The pragmatic approach to insolvency (Re Lehman Brothers Europe Ltd (in administration))

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Restructuring & Insolvency analysis: Joe Bannister, John Tillman and Margaret Kemp of Hogan Lovells examine the Lehman Brothers Europe Limited (LBEL) case and suggest the decision illustrates the courts are willing to adopt a pragmatic approach in assisting insolvency practitioners who need to act quickly in circumstances where their proposed actions are not expressly addressed in the Insolvency Act 1986 (IA 1986).

Original news

Re Lehman Brothers Europe Ltd (in administration) [2017] All ER (D) 44 (Aug), [2017] EWHC 2031 (Ch)

In this important case, a proposal by joint administrators to appoint a director to a company already in administration (LBEL), in order to distribute surplus funds to its sole member (Lehman Brothers Holdings plc (LBH)), as opposed to a creditor, was held to be legally permissible, as well as pragmatic and beneficial.

What approach did the administrators take towards distributions to members?

The three main players in this decision are LBEL, its parent company, LBH, and an affiliated company, Lehman Brothers Limited (LBL), all in administration.

Having paid dividends to LBEL's unsecured creditors of 100 pence in the pound, the administrators of LBEL (the administrators) held a considerable surplus. However, they were unable to distribute that surplus, partly because of an unresolved claim that LBL had made against LBEL's estate. A settlement of the *Waterfall III* proceedings had been proposed. As part of that settlement LBL would withdraw its claim against LBEL and LBEL's proof of debt submitted in LBL's estate would be admitted in an agreed amount. That settlement would allow the administrators to proceed with the distribution of the surplus. Equally, the distribution of LBEL's surplus was a key feature of the proposed settlement.

The administrators wanted to distribute the surplus (including any amount received from LBL) to make the following payments, as set out in para [20] of the judgment:

- to pay statutory interest to LBEL's unsecured creditors
- to make a reserve for the administrators' costs and any additional matters in the administration, including tax, and
- to distribute to LBEL's sole shareholder, LBH, the remaining surplus (being, at least, an initial distribution in the short term and a final distribution to be made once the extent to which the reserve was required had been established)

The key issue

IA 1986 expressly allows administrators to make distributions to creditors. However, save where the company is to continue as a going concern post-administration (which was not the case for LBEL), IA 1986 only expressly provides two options for distributions to members, both of which involve the liquidation of the company prior to the distribution. The administrators considered that, for various reasons including tax and matters associated with the proposed settlement, the making of each of these distributions (including to LBH as sole shareholder) while LBEL was in administration rather than liquidation was the better route for LBEL's creditors.

A further hurdle for both the administrators and the court in this case was that Mr Justice Briggs (as he was at the time) had held in *Re Lehman Brothers Europe Limited* (unreported, 25 June 2012) that the statutory administration regime did not permit administrators to make distributions (at least directly) to a company's members.

The proposed solution

In what Hildyard J described as 'a pragmatic solution to a practical problem', the administrators applied to court for directions approving a solution which relied on a combination of provisions under IA 1986, Sch B1 and provisions under the Companies Act 2006 (CA 2006). The proposed steps (the proposal) were as follows:

- pursuant to IA 1986, Sch B1, para 61(b), the administrators would appoint a new director of LBEL

- to the extent necessary, the administrators would consent to the director and LBH as shareholder exercising relevant management powers under IA 1986, Sch B1, para 64
- once the *Waterfall III* settlement had taken effect (and once statutory interest had been paid or provided for and the necessary reserves allowed for), the director and LBH would effect a capital reduction for LBEL in accordance with CA 2006, Pt 17, and use the distributable reserve thereby created to make a distribution to LBH as shareholder, under CA 2006, Pt 23—all while the administration continued

The decision

As he himself confessed, the proposal clearly gave Hildyard J pause for thought. Ultimately, however, he granted the directions sought by the administrators, having considered the below questions.

Should a director of a company in administration be permitted to make a distribution to members?

As noted above, there is nothing in IA 1986 which expressly allows a distribution to be made to shareholders while a company is in administration. The question before Hildyard J was whether an approach which used a combination of IA 1986 and CA 2006 to circumvent the apparent gap in the insolvency legislation was permitted, or whether the court should treat IA 1986 as a complete code, and not seek to allow a course of action not already expressly contemplated by IA 1986.

Citing both Snowden J's decision in *Re Nortel Networks UK Ltd* [2017] EWHC 1429 (Ch), [2017] All ER (D) 94 (Jun) and Lord Neuberger's decision in *Waterfall I* (*Re Lehman Brothers International (Europe)* [2017] UKSC 38, [2017] All ER (D) 102 (May)) Hildyard J stated that

'…notwithstanding that IA 1986 is fashioned as a complete code it is not entirely exclusive and the courts do have jurisdiction to supplement the legislation in appropriate circumstances, and particularly in areas where there is an apparent gap which might be covered or plugged by recourse to other legislation which is not expressly ousted or confined'. (para [54]).

In his view, use of a combination of IA 1986 and CA 2006 to carry out the proposal was not prevented or curtailed by IA 1986, provided (at the very least) that the purpose of the administration was not frustrated or impeded.

Did the proposal have to be consistent with and further the purposes of the administration?

An administrator's functions have to be carried out with the objective of achieving the purpose of the administration. In Hildyard J's view, any action taken by the administrators to give effect to the proposal would be a performance of their functions as administrators of LBEL. It was therefore not sufficient that their actions did not conflict with the purpose of the administration—their actions had to be carried out with the positive objective of achieving the aim of the administration.

It was less clear whether a director whose actions were authorised by the administrators had to act in accordance with the purpose of the administration. IA 1986, Sch B1, para 64 provides that a director or shareholder of a company cannot exercise 'management powers' without the consent of the administrator. 'Management powers' are defined as those which could be exercised to interfere with the exercise of the administrators' powers. However, precisely what powers remain available to directors and shareholders of a company in administration has not been clarified either in legislation or case law. Are directors still able to use processes set out in CA 2006 when their company is in administration?

As the director (and LBH) would be exercising powers in a way which was calculated to further the purpose of the administration (because the proposed shareholder distribution was a key part of the proposed settlement which was itself of benefit to creditors), there was no need for Hildyard J to decide whether the powers to be exercised in this case were 'management powers' or whether they needed to be consistent with the purposes of the administration. However, he tended to the view that as management powers could only be exercised with the consent of the administrator, and the administrator could only grant consent where to do so would be in furtherance of the objectives of the administration, hence it followed that any exercise by the company or the directors of management powers would have to be consistent with the purpose of the administration.

Were the administrators restricted by the proposals which they had published at the outset?

Unsurprisingly, the original proposals made by the administrators in 2008 did not contemplate the return of a surplus to shareholders. IA 1986, Sch B1, para 65 requires an administrator to manage its affairs, business and property in accordance with the proposals. Hildyard J was satisfied that the proposal was in keeping with the 2008 proposals—it related to the exercise of the administrators' powers to achieve the purpose of the administration, and although the 2008

proposals talked about distributions to creditors and an exit through liquidation, both were expressed to be at the discretion of the administrators and did not preclude the administrators from following other options available to them.

Was there a statutory trust over assets in a distributing administration and if so did that affect the proposal?

The assets of a company in liquidation are held subject to a 'statutory trust'. There is no definitive authority as to whether assets in a distributing administration are subject to a similar statutory trust. While not deciding the point (as he was of the view that whatever trust might affect the assets of LBEL, it did not affect the exercise of management powers in relation to a surplus), Hildyard J commented that the distinctions between the position of a company in liquidation and a company in administration made the description 'statutory trust' inapposite to administrations.

How did the case conclude?

Hildyard J's obvious concern to avoid approving a course of action just because it was a pragmatic solution to a situation not provided for in IA 1986 follows the approach of the court in cases such as *Nortel* and *Waterfall 1*. As Hildyard J says in para [86]:

'…the fact that a proposed course is beneficial and pragmatic in the particular and rare and exceptional circumstances does not justify assuming or presuming, let alone exercising, power where none in law exists; and a fortiori if such power is prohibited. It is important also that the objectives of having a full and detailed code, and especially the objective of certainty for office-holders and creditors alike, should not be undermined by unwarranted judicial intervention and, indeed, invention.'

In the end, however, he concluded that the gap which allows administrators to make distributions to creditors but not shareholders was filled not by judicial intervention but by an ingenious combination of insolvency and company legislation.

Hildyard J drew additional comfort from the fact that the interested parties (including HMRC which was invited to oppose or comment on the proposals at the hearing but declined to do so, preferring instead to wait until after the decision was handed down), LBH, the director and the administrators all either supported the proposal or at least did not object to it.

Will the decision be of assistance in the future?

It is unlikely that many (perhaps any) future administrations will result in a surplus of the size that has been generated in the Lehman administrations. For that reason, the decision in this case is unlikely to be of frequent direct application. Nevertheless, the case is a useful illustration that, while being mindful of Lord Neuberger's stricture as to the need for legal certainty and to avoid unjustified judicial creativity outside the insolvency legislation, the courts are still willing to adopt a pragmatic approach in assisting insolvency practitioners who need to act quickly in circumstances where their proposed actions are not are not expressly addressed in IA 1986. The decision also provides a pertinent reminder for insolvency practitioners that they must carry out their functions as administrators with the aim of achieving the statutory purpose of the administration—merely avoiding conflict with that purpose is not sufficient.

Hogan Lovells acted for the administrators of Lehman Brothers Holdings PLC in this case.

Interviewed by Ioan Marc Jones.

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