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CASE REVIEW SECTION

Burlington Loan Management and others v Lomas and others (as the joint administrators of Lehman Brothers International (Europe) (in administration)) [2017] EWCA Civ 1462

Madeleine Jones, Barrister, South Square, London, UK

Synopsis

The Court of Appeal has clarified a number of issues relating to the calculation of statutory interest under r. 2.88(7) of the Insolvency Rules 1986.

Introduction

On 24 October 2017, the Court of Appeal (Gloster LJ, Patten LJ and Lord Briggs JSC), handed down judgment in the appeal one tranche of the so-called Waterfall litigation, dealing with the proper distribution of funds in the solvent administration of Lehman Brothers International (Europe) ('LBIE').

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 Joint Administrators eventually found themselves charged with a surplus of around £7 billion. In this unprecedented situation, the Joint of Administrators applied to the Court for directions in relation to a number of matters relating to the distribution of the surplus to creditors.

The rules governing the distribution were largely contained in the Insolvency Rules 1986 (the '1986 Rules'), which have now been superseded by the Insolvency Rules 2016 (the '2016 Rules'). However, the 2016 Rules largely reorganized and restated the 1986 Rules, so the principles stated by the Court in this judgment remain relevant.

The Court of Appeal in this case were initially to consider appeals from each case in the second set of first instance hearings in the Waterfall litigation: Waterfall IIA, B and C. However, the issues from A and B largely fell away, and so the appeal dealt with questions on appeal from Waterfall IIC. These questions all related to the entitlement of creditors who, due to the surplus, were to receive the full principal amounts of their claims and to interest on these principal sums.

Creditors' entitlement to interest in an administration

The creditors' entitlement to interest on the amounts they claimed came from rule 2.88 in the 1986 Rules (this is now substantially reproduced at r. 14.23 in the 2016 Rules; ss. 189(2) and 328(4) of the Insolvency Act 1986 provide for the payment of interest on claims in windings up and bankruptcies, respectively).

So far as relevant, r. 2.88 of the 1986 Rules provided as follows:

> '(1) Where a debt proved in the administration bears interest, that interest is provable as part of the debt except in so far as it is payable in respect of any period after the company entered administration or, if the administration was immediately preceded by a winding up, any period after the date that the company went into liquidation.
>
> …
>
> (6) The rate of interest to be claimed under paragraphs (3) and (4) is the rate specified in section 17 of the Judgments Act 1838 on the date when the company entered administration.
>
> (7) 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 company entered administration.
>
> …
>
> (9) The rate of interest payable under paragraph (7) is whichever is the greater of the rate specified under paragraph (6) or the rate applicable to the debt apart from the administration.'

The Appeal dealt with a number of issues relating to the interpretation of these sub-rules.

Bower v Maris

The first issue concerned the calculation of interest awarded under r. 2.88(7). In *Bower v Marris* (1841) Cr & Ph 351 the Court of Chancery had held that, in circumstances where there was a surplus in a bankrupt's estate, dividends on a claim in the bankruptcy were to be applied *first* to the statutory interest due and thereafter to the principal amount claimed.

The Court of Appeal were asked to decide whether this rule applied in the instant administration, or whether the dividends should be applied to the principal sums claimed first.

At first instance, David Richards J had held that the dividends were to be applied to the principal sums first, that is, not in accordance with the rule in *Bower v Marris*, on the bases that allocation first to interest was incompatible with the statutory scheme for proof of debts and payment of statutory interest and that allocation first to principal better reflected both the language of r. 2.88(7) in its context and the recommendations of the Cork Committee.

Two of the appellants challenged this finding on the following bases: allocation to interest first is normal commercial conduct, it has historically been the approach of the courts in administrations, the *Bower v Marris* approach was applied in bankruptcies at least until the Bankruptcy Act 1883, *Bower v Marris* had been followed in cases concerning corporate insolvencies until 1986, the approach had not been abolished, either in the 1986 Rules, or in the *travaux préparatoires* preceding the 1986 insolvency legislation, attribution of dividends first to outstanding interest better ensures that contributories do not receive that which, apart from the insolvency, would have been paid to creditors, than the application of dividends to principal, *Bower v Marris* has been widely applied in other common law jurisdictions, and the judgment of the Supreme Court in *Waterfall I* (2017] 2 WLR 1497) affirmed the vitality of judge-made rules within the insolvency code, where compatible with the statutory scheme and necessary to do justice.

The Court rejected all these arguments, finding that David Richards J had been correct in his construction of r. 2.88(7), and that this rule, being clear, left no rule for the development of judge-made law. The Court found that the words of r. 2.88(7), alongside the provisions at rr. 2.88(8) and (9), provide 'a complete and clear code for the award of statutory interest on provable debts.' (at [26]). Rule 2.88(7) takes as its starting point the assumption that principal debts will already have been paid off, since there could be no surplus until they had been paid: 'The requirement that there should be a surplus out of which statutory interest is paid means that the aggregate of principal and pre-administration interest will for each creditor be a specific, known figure, ascertained during the course of the administration, prior to the calculation and payment of any statutory interest.' (at [27]).

Re-opening the question of the order of payment of principal and interest could lead to a scenario in which interest having been paid, there was not enough left to cover all the principal due (at [28]). This approach would also be incompatible with the rules at rr. 2.88(1) to (6) (ibid). The rule in *Bower v Marris* was developed to fill a lacuna, at a time when there was no express statutory provision for interest on proved debts (at [32]). None of the authorities showing the application of the rule had any application to the instant circumstances, where there was a clear statutory answer to the question of the application of dividends (at [34]). Although it was correct that the *Bower v Marris* approach made distribution to contributories rather than creditors less likely, a similar argument had failed to persuade the Supreme Court in *Waterfall I* that creditors were entitled to claim the value lost by creditors due to currency fluctuations between the date of the entry into administration and the date at which the claims were due to be satisfied (currency conversion claims) (at [36]).

Compounding under rule 2.88(9)

The second issue related to the compounding of interest. Where the rate under r. 2.88(9) is a compounding rate, does accrued statutory interest continue to compound following the payment in full of the principal amount by way of dividends? David Richards J had answered this question in the negative at first instance, and the Court of Appeal upheld this finding. Again, the first instance judge had treated this as a question of construction: in his view r. 2.88(9) made clear that statutory interest was only payable where the principal amount remained outstanding.

The Court of Appeal agreed with David Richards J. It said that the essence of compounding is that interest in arrears at the end of a particular period is added to the amount upon which interest is then payable in the subsequent period. The concept of arrears of interest arising after the payment of dividends sits uneasily with the basis for the payment of statutory interest, as expressed in rr.2.88(1) to (6). There is no room for the concept of interest, let along compound interests, being payable in respect of any period, after the payment of the final dividend.

Compensation for late payment of statutory interest

This ground of appeal concerned whether a creditor should be compensated for receiving interest sometime after a surplus arose in the administration, and therefore sometime after interest became payable under r. 2.88. Clearly, there is no express provision for

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such compensation in the rule; the appellants relied on a common law entitlement to such interest. David Richards J had rejected the existence of such an entitlement, on the basis that there was no stipulation in r. 2.88 as to *when* interest should be paid, so that the question a of a delay in payment did not arise, and that the rule makes no provision for the payment of interest on statutory interest due. In the absence of such a provision, he said, there was no jurisdiction to order interest, or any other monetary compensation for delay in payment, to be paid, because it could not be said that a duty to make payment by a certain time had been breached.

The Court of Appeal upheld David Richards J's ruling on this issue as well, for the same reasons. It was rightly submitted by the appellants that there is a common law entitlement to interest on a late paid debt. However, in this matter, there was no suggestion that the Administrators had behaved improperly by not paying creditors their dividends earlier. The basis for paying interest was therefore absent.

Interest on contingent debts

Contingent claims are provable in an administration and dividends payable upon them, even if the contingency has not occurred at the date of proof or the date of the dividend. However, it was unclear if interest is payable under r. 2.88 in respect of a period during which the debt remained contingent.

At first instance, David Richards J found that interest was payable on contingent claims, because distribution in an administration is made pari passu on the basis of proved debts, not the underlying claims, and interest is awarded in respect of proved debts too; some parts of r. 2.88 used the word 'debt' to refer to the underlying claim but the reference in r. 2.88(7) is to proved debts; this is consistent with the treatment of statutory interest on future debts and with the pari passu principle itself, which is applied as far as possible from a single date (in this case, the date of entry into administration).

The Appellant contended that where a contingency occurred late, the judge's interpretaton meant that interest would be paid in respect of a period when the debt was not in any ordinary sense interest bearing, and that this violated the pari passu principle.

However, the Court of Appeal upheld David Richards J's conclusion on this issue as well, again for the reasons given by him. The Court also noted that period during which statutory interest is payable is the same for all debts, including future and contingent ones. Debts which are still contingent at the date of the dividend are discounted. Under the appellant's proposed interpretation of r. 2.88(7), such debts would be both discounted and deprived of interest. The Court also considered that the view of the majority of the Supreme Court in Waterfall I, that the statutory process of proof entirely replaces and discharges the previous contractual liability, supported this conclusion.

Foreign judgment rates of interest

David Richards J held that here a creditor obtained a foreign judgment before the onset of the administration any interest rate applicable to that foreign judgment would fall within the phrase 'the rate applicable to the debt apart from the administration' in rule 2.88(9).

Could the 'rate applicable to the debt apart from the administration' in rule 2.88(9) include: (a) a foreign judgment rate of interest applicable to a foreign judgment obtained after the date of administration, or (b) a foreign judgment rate of interest which would have become applicable to the debt if the creditor had obtained a foreign judgment, when it did not in fact do so?

David Richards J had found that neither the rate at (a) or (b) was capable of falling under the sub-rule. The rate at (b) was rejected because the rule contemplated actual rather than hypothetical interest rates. Again, the Court of Appeal 'found it difficult to improve upon the judge's analysis' here.

The judge rejected the rate at (a) because pari passu distribution requires a universal cut-off date for claims, which precluded in his view the possibility that rates applied by judgments obtained after the cut-off date could be applied by statute. The Court of Appeal also agreed with this conclusion.

Contractual interest rate due only after close-out

The question of whether a contractual rate of interest applicable only after a close-out triggered by a creditor after the date of the administration is to be taken into account under rule 2.88(9) was treated both by Hildyard J in Waterfall IIC, who found that such contractual interest did fall under the rule.

The Appellants on this issue pointed out that Hildyard J's conclusion appeared to be incompatible with David Richards J's reasoning on the question of interest under post-cut-off date foreign judgments. Why should contractual interest arising upon the occurrence of an event after the cut-off date fall under the rule, when interest under foreign judgments obtained after the cut-off date did not?

However, the Court of Appeal held there was no tension between the two rulings, particularly in light of David Richards J's supplemental ruling in *LBI HF v Karen Denise Millen* [2016] EWHC 2132 (Ch) in which he found that where under a pre-existing contract, no interest was due on the date of administration but a rate (higher than the Judgments Act rate) was provided for on a later date, or the period between the date of administration and the contractual start-date for the

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payment of interest, the alternative rate under rule 2.88(9) was nil. Upon the contractual start date, the contractual rate applied. Then the two rates had to be combined to produce an overall average, which would be the rate payable under 2.88(7), if it exceeded the Judgments Act rate.

Given this, the correct approach to r. 2.88(9) is to examine what rights to interest existed as at the administration date – including rights to interest upon the occurrence of a given contingency or otherwise in the future. It is then necessary to apply these rates to the periods to which they would have applied if the administration had not occurred, and work out whether on average, they produce a rate for the whole period which exceeds the Judgments Act rate, for the purposes of r. 2.88(9).

This also means that 'Rule 2.88(9) constitutes a clear but limited departure from the emerging principle (fortified by the majority of the Supreme Court in *Waterfall I* [2017] 2 WLR 1497) that the process of proof of debt and dividend in insolvency, including administration, replaces and extinguishes creditors' previous contractual rights.' [77]

Thus, on this issue too, the Court of Appeal upheld the finding of David Richards J in *Waterfall IIB* and also of Hildyard J in *Waterfall IIC*.

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International Corporate Rescue

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