Briefing

Corporate Turnaround and Insolvency

BURGES SALMON

Administrations update – the contributory rule and set-off of competing claims

This update focusses on the recent Supreme Court decision in *Re Lehman Brothers International (Europe)* concerning the application of the "contributory rule" in administration and the admissibility and set-off of contingent claims in administration

Lehmans and the contributory rule

The Supreme Court decision in *Re Lehman Brothers International (Europe) (In Administration) (14/03/2014)* draws out several issues of interest surrounding the "contributories rule", which (in liquidation) means that a contributory of a company (such as a shareholder who has not fully paid up his share capital) cannot recover any claims he might have as a creditor of a company until he has paid his contribution in full.

The facts

This case concerned the claims of two Lehmans entities - both members of Lehman Brothers International (Europe) **(LBIE)** - who had provided subordinated loans to LBIE. LBIE is an **unlimited** company, and the subordinated loans formed part of its regulatory capital structures.

The members (LBL and LBH) were concerned that the administrators of LBIE would place it into liquidation, with a view to making calls on LBL and LBH, despite the fact that it appeared that there would be a substantial surplus in the LBIE administration and that LBL and LBH had substantial claims against LBIE under the subordinated loans. In liquidation the "contributory rule" would apply, meaning that LBL and LBH would have to pay in full as unlimited members of LBIE before anything could be recovered under the subordinated loans.

The issues

LBH and LBL asked the court to determine (i) what claims could be made against the LBIE surplus before any return was made to LBL and LBH and the order in which those claims ranked, (ii) the entitlement of overseas creditors for loss caused by currency fluctuations after the date of administration (due to the fact that they had to convert their claims to Sterling at the date of LBIE's administration), (ii) whether interest accruing during the administration would be provable in a subsequent liquidation, and (iii) the link (if any) between LBH and LBL's liabilities as members of LBIE and their rights as creditors of LBIE.

What did the court decide?

(i) The court ruled that LBH 's claims under its subordinated loan agreements were subordinated not only to provable debts, but to statutory interest and unprovable liabilities, (ii) foreign creditors were entitled to prove against LBIE for loss caused by currency fluctuations between the commencement of administration of LBIE and the date of distribution, (iii) If administration was immediately followed by liquidation, any interest accrued since commencement of liquidation would not be a provable debt or statutory interest, but **would be** capable of being paid as a matter of contract as an unprovable claim out of any surplus; (iv) the liability of the members of unlimited companies was not simply to cover provable claims, but other unprovable claims and statutory interest on debts; (v) The contributory rule only applied in liquidation, not administration, as there was no power for administrators to make calls on contributories as there is for liquidators under Section 74(1). However the rule in *Cherry v Boultbee* equally did not apply, so that claims by LBL and LBH against LBIE could not be netted off against potential distributions due by LBIE back to its members. However importantly (vi) in a **distributing** administration or a liquidation, the contingent claims of LBIE against LBL and LBH as contributories would be the subject of mandatory insolvency set-off against LBH and LBL's claims as creditors of LBIE.

continued overleaf

What does this mean in practice?

The decision provides useful guidance on a number of issues which are becoming increasingly common in both insolvencies where members are creditors of the company, and where there has been international trade where foreign currency claims have to be converted to Sterling for the purposes of proving in the administration. Although it is unusual to have an administration where a surplus is available, many of the principles in this case will be of application in routine administrations and for this reason alone the decision is to be welcomed.

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