditors across the EU has been evident in the wake of the economic crisis. In particular, non-performing loans remain a major issue faced by banks across the EU, as the Explanatory Memorandum repeatedly acknowledges.[4] The ECB has calculated that there are €980 billion worth of non-performing exposures on the balance sheets of banks across the EU. In some Member States, like Italy, the issue of non-performing loans has threatened to become a systemic issue for the banking sector. More generally, non-performing loans negatively affect banks' capacities to finance the real economy across the EU.[5] Improving the prevalence of rescues of struggling but viable debtors, and the effectiveness of restructuring regimes across the Member States has been identified as one way to combat this problem.

Restructuring models

The restructuring framework envisioned by the Proposed Directive draws inspiration from two principal models: the scheme of arrangement jurisdiction under Part 26 of the English Companies Act 2006 ('CA 2006'), and Chapter 11 of the U.S. Bankruptcy Code ('Chapter 11').

The influence of Part 26 CA 2006 on the Proposed Directive is most discernible in respect of the composition of classes voting on a restructuring plan, and the effect of such a plan once it has been confirmed:

a. First, the test for class formation under Article 9(2) of the Proposed Directive is similar to the approach developed by the English court,[6] with national courts having to consider whether each class 'comprises claims or interests with rights that are sufficiently similar to justify considering the members of a class a homogenous group with commonality of interest'. As with an English scheme, each voting class must approve the restructuring plan (subject to the cross-class cram-down exception discussed below), though Member States have been left with a discretion to fix the requisite majority in value, provided it does not exceed 75%. Unlike the position in England, there would appear to be no additional requirement under the Proposed Directive that a majority in *number* of creditors approve the plan.[7]

b. Second, like schemes under the CA 2006 but unlike Chapter 11, a restructuring plan under the Proposed Directive need not affect all of a debtor's creditors: only those involved in its adoption are bound by it,[8] though the identities of all non-affected parties are required to be submitted as part of the plan.[9]

The influence of Chapter 11 on the Proposed Directive, as discussed in further detail below, is most evident at the stage involving judicial confirmation of the restructuring plan, in particular, as regards the national court's power to 'cram-down' a plan despite the dissent of an affected class.

By taking elements from both the debtor-friendly Chapter 11 and the more creditor-friendly Part 26 CA 2006, the Proposed Directive is not doing something entirely novel. Schemes of arrangement under Part VII of the Revised SCA, despite being heavily based on the English scheme of arrangement jurisdiction, have now been modified by the Companies (Amendment) Act 2017 so as to incorporate Chapter 11 concepts like cross-class cram-downs, as well as 'super-priority' for rescue funding.

Preventive restructuring framework: Title II

Below, the key elements of the common restructuring framework envisaged under the Proposed Directive are considered in turn.

(1) Stay of enforcement action

Under Article 6 of the Proposed Directive, Member States are required to introduce a stay of individual enforcement actions against a debtor 'if and to the extent such a stay is necessary to support the negotiations of a restructuring plan.' The envisaged stay would be broad. It would apply to both secured and preferential creditors,[10] and prevent the opening of insolvency

Notes

3 World Bank data suggests that in economies where restructuring is most prevalent, creditors can expect to recover 83% of their claims, against an average of 57% where liquidation procedures prevail: page 3 of the Explanatory Memorandum.
4 Pages 3, 5, 8, 12, 13 and 18 of the Explanatory Memorandum, and Recital 2 of the Proposed Directive.
5 Page 5 of the Explanatory Memorandum.
6 See *Re Hawk Insurance* [2001] 2 BCLC 480 at [26].
7 See s. 899(1) CA 2006.
8 Article 14(2) of the Proposed Directive.
9 Article 8(1)(e) of the Proposed Directive.
10 Article 6(2) of the Proposed Directive.

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procedures in respect of the debtor.[11] The initial time limit for the stay would be no more than 4 months, with the possibility of extensions and renewals leading to a total duration of 12 months, provided certain requirements are met.

The stay is subject to the relevant judicial or administrative authority's discretion to lift it if creditors with a blocking vote do not support the continuation of the negotiations over the restructuring plan.[12]

Article 6 of the Proposed Directive only requires a stay to be made available by the national court on application. Singapore has gone further with regard to the statutory stay in support of schemes of arrangement under the Revised SCA. Under s. 211B(8) thereunder, there is now an automatic stay which takes effect upon an application for a scheme of arrangement being made under s. 211B(1), as well as an option to apply for a stay in advance of such an application being made. Further, the Singaporean stay is capable of (i) being extended to subsidiaries of the corporate debtor (s. 211C), and (ii) being expressly made by the court so as to have extraterritorial effect and apply to the acts of any person within the court's *in personam* jurisdiction (s. 211B(5)).

In England there is no statutory provision expressly supporting a moratorium pending consideration of a scheme of arrangement. However, a debtor embroiled in litigation may nevertheless seek to rely on the English court's general powers of case management under CPR r. 3.1 to stay a particular action, where it is able to demonstrate that it wishes to propose a scheme of arrangement which has a reasonable prospect of going ahead.[13] The Consultation suggested that there ought to be a statutory moratorium available pre-insolvency, and that it should be no longer than *three* months. The majority of respondents agreed.[14]

(2) Cross-class cram-downs

Under Article 11 of the Proposed Directive, even where a restructuring plan does not receive the requisite majority of each and every class voting on the plan, the plan may still be confirmed by a judicial or administrative authority.[15] In order to effect a cross-class cram-down a number of requirements must first be met. These requirements are intended as protection for the dissentient class or classes. In particular, in order to approve a cross-class cram-down the restructuring plan must:

a. Comply with the absolute priority rule, namely, that a dissenting class of creditors must be satisfied in full before a more junior class can receive any distribution or keep any interest under the restructuring plan;

b. Meet the 'best interest of creditors' test. That test requires no dissenting creditor to be worse off under the restructuring than they would be in the event of liquidation whether piecemeal or sale as a going concern;

c. Be approved by at least one affected class, though Member States may specify that a higher number of affected classes are required to approve a plan; and

d. Be accompanied by expert evidence to enable the court to determine the debtor's enterprise value on the basis of the value of the enterprise as a going concern. The Proposed Directive envisages evidence being provided by qualified experts.[16]

The influence of Chapter 11 on Article 11 of the Proposed Directive is clear. The various safeguards in respect of cross-class cram-down appear to be taken wholesale from the U.S. legislation. More particularly, the best interest of creditors test, the absolute priority rule, and the requirement that at least one affected class approve the plan, all appear to be drawn from Chapter 11.[17]

The danger of the European Commission's heavy reliance on the U.S. model is that the Proposed Directive might import some of the downsides of the Chapter 11 regime, in particular, its high costs. Under the Proposed Directive, costs would need to be incurred in the provision of expert evidence on the corporate debtor's enterprise value or liquidation value, and in relation to the question of a plan's compliance with the best interest of creditors test.

At present, there is no statutory cram-down provision in the UK. In order to achieve a similar effect to a cross-class cram-down in the UK, one has to resort to the use of a scheme and an administration *in tandem*.[18] The majority of respondents to the Consultation considered that the inclusion of such a mechanism represented a positive development.[19] In Singapore, the power to approve a cross-class cram-down has been

Notes

11 Article 7(2) of the Proposed Directive.
12 Article 7(8)(a) of the Proposed Directive.
13 *BlueCrest Mercantile BV v Vietnam Shipbuilding Industry Group* [2013] EWHC 1146 (Comm).
14 67% of the respondents: para 2.1 of the Response to the Consultation.
15 Article 9(6) of the Proposed Directive.
16 Article 13(3) of the Proposed Directive.
17 See Philip Wood, *Principles of International Insolvency* (2nd ed.) paras 23-103 to 23-108 for a summary of Chapter 11.
18 Para 9.9 of the Consultation.
19 61% were in favour: para 4.5 of the Response to the Consultation.

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embraced under what is now s. 211H of the Revised SCA.

(3) Rescue funding

Chapter 4 of the Proposed Directive would introduce certain protections for new and interim finance. Article 16(1) provides that 'new and interim financing shall not be declared void, voidable or unenforceable as an act detrimental to the general body of creditors in the context of subsequent insolvency procedures, unless such transactions have been carried out fraudulently or in bad faith.' A similar carve-out from avoidance actions is conferred by Article 17 on transactions carried out to further negotiations of a restructuring plan. Further, pursuant to Article 16(2), Member States may ensure that new or interim financing receives payment in priority to other creditors who would otherwise have superior or equal claims.

Chapter 4 of the Proposed Directive is designed to foster the primary objective of favouring a rescue culture by creating legal certainty in relation to rescue funding across Member States. Again, Chapter 11 is the inspiration. Super-priority rescue funding has now also been adopted in Singapore under the Revised SCA.[20]

A number of issues are raised by the rescue funding provisions under the Proposed Directive.

First, despite the Proposed Directive expressly stating that it does not seek to 'harmonise core aspects of insolvency such as rules on conditions for opening insolvency proceedings, a common definition of insolvency, ranking of claims and avoidance actions broadly speaking,'[21] it does veer into that territory in Chapter 4. In England, it has been repeatedly said by high judicial authority that the conditions for avoidance of antecedent transactions and the ranking of claims in a liquidation differ from country to country because these reflect matters of national public policy.[22] By creating a compulsory carve-out from avoidance actions for rescue funding and transactions related to restructuring negotiations, and by encouraging super-priority status to be accorded to such funding,[23] the Proposed Directive encroaches directly into areas normally reserved to national legislatures.

In this connection, it should be noted that in England the majority of respondents to the Consultation disagreed with the introduction of super-priority funding provisions,[24] with some replying that lack of rescue finance rarely prevents business rescue given that, if a business truly remains viable, there is rarely a shortage of such finance.

Second, there is a possibility that the statutory protection of new and interim lending may well have broader, undesired economic effects. In particular, one concern is that such an innovation may lead to the costs of borrowing for businesses in Member States which decide to adopt the super-priority proposal increasing to reflect the increased risk borne by ordinary lenders, who might find themselves leap-frogged by a super-priority lender in an eventual insolvent distribution.

Ancillary provisions: Title IV

With a view to supporting the efficiency of restructuring, insolvency and second chance, Title IV of the Proposed Directive sets out fairly broad guidelines relating to:

a. The appropriate level of judicial training with regard to restructuring, insolvency and second chance;

b. The appropriate training of insolvency practitioners to ensure that their services are provided effectively, impartially, independently and competently;

c. The development and adherence to voluntary codes of conduct by insolvency practitioners; and

d. Appropriate oversight and regulatory structures over insolvency practitioners.

It is likely that the reforms under Title IV will be critical to the overall success of the Proposed Directive. The Proposed Directive places the onus on national courts in relation to issues like the determination of a corporate debtor's enterprise value. It also envisages the involvement of insolvency practitioners in certain specific situations.[25] Closing the gap between restructuring frameworks across the EU will not merely depend on having statutory provisions in place across Member States with common core elements, but ensuring that the quality of legal professionals and insolvency practitioners is brought up to scratch.

This is an ambitious project. The Proposed Directive's timetable for implementation recognises that Title IV will be the most difficult to conform to: Member States have been given 2 years from the Proposed Directive's

Notes

20 Section 211E of the Revised SCA.
21 Page 6 of the Explanatory Memorandum.
22 *Rubin v Eurofinance SA* [2012] UKSC 46 at [15].
23 See Recital 31 to the Proposed Directive.
24 73% disagreed with the super-priority proposals: para 5.2 of the Response to the Consultation.
25 See Article 5(3) of the Proposed Directive.

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entry into force to comply with all other titles, but 3 years to comply with Title IV.[26]

Difficulties

We have already mentioned certain issues arising under Title II and Title IV of the Proposed Directive, including the potential costs implications for restructuring plans by virtue of having chosen a model strongly influenced by Chapter 11, the issues posed by imposing a carve-out relating to rescue funding from avoidance actions, and the sweeping nature of the ancillary provisions under Title IV.

Some further difficulties are also apparent. Perhaps one of the most significant concerns is the Proposed Directive's silence on recognition and enforcement of a restructuring plan confirmed in one Member State in other Member States. It is far from clear that a restructuring plan under national legislation implementing the Proposed Directive would fall to be enforced under the relevant provisions of the Recast EU Insolvency Regulation (2015/848) (the 'Recast Regulation'). A restructuring plan binding on certain affected classes might well not be considered 'public collective proceedings' within the meaning of Article 1 of the Recast Regulation. It remains to be seen, therefore, whether a restructuring plan would fall to be enforced as a judgment under the Recast EU Judgments Regulation (No. 1215/2012) (the 'Judgments Regulation').

By way of illustration of this difficulty, one can take the example of the English scheme of arrangement. Absent Brexit, schemes would have been one of the procedures the UK government would have relied on for the purpose of complying with the Proposed Directive. Yet schemes of arrangement are not included as 'insolvency proceedings' for the purpose of the Recast Insolvency Regulation.[27] There is an open question in the English jurisprudence as to whether schemes fall under the Judgments Regulation.[28] The concern would be that restructuring plans arising from national legislation transposing the Proposed Directive would occupy a similar lacuna to schemes of arrangement when it comes to recognition and enforcement across the EU. This would be an undesirable outcome for a proposal aiming to bolster legal certainty in this field across Member States.

There are additional issues with the broad and at times ambiguous wording of certain provisions of the Proposed Directive. What the 'early warning tools' for the purpose of detecting deteriorating business development would consist of under Article 3 is left entirely vague. The definition of an 'over-indebted entrepreneur' as 'a natural person exercising a trade, business, craft or profession, who is otherwise than temporarily unable to pay debts as they fall due' is likely to be difficult to deploy in practice and to result in litigation over the scope of the concept. A final ambiguity lies in the directors' duties under Article 18 of the Proposed Directive, which would require directors 'to take reasonable steps to avoid insolvency' and 'to avoid deliberate or grossly negligent conduct that threatens the viability of the business.' The ambit of both of these duties may well prove difficult to establish in practice.

Effect on the UK

Taking into account the timetable for Brexit and the remaining legislative steps still to be completed in respect of the Proposed Directive, it is unlikely that the UK will ever be required to implement the Proposed Directive.

Member States have 2 years from the date of entry into force of the Proposed Directive to implement it, save for the more wide-ranging provisions of Title IV, for which a 3-year deadline is prescribed. There are numerous steps before the Proposed Directive even comes into force, including discussions between the European Parliament and the Council of the EU, before publication in the Official Journal of the EU. If and when the Proposed Directive is published in the Official Journal thus starting the 2-year countdown for compliance, it is unlikely that this deadline will elapse prior to the UK's scheduled exit from the EU on 29 March 2019 (assuming time for negotiations is not unanimously extended by the EU's Member States).

The remaining question concerns the more indirect pressure the Proposed Directive will eventually bring to bear on the UK government to update restructuring frameworks so that this jurisdiction can remain one of choice for European corporate debtors seeking to restructure their debts. Many debtors incorporated elsewhere in the EU have chosen England in the recent past to carry out restructurings.[29] Whether the UK remains an attractive jurisdiction post-Brexit and following the implementation of the Proposed Directive is difficult to say. From the EU perspective, much will likely depend not only on the substantive provisions of the restructuring frameworks put into place across Member States but also on Member States' ability to have those frameworks supported by efficient and effective judiciaries and insolvency professionals. From the

Notes

26 Article 34 of the Proposed Directive.
27 See Annex A to the Recast Insolvency Regulation.
28 See, for example, *In re Van Gansewinkel Groep BV* [2015] EWHC 2151 (Ch).
29 Where English law governed the debt (for example, *Re Global Garden Products Italy S.p.A.* [2016] EWHC 1884 (Ch)) or where the company effected a COMI shift to England (for example, *Re Magyar Telecom BV* Chancery Division [2013] EWHC 3800 (Ch)).

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UK perspective, there will be a real question as to the recognition and enforcement of schemes of arrangement, especially of non-English law governed debts, if and when the Judgments Regulation ceases to apply.

At the very least, for the UK to keep abreast with the fast-moving developments in this area internationally both in Europe and in Asia, the UK government will have to think seriously about adopting some of the proposals under the Consultation that have been well received by the profession, such as a mechanism to enable a dissentient class to be crammed-down in appropriate circumstances, or a statutory moratorium. The UK risks being left as the odd one out now that Singapore has followed Chapter 11 in embracing these debtor-friendly concepts, and the EU appears poised to follow.

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The Joint Administrators of Lehman Brothers Limited (Appellant) v Lehman Brothers International (Europe) (In Administration) and others (Respondents) [2017] UKSC 38

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Lehman Brothers International (Europe) ('LBIE') was the UK subsidiary of Lehman Brothers Holdings Inc., the fourth largest investment bank in the United States, which filed for Chapter 11 bankruptcy protection on 15 September 2008. LBIE's shares were held by two other group companies: LB Holdings Intermediate 2 Ltd ('LBHI2') and Lehman Brothers Ltd ('LBL'). Following the US parent's collapse, LBIE and LBL were put into administration, also on 15 September 2008. LBHI2's administration followed in January 2009.

However, the English bank had never been balance sheet insolvent. Accordingly, the administrators of LBIE eventually found themselves charged with a surplus of around £7 billion – a highly unusual situation.

Law regarding distributions by administrators of course exists. Part 2 of the Insolvency Rules 1986 (the '1986 Rules') contained a number of provisions regarding distributions by administrators. In *In re Nortel GmbH* [2014] AC 209, [39] Lord Neuberger summarized the payment waterfall in a liquidation or distributing administration as follows:

> 'In a liquidation of a company and in an administration (where there is no question of trying to save the company or its business), the effect of insolvency legislation ... as interpreted and extended by the courts, is that the order of priority for payment out of the company's assets is, in summary terms, 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.'

This excess of funds available for distribution in LBIE's administration generated argument over novel legal points concerning precisely how the surplus should be dealt with. The Waterfall litigation is the result of applications by the administrators of LBIE (the 'Administrators') to the court for guidance as to the correct interpretation of the rules governing the distribution of the surplus.

The first of three such applications, which came to be known as Waterfall I, concerned the order of payment of certain non-provable claims and ancillary issues regarding these claims. This application was dealt with by David Richards J at first instance, but aspects of his judgment were considered by the Court of Appeal (Moore-Bick, Lewison and Briggs LJJ), which upheld most but varied some of David Richards J's findings, and then by the Supreme Court.

This case digest covers the Supreme Court's findings on those issues, which are as follows:

(1) The ranking of LBHI2's claim as holder of subordinated loans –
  (a) Was it subordinate to statutory interest?
  (b) Was it subordinate to non-provable liabilities?
(2) Currency conversion claims
(3) If statutory interest was not paid during an administration could it be claimed in a subsequent liquidation?
(4) Could LBIE seek contributions from members under s.74(1) for statutory interest and non-provable liabilities?
(5) Could LBIE prove in the administrations of its members for a potential contribution claim under s.150?
(6) Could the members' potential liabilities under s.150 as contributories be set off against their claims as subordinated creditors?
(7) Could LBIE rely on the contributory rule to resist paying the members on their proofs until they met their liabilities as contributories?

Lord Neuberger gave the leading judgment. Lords Kerr and Reed agreed with him. Lord Sumption also agreed with him (see at [188]) but added his own judgment on the issue of currency conversion claims. Lord Clarke agreed with him on every issue, other than that of currency conversion claims: [202].

Issue 1: The ranking of LBHI2's claim as holder of subordinated loans – (a) Was it subordinate to statutory interest? (b) Was it subordinate to non-provable liabilities? Lord Neuberger (Lords Clarke, Kerr, Reed and Sumption agreeing): [37]-[67]

LBHI2 had made three loans to LBIE which were expressed in the loan documentation to be subordinated in an insolvency situation to 'all present and future sums, liabilities and obligations payable or owing by [LBIE] (whether actual or contingent, jointly or severally or otherwise howsoever)'. The loan documents also provided that LBHI2 would have no remedy against LBIE other than that provided in those documents.

The documents also contained a provision regarding when LBIE would be regarded as insolvent: its solvency was to be assessed with regard to its liabilities, disregarding those which were not 'payable or capable of being established or determined in [its] insolvency.'

David Richards J and the CA held that these debts were provable, but subordinated to other provable debts, statutory interest and non-provable liabilities. However, David Richards J had held that LBHI2 was not entitled to prove until all other proving creditors had been paid in full, and here the CA disagreed.

Before the SC the LBHI2 administrators argued that the courts below were wrong to hold that the subordinated debt ranked behind statutory interest or non-provable liabilities, and that it was subordinate only to other provable debts. The LBIE administrators argued that the original finding of David Richards J was correct.

The LBHI2 administrators' contention was that non-provable liabilities, although they were liabilities in the meaning of the loan documents, were not 'payable or capable of being established or determined in the insolvency' of LBIE, as the loan document, and were accordingly expressly said to be disregarded when establishing whether or not LBIE as solvent. They argued that this meant that their existence did not prevent the repayment of the subordinated debt, since the restriction on its repayment applied only to a distribution in the course of LBIE's insolvency.

They further argued that statutory interest is not one of the liabilities defined in the relevant part of the contract, due to its being payable under r. 2.88(7). They also argued that if they were wrong about this the subordinated debt was not subordinate to statutory interest for the same reason as in respect of non-provable liabilities.

The Supreme Court rejected both of these arguments as a matter of contractual construction. It did note that the payment of non-provable liabilities is expressed to be an obligation on the office-holders rather than on the Company, which might seem to go in favour of the LBHI2 Administrators' first point. However, this is also true of provable liabilities, and these liabilities clearly did constitute Liabilities in the meaning of the contracts.

An office-holder making a payment of a non-provable liability was making this 'in the Insolvency' regardless of the fact that there is no reference to non-provable liabilities in the statutory framework.

As for the argument regarding statutory interest, because this is only ever payable in an insolvency process, the Court could not see how it could be said not to be payable 'in the Insolvency.'

Additionally, there was no commercial reason for the contracts to be construed otherwise, and a reasonable reader would construe them as the SC suggested.

Issue 2: Currency conversion claims: Lord Neuberger (Lords Kerr, Reed and Sumption agreeing): [73]-[112]; Lord Sumption: [189]-[201]; Lord Clarke (dissenting): [202]-[222]

Some of LBIE's creditors held debts denominated in foreign currencies. Rule 2.86 of the 1986 Rules stipulates that such debts are converted to sterling for the purpose of a distribution as at the date of the commencement of the insolvency process. However, movements in exchange rates meant that some debts were worth far more if they were converted as at the date of distribution than as at the date of LBIEs entry into administration. Both David Richards J and a majority in the Court of Appeal had held that creditors in this situation could had a 'currency conversion claim' for the increase in the sterling value of their debt, and that this claim was a non-provable debt.

Because if it failed on Issue 1 (as it did), LBHI2's subordinate debts would fall to be paid after any such currency conversion claims had been paid, LBHI2 challenged the findings of the lower courts, and the existence of currency conversion claims. Another creditor, CVI, argued in favour of currency conversion claims.

LBHI2 had two main arguments on this issue.

Firstly, it argued that r. 2.86 obliges creditors to prove for their foreign currency debts in sterling, and that payment of the debt converted in accordance with the rule extinguishes the liability, so that the creditor can have no further claim in respect of later currency fluctuations.

Secondly it argued that in general, payment of a proved debt extinguishes the liability.

Here, the Supreme Court (Lord Clarke dissenting) agreed with LBHI2. The Justices (Lord Clarke dissenting) accepted LBHI2's first argument – that r. 2.86 sets out in full the rights of creditors in respect of provable debts denominated in a foreign currency.

At [194] Lord Sumption made some remarks on this point which may have a more general application to the application of the Insolvency Rules 1986 and 2016 in future:

> 'It is axiomatic that where the Insolvency Rules deal expressly with some matter in one way, it is not open to the courts to deal with it in a different

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and inconsistent way. The recoverability of non-provable debts out of a surplus means that that the statutory rules for recovering a dividend on provable debts cannot be regarded as a complete code of the creditor's rights of recovery. But rules 2.86 and 4.91 must be regarded as a complete code for the specific case of foreign currency debts. Non-provable debts are normally debts for which no provision is made in the statutory mechanism of proof and distribution. But the Insolvency Rules do provide for foreign currency debts. Rules 2.86 and 4.91 provide that they are to be valued at the cut-off date and that distributions are to be made in accordance with that valuation. The limitations of these provisions are as much part of the statutory scheme as their positive enactments. It follows that if a debt is provable but the limited character of these provisions nonetheless leaves part of it unsatisfied, the creditor cannot recover more in respect of the same debt by reference to the judge-made rules governing non-provable debts. A foreign currency debt is a provable debt.'

Lord Neuberger (Lords Kerr, Reed and Sumption agreeing) also accepted LBHI2's narrower basis – payment in full of a proved debt satisfies the underlying contractual liability. Lord Sumption and Lord Clarke disagreed here. Both Lord Sumption and Lord Clarke pointed to the decision of the House of Lords in *Miliangos v George Frank (Textiles) Ltd* [1976] AC 443, where it was held that a debt contractually payable in a foreign currency must be discharged in that currency. It follows, as Lord Sumption put it, that '[a]s a matter of contract, the only sterling sum which will satisfy the obligation is the sterling equivalent of the debt at the time of payment' [189].

Lord Clarke pointed to the majority judgments of Briggs and Moore-Bick LJJ in the Court of Appeal on this issue, which pointed out that nothing in the 1986 Act or Rules prevent a foreign currency creditor from reverting to his contractual rights after proving, if there is a surplus.

Issue 3: If statutory interest was not paid during an administration could it be claimed in a subsequent liquidation? Lord Neuberger (Lords Clarke, Kerr, Reed and Sumption agreeing): [113]-[128]

This issue concerned whether a creditor which had been entitled to statutory interest under r. 2.88(7) of the 1986 Rules in LBIE's administration, but which had not proved for this, could claim this in the subsequent liquidation.

Rule 2.88(7) provides that creditors may claim interest accrued *after* the date of administration, at the rate specified in r. 2.88(9), out of any surplus after the creditors have proved. David Richards J had held that any such claim was not enforceable in an administration. The Court of Appeal, by contrast, held that the surplus held by the administrators was charged with the obligation under r. 2.88(7) and that this charge survived the entry into liquidation.

Lord Neuberger (Lords Kerr and Reed agreeing) took the view that this scenario had not been envisaged under the statutory regime, and although this was regrettable, it was not for judges to fill the gaps left by statute.

He therefore agreed with David Richards J that such claims of statutory interest which would have been due in the administration but which were not payable in a subsequent liquidation.

Lord Neuberger went further than David Richards J, as he held that contractual entitlement to interest was also extinguished in these circumstances. David Richards J had thought this entitlement was not extinguished by r. 2.88(1), which provides that creditors may only prove for contractual interest up to the date of the administration, so that contractual interest was still due, as a non-provable liability.

However, Lord Neuberger held that together, r. 2.88, r. 4.93 and 2.189 of the 1986 Rules constituted a complete code for the recovery of interest on proved debts, and therefore contractual interest was no longer recoverable.

Issue 4: Could LBIE seek contributions from members under s.74(1) for statutory interest and non-provable liabilities? Lord Neuberger (Lords Clarke, Kerr, Reed and Sumption agreeing): [135]-[148]

Issues 4 to 7 all deal with LBIE's status as an *unlimited* company.

Section 74 of the 1986 Act provides that members of an unlimited company may be called upon to make contributions to meet its liabilities in a liquidation.

Issue 4 dealt with whether s. 74 made members liable for statutory interest and non-provable liabilities.

Lord Neuberger had little difficultly finding that non-provable liabilities were 'liabilities' in the meaning of s. 74, the section referring to liabilities of the company rather than of the liquidator, and therefore that members were indeed liable to meet them under the section.

David Richards J and the CA had held that members were liable for statutory interest under s. 74. However, Lord Neuberger held that this could not be, since by r. 2.88(7), statutory interest was only ever payable out of a 'surplus remaining after payment of the debts proved'. If there is a deficit, there is no liability for statutory interest, and if there is a surplus, there is only a liability for statutory interest to the extent of the surplus. In the absence of such a surplus there is no liability to pay statutory interest, and so no liability which the contributories may be called upon to meet.

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Issue 5: Could LBIE prove in the administrations of its members for a potential contribution claim under s.150? Lord Neuberger (Lords Clarke, Kerr, Reed and Sumption agreeing): [149]-[165]

Issues 5-7 all stem from the fact that LBHI2 and LBL were both creditors and members of LBIE.

Section 150 of the 1986 Act provides that any time after a winding up order is made members may be called upon to pay 'of any money which the court considers necessary to satisfy the company's debts and liabilities, and the expenses of winding up' and the court may adjust the rights of contributionaries among themselves. In this case, the court would exercise its power under s. 74 to have them make a contribution.

Issue 5 was whether as creditors of LBIE, LBHI2 and LBL could prove in the administration for such contributions that they might be called on to make as members under s. 150.

Lord Neuberger held that although contributories could prove in a *liquidation* for s. 150 liabilities, they could not do so in an administration. The right to make calls on contributories under s. 150 only arises when the company is in liquidation. Furthermore, any money paid pursuant to a call made under s. 150 is not paid to the company but to the liquidator.

Where the company is seeking to prove possible future call is not in liquidations, there is not only no extant debt but also no existing creditor, just a potential future liquidator.

Issue 6: Could the members' potential liabilities under s.150 as contributories be set off against their claims as subordinated creditors? Lord Neuberger (Lords Clarke, Kerr, Reed and Sumption agreeing): [166]-[171]

Issue 6 was whether, if LBIE could not so prove, it could exercise a right of set-off. Lord Neuberger held that they could not – for the same reasons he gave for his findings in Issue 5.

Issue 7: Could LBIE rely on the contributory rule to resist paying the members on their proofs until they met their liabilities as contributories? Lord Neuberger (Lords Clarke, Kerr, Reed and Sumption agreeing): [172]-[187]

Issue 7 was whether, if LBIE could not exercise such a right of set-off, it could rely on the 'contributory rule' which states that a creditor in a liquidation may not recover until his liability as a contributory has been discharged.

Here Lord Neuberger reversed the findings of both David Richards J and the Court of Appeal and held that this rule should also apply to distributing administrations

He noted that the extension of this rule might seem at odds with the conception of the 1986 Act and Rules as a 'complete code' for rights of creditors in insolvency, which is not to be supplemented by judge-made rules.

However, the 'code' does not oust previously existing judge-made rules, and the application of the contributory rule here could not, he said, be regarded as the creation of a new rule, but simply the extension of a previously existing one to an analogous situation.

The extension of the rule did not conflict with the statutory regime – provisions that were said to conflict with it had their equivalents in a liquidation where the contributory rule undoubtedly applied.

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