RIGHTS OF FOREIGN CURRENCY CREDITORS IN ENGLISH INSOLVENCY PROCEEDINGS

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UK Restructuring and Insolvency Alert

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The 2008 collapse of the Lehman Brothers group ("the Group") continues to generate questions of English insolvency law of interest to the international business community. A recent judgment of the UK Supreme Court considered, amongst other issues, the rights of foreign (non-sterling) currency creditors in English insolvency proceedings. This Alert considers that issue and provides some takeaway points for you to consider in your dealings with English counterparties.

BACKGROUND

The appeals concerned the Group's main trading company in Europe, Lehman Brothers International (Europe) ("LBIE"), an unlimited company. LBIE appears to be able to repay its external creditors in full. Under the provisions of the English Insolvency Act 1986 as amended ("the 1986 Act"), an administrator of a company is permitted to make distributions to creditors. Since December 2009, LBIE has been in a distributing administration. The LBIE administrators declared and paid a first interim dividend to its unsecured creditors in November 2012. The LBIE administrators received proofs of debt from unsecured creditors.

A consolidated set of rules regarding English corporate insolvency is set out in the 1986 Act and the Insolvency Rules 1986 as amended ("the 1986 Rules") (together, "the 1986 legislation"). The 1986 Rules were replaced and amended by the 2016 Rules on 6 April 2017 but these events pre-dated that change. Schedule B1 to the 1986 Act contains provisions dealing with administration. Part 2 of the 1986 Rules is concerned with "Administration Procedure" and Chapter 10 of that Part, which includes Rules 2.68 to 2.105, deals with "Distributions to Creditors." The 1986 legislation does not constitute a complete insolvency code and certain established judge-made rules may continue to operate. In a distributing administration, as in a liquidation, the duty of the office holder is to gather in and realise the assets of the company and to use them to pay off the company's liabilities.

The issue which is the subject of this Alert arises from the fact that some of the proofs of debt submitted to LBIE's administrators were in respect of debts denominated in a foreign (non-sterling) currency. Under Rule 2.86, these would be paid at the rate of exchange prevailing at the date LBIE went in to administration, and, in some cases, sterling depreciated on the foreign exchange markets between that date and the date of payment. The foreign currency creditors claimed that they were entitled to receive any contractual shortfall as a non-provable claim.

JUDGMENT

Disagreeing with the first instance Judge and the majority of the Court of Appeal, the five person Supreme Court

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concluded (by a majority of four to one) that Insolvency Rule 2.86, which provides that unsecured debts payable in foreign currencies are to be converted in to sterling at the official rate on the administration date, spells out the full extent of a foreign currency creditor's rights. Therefore foreign currency creditors cannot claim as a non-provable debt the difference between the sterling value of the debt at the administration date and that at the date the debt was paid.

This is consistent with the conclusion reached in reports produced prior to the 1986 legislation. It is also supported by the fact that the contrary conclusion would lead to a one-way option in favour of the foreign currency creditors and that, in contrast to proofs for certain other debts, there is no provision in the 1986 Rules for their adjustment. It was dangerous to rely on judicial commentary regarding a previous and historic insolvency code. Lord Clarke was the dissenting judge on this issue.

On the wider issue whether the payment in full of a proved debt satisfies the underlying contractual debt, by a majority of three to two the Supreme Court inclined to the view that it is inconsistent with Chapter 10 of Part 2 of the 1986 Rules, and the natural meaning of Rule 2.72(1), that a debt met in full nonetheless has a component which is capable of resurrection. Lord Sumption was inclined to disagree on this issue and Lord Clarke agreed with him.

DETAILED CONSIDERATION

Lord Neuberger, the President of the Supreme Court, delivered the main judgement. Where sterling has depreciated relative to the relevant currency since the company went into administration or liquidation, a foreign currency creditor who is paid out on his proof will have received less at the time of payment than he would have been contractually entitled to receive. Accordingly, it was hard to disagree with the argument that, if it turns out that there is a surplus, it would be commercially unjust to distribute it to the members without first making good the shortfall suffered by the foreign currency creditor.

However, in a report that proceeded the 1986 legislation, the relevant committee explained that "a primary purpose of the winding up of an insolvent company [is] to ascertain the company's liabilities at a particular date" and "strongly recommend[ed] that any future Insolvency Act should expressly provide that the conversion of debts in foreign currencies should be effected as at the date of the commencement of the relevant insolvency proceedings". Importantly for present purposes, the report then stated that "we take the same view as the Law Commission (Working Paper No 80) that conversion as at that date should continue to apply, even if the debtor is subsequently found to be solvent", and adding that "[t]o apply a later conversion date only in the case where the exchange rate has moved to the advantage of the creditor, but (necessarily) not where it had moved against him, would, in our view, be discriminatory and unacceptable". The Law Commission is an independent body set up by the UK Parliament to keep the law of England and Wales under review and to recommend reforms.

The Law Commission referred to the alternative suggestion that "conversion of a foreign currency obligation into sterling … be effected at the latest practicable date - which would seem to be each occasion on which it is decided to declare and pay a dividend". While accepting that there were arguments both ways, the Law Commission rejected that alternative suggestion and stated that it "remain[ed] of the view which [was] expressed in the working paper".

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Accordingly, it is quite clear that the relevant committee and the Law Commission each carefully addressed this very issue during the five years leading up to the 1986 insolvency legislation, and reached the clearly expressed and firmly held conclusion that foreign currency claims should be dealt with in this way in solvent, as well as insolvent, liquidations. Indeed, the very fact that rule 4.91 (which was in the 1986 Rules from their inception, and applies to liquidations) is and was expressed as it is (i.e. effectively the same as Rule 2.86) strongly suggests that the 1986 legislation was intended, on this aspect, to follow the views expressed in the committee and the Law Commission.

In addition, the notion of foreign currency creditors having a possible second bite also appears to be inconsistent with one of the purposes of the 1986 legislation, namely to "simplify" the insolvency process. It was inconsistent with the drive for simplicity that this simple one-stage approach to conversion should be replaced by a potential two-stage process, particularly when there is no provision in the 1986 legislation which can possibly be said even to hint at such a process.

It is common ground that, if sterling appreciates against the foreign currency in which the debt is denominated after the date of administration, Rule 2.86 would work to the benefit of the foreign currency creditor. Rule 2.86 would in effect operate as a one-way option on the currency markets in a foreign currency creditor's favour: a classic case of "heads I win, tails I don't lose". An opposing argument would mean that foreign currency creditors are treated more favourably than partly secured creditors or contingent creditors, in respect of whom the 1986 Rules provide for post-proof adjustments either way.

It is true that there are statements of high judicial authority which can be cited to support the notion that a contractual claim can survive the payment in full of a proof based on that claim. However, in none of those cases was that question being addressed or even considered. It appeared to Lord Neuberger that there is a strong case for saying that it would be inconsistent with the general thrust of Chapter 10 of Part 2 (or indeed Chapter 9 of Part 4) of the 1986 Rules that a debt, which has been the subject of a proof that has been met in full, nonetheless includes a component which is somehow capable of resurrection. There are provable debts and non-provable debts, but he considered that it is inherently rather unlikely that the legislature intended that there could be a class of debts which, while wholly provable, may nonetheless transpire to have a non-provable element. In other words, the notion of a category of hybrid debt with a presently provable element and a contingently unprovable element seems improbable, particularly bearing in mind that the 1986 legislation was intended to simplify and that its policy was to render as many debts as possible provable.

Many of the rules contained in Chapter 10 of Part 2 (and the equivalent rules relating to liquidations in Chapter 9 of Part 4 of the 1986 Rules) appeared to Lord Neuberger to support the notion that a proving creditor should be treated as having had his contractual rights fully satisfied once he is paid out in full on his proof.

Where a creditor proves for a debt, his contractual rights as a creditor are satisfied if his proof is paid in full. By submitting a proof, a creditor is seeking "to recover his debt in whole or in part". The words "or in part" plainly refer to a case where part of the debt is protected by security, a possibility which is specifically catered for in Rules 2.83, 2.93 and 2.94.

The suggestion that an unsecured foreign currency creditor who proves for the totality of the sum which he is owed at the time of his proof is seeking to recover only "part" of his debt appeared to Lord Neuberger to be self-evidently wrong. Accordingly, he thought that the natural import of Rule 2.72 (and the similarly worded Rule 4.73 in the case of liquidations) is that, save where the debt is partially secured, a creditor is treated as seeking to

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recover his debt "in whole" when he proves. If that is right, if and when a foreign currency debt, which has been converted into a sterling-denominated proof in accordance with Rule 2.86, is paid in full, the debt has been recovered "in whole". On that basis, there is no basis upon which the foreign currency creditors can base their claims for a contractual shortfall.

In these circumstances, the Supreme Court concluded that it is not open to the foreign currency creditors to seek to claim as a non-provable debt, the difference between the sterling value of the debt at the administration date and the sterling value of that debt when paid, where the latter exceeds the former.

BUSINESS TAKEAWAYS

If you are currently a non-sterling creditor of an English company:

- be aware of this possible shortfall on repayment in the event of the insolvency of your counterparty if you have contracted to be paid in a currency other than sterling but must prove in sterling under the insolvency process;
- carry out thorough due diligence on the English party (including credit checks) at the outset of your dealings and throughout the period of your business relationship in order to minimise exposure on the worst happening;
- consider taking out trade credit insurance or putting in place security over the company's assets to put yourself in a better position if the worst happens; and
- familiarise yourself with the English insolvency regime, especially in relation to high value contracts.

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