CR-2008-000026 & CR-2009-000052

IN THE HIGH COURT OF JUSTICE
BUSINESS AND PROPERTY COURTS OF ENGLAND AND WALES
COMPANIES COURT (ChD)

IN THE MATTER OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)
AND LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)
AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

THE JOINT ADMINISTRATORS OF LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)

LBHI2 Applicants

-and-

(1) LEHMAN BROTHERS HOLDINGS SCOTTISH LP 3

(2) THE JOINT ADMINISTRATIORS OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)

(3) DEUTSCHE BANK AG (LONDON BRANCH)

LBHI2 Respondents

AND BETWEEN:

THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)

PLC Applicants

-and-

(1) LEHMAN BROTHERS HOLDINGS INC

(2) THE JOINT LIQUIDATORS OF LB GP NO 1 LIMITED (IN LIQUIDATION)

(3) DEUTSCHE BANK AG (LONDON BRANCH)

PLC Respondents

SKELETON ARGUMENT OF THE JOINT LIQUIDATORS OF LB GP NO 1 LIMITED (IN LIQUIDATION)

I. INTRODUCTION

1. This skeleton argument is filed on behalf of the Joint Liquidators ("the **JLs**") of GP1, the second of the PLC Respondents, for the trial in these proceedings. Save where otherwise indicated, it adopts the agreed definitions[1]. References to the trial bundle are in the form **[Bundle/Tab]** or **[Bundle/Tab/Page]**.

2. As foreshadowed in the JLs' position paper[2], GP1 focusses its submissions on the relative ranking of the PLC Sub-Notes and the PLC Sub-Debts as a matter of the construction of those documents. That is "Issue 2" in the PLC Application.

3. The JLs' position is that, as a matter of construction, the PLC Sub-Notes rank ahead of the PLC Sub-Debts. Its position rests on a short construction argument; which might be labelled as a 'bottom of the pile' analysis. In short:

   3.1 By their terms, the PLC Sub-Debts[3] do not recognise the possibility of them ranking *pari passu* with any other liability. Save for liabilities expressed to be more junior still (which the PLC Sub-Notes are not), the PLC Sub-Debts subordinate themselves to – i.e. rank behind – every other liability. Save for expressly yet more junior liabilities (which are not relevant for the purposes of this analysis), the PLC Sub-Debts will always fall to the 'bottom of the pile' when it comes to payment.

   3.2 By contrast, the PLC Sub-Notes[4] expressly recognise in their terms the possibility that they might rank *pari passu* with other liabilities. Whilst the PLC Sub-Notes also are subordinated – they are not subordinated to the same degree.

   3.3 Thus, when forced to try to break the 'race to the bottom' that the PLC Sub-Debts and PLC Sub-Notes appear at first blush to be locked in, the break is to be achieved by recognising that: (i) the PLC Sub-Notes could accommodate the PLC Sub-Debts *pari passu* at the same level of subordination; but (ii) from the PLC Sub-Debts' perspective they cannot assume that role – and must assume a lower level of priority.

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[1] Which are found at **[C/24]**
[2] **[A/9]**
[3] **[E/6]**, **[E/7]** & **[E/8]**
[4] Offering Circulars at **[E/9]**, **[E/12 & 13]** & **[E/14]**

3.4 It follows that the PLC Sub-Debts must be more deeply subordinated than the PLC Sub-Notes.

4. Deutsche Bank ("**DB**") has a substantial interest in the "ECAPS", the proceeds of which were used to purchase the PLC Sub-Notes, and which look to repayments of the PLC Sub-Notes for returns. It is therefore (along with all other ECAPS holders) ultimately financially interested in the relative ranking of the PLC Sub-Notes and PLC Sub-Debts (and, for that matter, the relative ranking of the LBHI2 Sub-Debts and LBHI2 Sub-Notes, being the earlier stage in the waterfall). In order to avoid duplication of cost, and because those matters will be fully canvassed by DB, the JLs leave it to DB (with the JLs' support) to advance submissions on Issues 1 and 4 in the PLC Application, namely:

4.1 the question of whether the PLC Sub-Debts have been released by reason of the 24 October 2011 settlement (Issue 1); and.

4.2 whether PLC's liability under the PLC Sub-Debts falls to be discounted under Rule 14.44 of the Insolvency Rules 2016 (Issue 4).

5. Issue 3 (concerning the relative ranking of certain guarantees given by PLC in favour of the ECAPS holders) is not understood to remain controversial; in that all parties now appear to recognise that those guarantees rank behind both the PLC Sub-Debts and the PLC Sub-Notes. It is understood that an issue remains between LBHI and DB as to whether the PLC Guarantees have terminated. The JLs remain neutral on that question, and no more is therefore said about it in this skeleton argument.

6. The JLs recognise at the outset:

6.1 Their proposed route to the correct ranking of the PLC Sub-Debts and PLC Sub-Notes differs from that advanced by DB. It is for that reason that the JLs advance full submissions on the issue; so that the Court is appraised of all relevant arguments. The JLs' position is that it is possible to address the relative ranking of the PLC Sub-Debts and PLC Sub-Notes via a purely textual analysis of the relevant clauses. If they are right about that, then there is perhaps little need to consider the commercial drivers which DB argue lead to the same result.

6.2 DB's exposition of the broader commercial drivers of the Lehman group points to the same conclusion. To the extent that such commercial drivers are to be inferred

from the terms of the relevant instruments or are matters otherwise 'known to the market', they can properly be taken into account. By contrast (and as set out further below), the particular subjective intentions, views, beliefs or considerations of the actual decision makers within the Lehman group – which are relied upon by LBHI/SLP3 in their analysis – are outwith the scope of the factual matrix which is relevant to the construction exercise in any case, and especially in the case of negotiable instruments such as the PLC Sub-Notes.

6.3 If the JLs (and DB) are wrong on their arguments concerning the ranking of the PLC Sub-Debts and PLC Sub-Notes, then it seems that they must rank *pari passu*. There is no suggestion that the former can rank *ahead* of the latter.

6.4 The JLs recognise that their proposed construction at the PLC Application level *may* have some bearing on the question of the relevant ranking of the LBHI2 Sub-Debts and LBHI2 Sub-Notes (before they were amended in 2008). However, in circumstances where: (i) there are material differences in the definitions of the "Senior Creditors" at that level; (ii) the ranking is clear following the 2008 amendments, and the rectification arguments hopeless (for the reasons articulated by PLC and DB); and (iii) the JLs are not a party to the LBHI2 Application, the JLs do not address this issue any further. It is to be emphasised that the LBHI2 Sub-Notes post-date the instruments at the PLC level, and so cannot in any case assist with or influence the construction exercise at the PLC level.

II. SCOPE OF RELEVANT FACTUAL MATRIX

7. The JLs do not, in these submissions, set out any detailed factual background. This is for three reasons (the second and third of which are developed more fully below):

7.1 First, it is envisaged that the Court will be presented with detailed accounts of that background from the other parties, and the JLs do not wish to overburden the Court with further repetitive accounts.

7.2 Second, as a matter of principle it is submitted that much of the "factual background" that LBHI / SLP3 seek to rely upon is inadmissible (or, if strictly admissible, of no weight), because it is either: (i) evidence of subjective intention (or a lack of it); or (ii) of too broad a nature to assist with the construction exercise given the particular nature of the instruments.

7.3 Third, this factual background in fact does not assist the construction exercise facing the Court. This issue concerns a narrow question of construction, and the start and ultimately the end point of the exercise is to consider the words used. The purely textual approach leads to a satisfactory and principled means of deciding the relevant ranking of the PLC Sub-Notes and PLC Sub-Debts, such that there is no need to look and little to be gained by looking to the factual background more widely to seek to resolve the issue.

8. This skeleton argument first sets out the applicable principles and analysis which justifies that approach, before turning in section III to the requisite narrow construction exercise which is applicable in this case.

Applicable principles

9. Lord Hoffmann explained in *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988 at [16] that:

> *"The court has no power to improve upon the instrument which it is called upon to construe, whether it be a contract, a statute or articles of association. It cannot introduce terms to make it fairer or more reasonable. It is concerned only to discover what the instrument means. However, that* **meaning** *is not necessarily or always what the authors or parties to the document would have intended. It is the meaning which the instrument would convey to a reasonable person having all the background knowledge which would reasonably be available to the audience to whom the instrument is addressed."*

10. The concluding words of that quotation are important. The breadth of the relevant background knowledge (i.e. 'factual matrix') to be taken into account in each case depends upon that which would be available to the *"audience to whom the instrument is addressed."*

11. That "audience" must be assessed at the date of the contract. Per Lewison LJ in *Cherry Tree Investments Ltd v Landmain Ltd* [2012] EWCA Civ 736; [2013] Ch 305:

> *"A contract cannot mean one thing when it is made and another thing following court proceedings. Nor, in my judgment, can it mean one thing to some people (eg the parties to it) and another thing to others who might be affected by it."*

12. It was held by Lewison LJ in *Cherry Tree* that even though background evidence – such as the draft lease in *KPMG LLP v Network Rail Infrastructure Ltd* [2007] Bus LR 1336 - might be strictly *admissible* as an aid to construction, that is not to say that any weight

ought to be attached to it (see [104]). The question of weight depends upon the context. And, there, in the context of a legal charge registered with the Land Registry, it was relevant that the charge itself would be registered (and available for inspection by those who applied to do so) but the facility letter being sought to be used as an aid to construction would not be. The facility letter was therefore not something within the background knowledge of the person to whom the registered document was addressed and was not to be afforded weight in the construction exercise.

13. Whilst that was a decision in the context of land registration, the point made is of broader application. See, e.g., the discussion at [124]-[125] of *Cherry Tree* and the cases cited therein:

> *"124. Our courts have already drawn distinctions between the use of background material in the interpretation of what I might call "ordinary" commercial contracts on the one hand, and the interpretation of negotiable and registrable contracts or public documents on the other. It is true, as Arden LJ points out at para 41, that in his speech in Chartbrook Lord Hoffmann did not expressly refer to documents in a public register. But he did refer to articles of association and to bills of lading; and made the point that the background relied on in Chartbrook would have been available to any prospective assignee or lender....*
>
> *125. This is not an isolated occurrence. The same principle has been applied to the meaning of planning permissions both by the House of Lords (Slough Estates Ltd v Slough Borough Council (No 2) [1971] AC 958) and by this court: Secretary of State for Communities v Bleaklow Industries Ltd [2009] 2 P & CR 385. It has been applied to a company's memorandum and articles of association (Egyptian Salt and Soda Co Ltd v Port Said Salt Association Ltd [1931] AC 677); and also to the interpretation of an injunction or receivership order: Masri v Consolidated Contractors (Oil and Gas) Co SAL [2009] 1 CLC 82.* ***In all these cases the justification for the restrictive approach is that third parties might (not will) need to rely on the terms of the instrument under consideration without access to extraneous material.***" (emphasis added)

14. Subsequent cases have applied and extended this principle to other instruments: in the case of credit notes issued by companies, in particular, see the guidance of Lord Neuberger in *BNY Mellon Corporate Trustee Services Ltd v LBG Capital No 1 Plc* [2016] UKSC 29; [2017] 1 All E.R. 497 at [30]-[31]:

> *"30. Over the past 20 years or so, the House of Lords and Supreme Court have given considerable (some may think too much) general guidance as to the proper approach to interpreting contracts and indeed other commercial documents, such as the trust deed in this case. What, if any, weight is to be given to what was said in other documents, which were available at the time when the contract concerned was made or when the trust deed in question took effect, must be highly dependent on the facts of the particular case. However,* ***when construing a contract or trust deed which governs***

the terms upon which a negotiable instrument is held, as in the present case, very considerable circumspection is appropriate before the contents of such other documents are taken into account.

31. In this connection, it is worth repeating the remarks of Lord Collins of Mapesbury JSC (with whom Lord Hope of Craighead DPSC and Lord Mance JSC agreed) in In re Sigma Finance Corpn [2010] 1 All ER 571, paras 36–37. Having pointed out that the trust deed in that case concerned "debt securities" issued to "a variety of creditors, who hold different instruments, issued at different times, and in different circumstances", Lord Collins JSC, at para 37, said "Consequently this is not the type of case where the background or matrix of fact is or ought to be relevant, except in the most generalised way." More generally, he said:

> *"Where a security document secures a number of creditors who have advanced funds over a long period it would be quite wrong to take account of circumstances which are not known to all of them. In this type of case it is the wording of the instrument which is paramount. The instrument must be interpreted as a whole in the light of the commercial intention which may be inferred from the face of the instrument and from the nature of the debtor's business.""* (emphasis added)

Different nature of the Sub-Debts and Sub-Notes

PLC Sub-Debts

15. The principles applicable to the relevant background in construing the PLC Sub-Debts are not controversial:

    15.1 The PLC Sub-Debts are *""ordinary" commercial contracts"* between group companies. The full range of background material can be looked to as an aid to their construction (save for subjective intention, which is always inadmissible).

    15.2 In circumstances where those documents are (largely) derived from standard forms, there is, however, little factual material which is of assistance in determining what they mean (see, e.g. *AIB Group v Martin* [2001] UKHL 63 at [7]).

16. In any case, the problem of construction is not (primarily) in determining what these instruments mean, but rather in determining whether the subordination provisions in the PLC Sub-Notes mean something different from the subordination provisions in the PLC Sub-Debts, and how the two different sets of subordination provisions interact.

PLC Sub-Notes

17. The approach to the relevant background for construing the PLC Sub-Notes is quite

different. They are negotiable instruments. The holder(s) of the Notes were free to transfer them (even if they were not in fact transferred outside of the Lehman group). The Notes therefore recognise in their terms the possibility, if not expectation, that they would be traded. For example, condition 6(e) of the Notes provides that *"the Issuer or any of its Subsidiaries may at any time purchase Notes in the open market or otherwise and at any price,* provided that *all unmatured Coupons are purchased therewith."*[5] The PLC Sub-Notes also had very long life-spans, being due in 2035 & 2036. Whatever might have been the intention or expectation of the Issuer when they were made, the PLC Sub-Notes must mean the same thing throughout their thirty-year life span, regardless of who in the market might have come to hold them.

18. Thus, by their nature, *"very considerable circumspection"* is required before permitting the contents of other documents to be taken into account in construing the PLC Sub-Notes.

19. LBHI/SLP3 seek to avoid this conclusion by contending (§13(4) of their Reply Position Paper)[6] that the PLC Sub-Notes were: *"(i) not publicly available documents; (ii) addressed solely to entities forming part of the Lehman Group; (iii) devised and implemented by common, centralised decision makers and operational personnel as part of the ongoing restructuring of the Lehman Group's capital structure; (iv) negotiated in a non-adversarial context by the decision makers and/or personnel referred to above; and (v) intended never to be traded or transferred outside of the Lehman Group."*

20. Those points do not individually or collectively justify looking as an aid to construction to the particular *internal* commercial drivers of the Lehman Brothers group, nor more generally bring in to the scope of relevant factual background matters known to individuals within that group which would not be known to any potential third party holder of the PLC Sub-Notes:

    20.1 The logic of a narrow approach to the relevant background when construing documents such as these does not turn on them being publicly available. The key question is not whether they are "public", but the background knowledge of those to whom they are "addressed". Publicly available documents are an *example* of

[5] E.g. **[e/9/312]**
[6] **[A/10/179]**

documents for which a narrow range of background facts is relevant, but the narrow approach is not limited to those cases.

20.2 The PLC Sub-Notes are not "addressed" to entities which are part of the Lehman group. Their terms and conditions are addressed to the holders of the Notes from time to time; i.e. (potentially) to anyone in the world. The fact that they were in fact held by Lehman entities at all times does not change that.

20.3 In the event, the PLC Sub-Notes were listed on the Channel Islands Stock Exchange, and stored by that stock exchange in connection with that listing (as accepted at §18(2)i. of LBHI's Reply Position Paper[7]). The purpose of the provision of the PLC Sub-Notes to the stock exchange can only have been to inform the stock exchange as to the terms of the notes (e.g. so as to satisfy the stock exchange that they met its listing requirements). The stock exchange was therefore an addressee of the notes (i.e. an entity legitimately concerned, and intended to be concerned, with understanding their terms) which was not part of the Lehman group. The relevant factual background (at its widest) cannot be more than that which was known to the stock exchange, which (in the absence of any evidence to the contrary) is assumed to be no more than known to the world at large.

20.4 The context in which the PLC Sub-Notes were devised or "negotiated" (if that is a meaningful term to use in the context of an offering circular for notes) cannot have any bearing on the admissible or relevant background when it comes to the exercise of construction. For that exercise, the relevant question is the nature of the instrument and its potential audience, not who created it or their intention.

20.5 The fact that they were never *intended* to be transferred out of the Lehman group can also make no odds. What is relevant is that – by their nature - third parties *"might (not will) need to rely on the terms"* (adopting the language of *Cherry Tree* at [125]).

20.6 Focussing on intention on the likelihood of transfer to third parties at the time of creation risks the absurd result whereby negotiable instruments might mean one thing in the hands of the original parties, and another in the event (contrary to the

[7] **[A/10/182]**

initial intention) that they were transferred. That cannot be right.

20.7 For example, on LBHI's logic, a wide range of context and the group's intentions could be taken into account for so long as the notes were within the Lehman group. That may give one meaning following a construction exercise. However, it would appear to be common ground that only a narrow context (that known to all potential transferees) could be looked to in the event that the instrument is *in fact* transferred. Against this narrow context, the construction exercise may yield a different result.

20.8 Negotiable instruments cannot mean one thing in the hands of the original parties, but (in theory, at least) something else if and when they are transferred. It is therefore right only to look to the narrow factual context in both instances.

20.9 In the event, the intention was always that the PLC Sub-Notes should be listed on the Channel Islands Stock Exchange, and therefore to a non-Lehman entity for that purpose.

21. A narrow approach to the relevant background is therefore appropriate when it comes to construing the PLC Sub-Notes. There can be no reliance on material which would not have been available to any potential third party acquirer of the PLC Sub-Notes. That is limited to an analysis of the terms of the PLC Sub-Notes as a whole, the inferences that can be drawn from them, and other publicly available material known to the market.

22. In particular, none of the material deployed by LBHI/SLP3 as to the process by which the PLC Sub-Notes came to drafted or approved by the FSA would have been available to such potential third parties, and should not therefore influence the construction exercise. This is strictly inadmissible as it is evidence of the draftsperson's subjective intention. To the extent it might be admissible, however, it should carry no weight for this additional reason – i.e. that it was not material known to potential third parties.

The Regulatory Context: IPRU(INV) & GENPRU

23. The regulatory context is potentially relevant background material, because the regulatory context was known to the whole world. Contrary to the position adopted by LBHI/SLP3, however, this regulatory context is not *"crucially important"*[8]. Indeed, it

[8] §26(3) of LBHI/SLP's Reply Position Paper **[A/10/186]**

takes matters no further. In summary:

23.1 The sacrosanct nature of the IPRU(INV) standard forms is overstated. The PLC Sub-Debts did not, it seems, comply with those forms in all material respects to begin with – and once that is appreciated the force of the suggestion that it is inconceivable that the PLC Sub-Notes may further have departed from their key features is substantially diminished.

23.2 The relevant regulatory context was concerned solely with ensuring that certain forms of debt were *sufficiently* deeply subordinated that they could be regarded as capital for regulatory purposes. That was the FSA's only concern. Subject to that, the regulatory regime was entirely uninterested in how those subordinated debt instruments may have ranked between themselves. The reality (so far as relevant) seems to be that no one gave that question any particular thought.

23.3 The tail cannot wag the dog: the PLC Sub-Notes mean what they mean, and if the consequence is that regulatory regime was not fully complied with then that is the consequence. It does not mean that the PLC Sub-Notes must mean something else.

23.4 Similarly, LBHI/SLP3's argument that *"If the additional words… under the PLC Sub-Notes had an effect that was materially different to the… PLC Sub-Debt, then PLC clearly would not have obtained an IPRU(INV) waiver from the FSA"*[9] is illogical. Even if the FSA was concerned with the relative rankings of the PLC Sub-Debts and PLC Sub-Notes, the FSA's opinion on what the PLC Sub-Notes mean is not relevant to the question of what they in fact mean.

23.5 There is, further, no suggestion that the FSA in fact ever gave this relative ranking question any consideration.

24. Those first two points are addressed in more detail below.

<u>Departures from the standard forms</u>

25. It is common ground that when the PLC Sub-Debts and PLC Sub-Notes were created the relevant regulatory regime (until 31 December 2006) was contained in the FSA Interim

[9] §26(3) of LBHI/SLP's Reply Position Paper **[A/10/186]**

Sourcebook for Investment Businesses ("IPRU(INV)").[10]

25.1 IPRU(INV) contained various standard forms which regulated entities were to use (as mandated by Rule 10-63(2)[11]) for the creation of debt obligations which were to qualify as capital for regulatory purposes.

25.2 The applicable standard form depended both on how the relevant entity was regulated (i.e. whether on a consolidated or non-consolidated basis) and whether the lending was short or long term.

25.3 The Lehman group became subject to regulation on a consolidated basis in October 2005.[12]

25.4 The FSA guidance (paragraph 4(b) of section 10.8[13]) directed that *"Rather than re-type the Standard Terms (Schedule 2),* ***firms should simply photocopy Schedule 2 of the FSA precedent or print it from the website and include it as part of the original Agreement****"* (emphasis original) (the "original Agreement" being the agreement being created with use of the standard forms).

26. As the JLs noted in their position paper, the PLC Sub-Debts did not in fact fully comply with those IPRU(INV) requirements.[14] This failure is not something that has been addressed in LBHI/SLP3's evidence. The first two PLC Sub-Debt agreements were apparently *based* on Form 10.1.[15] Notwithstanding the very prescriptive approach of IPRU(INV) as regards standard forms, these two long-term facilities contained significant amendments to that standard form. For example:

26.1 The front page does not refer to the indebtedness as being intended to be in accordance with IPRU(INV) 10-63 (Form 10.1).

26.2 The standard form wording for paragraphs 4(2) & (3) of the Standard Terms (dealing with Repayment) was omitted in the PLC Sub-Debts as executed, with the effect that the reference to paragraph 4(3) at paragraph 5(1)(a)(i) of the Standard

[10] See, e.g, WS of Sophie Hutcherson at §16 **[C/6/72]**
[11] **[J2/10/516]**
[12] WS of Sophie Hutcherson at §39 **[C/6/76]**
[13] **[J2/10/795]**
[14] §§23-26 at **[A/9/162-163]**
[15] WS of Sophie Hutcherson at §35 **[C/6/75]**; Form 10.1 is at **[J2/10/729]**

Conditions makes little sense.[16]

26.3 Further, the as-executed documents delete the concepts of "Partner" and "Loan" and the definition of "Subordinated Liabilities" is amended from the standard form, by the deletion of the words "the Loan": i.e. - "*"**Subordinated Liabilities**" means all Liabilities to the Lender in respect of ~~the Loan or~~ each Advance made under this Agreement and all interest payable thereon."*

26.4 Furthermore, the following terms at paragraph 2(1) & (3) are included in the Standard Terms, but omitted in the executed version:

> *"(1) Where as indicated in the Variable Terms this Agreement is for a loan, the Borrower hereby acknowledges its indebtedness to the Lender in the sum mentioned in the Variable Terms as an unsecured loan upon and subject to the terms and conditions of this agreement.*
>
> *...*
>
> *(3) The Lender and the Borrower undertake to provide the FSA, immediately upon request, with details in writing of all principal and interest in respect of the Loan or each Advance outstanding for the time being and all payments of any amount made in the period specified by the FSA in the request."*

26.5 Most significantly, the ability of PLC to prepay the sums due under the debts on two business days' notice (paragraph 9 of each of these PLC Sub-Debts) does not sit easily with the instructions in the guidance notes that repayment must be at least five years hence.

27. Whatever the reason(s) for these departures from the relevant standard form, it serves to demonstrate that it is wrong to place too great a weight on them or, therefore, to assume that the departures from the standard forms when it came to drafting the PLC Sub-Notes were (objectively) intended *only* to update the form to a note format.

<u>The purpose of the regulatory regime</u>

28. As Ms Hutcherson explains in her witness statement, no doubt correctly:

> *"29. The purpose of regulatory capital was to ensure that there was sufficient capital to cover the risks to which a firm was exposed (above and beyond a simple insolvency test) by reducing to a minimum the likelihood of investment firms failing. This protected*

[16] And the words in square brackets inserted in the quotation of clause 5(1)(a)(i) at §60 of Ms Bruce's third witness statement (at **[A/4/23]**) may, therefore, be inaccurate to the extent that she assumes that the literal cross-reference to paragraph 4(3) in those notes is the correct interpretation

the clients of a firm and the market as a whole (i.e. the unsubordinated creditors).

30. INPRU(INV) did not expressly address the relative ranking of subordinated debts. Its effect was that subordinated debt was meant to be as near to equity as possible (whilst ranking above equity). There were no provisions in the Standard Forms stating that one subordinated debt ought to take priority over another."[17]

29. Similarly, in her interview on 25 March 2019, Ms Hutcherson assented to the unsurprising proposition that *"the regulator wasn't concerned about where different layers of subordinated debt ranked versus each other; they were just concerned to see that they were subordinated to unsubordinated creditors"*.[18] No-one has suggested otherwise. It is therefore unsustainable for LBHI/SLP3 to seek to argue (to the extent it is relevant) that the FSA would have had any concern with the relative rankings of the PLC Sub-Notes and PLC Sub-Debts or would have refused a waiver had it appreciated that they did not rank *pari passu* with each other.

30. It must follow that so long as the relevant subordinated debts ranked appropriately as compared to equity and unsubordinated creditors – i.e. in the appropriate band or tier between the two – it mattered not for regulatory purposes how they might rank as between themselves. Such matters were outside the scope or concern of the regime.

31. Thus, the objective bystander appraised of the regulatory context might well have reasonably concluded that the standard form was the starting point for the drafting of the PLC Sub-Notes. The bystander might also have concluded that the intention of the draftsperson (objectively construed) must have been for the liability under the PLC Sub-Notes to rank within the same band or the same tier as the PLC Sub-Debts: i.e. behind unsubordinated creditors and ahead of equity. But that context would give no clue as to how the PLC Sub-Notes and PLC Sub-Debt ought to rank between themselves, because that is not something on which the regulatory regime had any bearing.

32. Similarly, to the extent that it is relevant to the exercise of their construction at all, the FSA waivers[19] for the form of the PLC Sub-Notes cannot reasonably be read or understood as seeking to impose any requirement that the PLC Sub-Notes must rank *pari passu* with the PLC Sub-Debt. When those waivers provide a condition that *"the degree of subordination of the loan capital is no less than that provided for by form 10-6"* that,

[17] **[C/6/74-75]**
[18] **[C/19/248]** at lines 12-15
[19] **[F2/-/777-780]** (26 May 2005); **[F3/-/1328-1331]** (31 October 2005); **[F3/-/1448-1451]** (19 December 2005)

in context, must be understood as being directed to the need for the PLC Sub-Notes to be subordinated behind unsubordinated debts as a loan under Form 10.6 would have been – but not a prohibition as to how such subordinated debts were to rank between themselves.

33. The purpose of the regulatory regime, and the focus on the adequacy of regulatory capital, was to protect the wider economy from the systemic risk of banks failing (as Ms Hutcherson had noted at §29 of her witness statement). The fact that standard form agreements entered into in that context may lead to results which are surprising and not entirely satisfactory from a commercial perspective if a bank *did* fail, or which would have been dealt with differently had they been foreseen, is neither surprising nor of any assistance to the construction exercise.

34. These were complex and sophisticated financing arrangements, heavily driven by tax considerations in an environment where insolvency was not foreseen by those involved in their creation. The words of Lord Walker in *BNY Ltd v Eurosail Plc* [2013] UKSC 28; [2013] 1 WLR 1408 at [50] are apt to apply in response to arguments about the unsatisfactory commercial outcomes:

> *"[T]he court might well have taken the view, on documents of such complexity, that the draftsman had simply failed to grasp all its many and various implications, and that it was not for the court to rewrite the documents for the parties."*

35. Indeed, one of the great oddities of the subordination provisions in this context is that they were seemingly drafted with no expectation that they would ever be called upon. Insolvency was not foreseen. What drove the form of the provisions was what was required for regulatory capital purposes, not what result should in fact pertain in the case of insolvency.

Specific inadmissibility or irrelevance of the Allen & Overy opinions

36. Significant weight is placed by LBHI/SLP3 on the "confirmatory" opinions of Allen & Overy dated 15 April 2005, 26 September 2005 and 23 February 2006[20], which purported to confirm that "*the terms and conditions of the Notes provide equivalent subordination to that in the FSA Standard Form and that each Note is similarly and identically bound*

[20] **[F2/-/766-768]**; **[F2/-/1137-1139]** & **[F3/-/1560-1562]** respectively

by the subordination requirements" (see, e.g., §13(8) of LBHI/SLP3's Position Paper[21]).

37. These opinions must be irrelevant, and therefore inadmissible, as a matter of logic:

    37.1 As with the FSA waiver, they are addressing the question of whether the PLC Sub-Notes are subordinated behind the same liabilities as the PLC Sub-Debts, not how those two instruments should rank between themselves.

    37.2 Whilst Ms Hutcherson's evidence is that these opinions *"confirmed"* equivalent subordination to the PLC Sub-Debts[22] they can of course do no such thing. All they can do is *opine* on what the PLC Sub-Notes mean. That opinion can have no bearing on what the PLC Sub-Notes in fact mean; the opinion may be correct, or it may be incorrect.

38. There is a more fundamental objection to the admissibility of the opinions, however: they are evidence of the subjective intention of the draftsperson as to what they did or did not intend the instrument to mean.

39. In *Rabin v Gerson Berger Association Ltd* [1986] 1 WLR 526 it was held that a written opinion prepared by counsel is not admissible as evidence for the purposes of construing a deed of settlement drafted by counsel. It was held by Fox LJ that:

> *"[T]o look generally at the opinions can only be for the purpose of asking the court to conclude that, because counsel thought that the words he used had a particular effect, the court should give them that effect, even though that is not their meaning in law according to ordinary English usage. That, it seems to me, is contrary to the rule against the admission of parol evidence; it is no different from tendering documents in which the settlor or grantor himself tells his solicitors the effect which he wishes to be achieved, and is, indeed, no different from the settlor or grantor giving evidence of the general aim which he wishes to be perfected. Such evidence, I think, is simply parol evidence of the intention of the grantor, either personally, or formulated by counsel and imputed to (or accepted by) the settlor personally. The result, in my view, is that the opinions cannot be referred to generally for the assistance that their contents may give."*

40. Similarly, the only purpose of looking at the Allen & Overy opinions is to look to see what lawyers at that firm thought their drafting achieved. That is not admissible evidence in construing the instrument they have drafted; the words they have used mean what they

[21] **[A/5/60]**
[22] WS of Sophie Hutcherson at §49 **[C/6/79]**

mean regardless of what they subjectively intended them to mean.

III. CONSTRUING THE PLC SUB-DEBTS AND THE PLC SUB-NOTES

The PLC Sub-Debts

41. The PLC Sub-Debts are *"subordinated to the Senior Liabilities"* (clause 5(1) of the Standard Terms), which means they are subordinated to *"all Liabilities except the Subordinated Liabilities and Excluded Liabilities"*.

42. The *"Subordinated Liabilities"* are other advances under the same sub-debt agreement (*"all Liabilities to the Lender in respect of each Advance made under this Agreement and all interest payable thereon")*, and so can be disregarded.

43. So far as material, the PLC Sub-Debts are therefore subordinated to everything other than "Excluded Liabilities", that is: *"Liabilities which are expressed to be, and in the opinion of the Insolvency Officer of the Borrower, do, rank junior to the Subordinated Liabilities in any Insolvency of the Borrower."*

44. As foreshadowed in the JLs' position paper[23], it is appropriate to assume that the Insolvency Officer's opinion will be guided by what the Court determines these instruments to mean (and no one to date has doubted the appropriateness of this assumption). Accordingly, that separate requirement can also be disregarded.

45. For present purposes, therefore, the PLC Sub-Debts are each subordinated to all liabilities save for those which *"are expressed to be... junior to the Subordinated Liabilities."* Pausing there, one of LBHI's objections to the JLs' construction analysis can be dismissed immediately. LBHI ask why, on the 'bottom of the pile' thesis, the PLC Sub-Debts should not fall to rank below Upper Tier 2 or Tier 1 Capital (§29(4) of its Reply Position Paper[24]). The (obvious) answer is that capital or debt which is expressed to be more deeply subordinated will be an "Excluded Liability" and therefore beneath the floor to which the PLC Sub-Debts can fall. Or, if it is capital, it will not be a "Liability" at all for the purposes of the subordination clause.

46. The PLC Sub-Debts, by the definition of "Excluded Liabilities" do not in terms recognise

[23] At §49 **[A/9/169-170]**
[24] **[A/10/188]**

the possibility that they might rank *pari passu* with any other debt; even as between themselves. Save for other debts which are expressed to rank more junior still, the PLC Sub-Debts are *prima facie* locked in an indefatigable 'race to the bottom'. As between themselves, there is therefore a circularity problem: literally, each PLC Sub-Debt purports to be subordinated to the other two – because no PLC Sub-Debt expresses itself to be more junior still.

47. It is not for the JLs to present the solution to that circularity problem; but a *pari passu* solution as between them is not an *unattractive* solution. Where there would otherwise be an intractable circularity problem as between the PLC Sub-Debts, it may be appropriate to view them as falling due at precisely the same level in the waterfall (there being no other way to distinguish between them and no further for any of them to fall than to the bottom) such that r.14.12(2) of the Insolvency Rules may well compel a *pari passu* solution: *"Debts other than preferential debts rank equally between themselves and, after the preferential debts, must be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves."*

48. It is important to recognise, however, that such a *pari passu* solution (if available) only arises because none of the PLC Sub-Debts can otherwise be treated as ranking ahead of the other as a matter of contractual construction. That is a question which needs to be determined logically before reference (or recourse) is had to r.14.12.

    48.1 If there is some other means of identifying a preferential debt in a circularity problem, there is no need to look to r.14.12 to solve the problem – indeed, there is no *ability* to look to r.14.12 for assistance, because that rule is predicated on the entitlement of all debtors to prove in the full face value of the debt at the same time.

    48.2 If as a matter of contract a debt is subordinated to another class of debt, then the more subordinated debt will be valued at zero for the purposes of r.14.12, or not permitted to prove at all (see, e.g. the discussion at [68*ff*] of Lord Neuberger's judgment in *Waterfall I*), and r.14.12 cannot compel a *pari passu* distribution between such debts.

    48.3 Thus, whilst r.14.12 might serve to solve the problem by way of abatement in equal proportions should there be no other means of breaking the circularity – it is a refuge of last resort, not the first port of call.

49. Again, whilst the *pari passu* solution to the internal ranking of the PLC Sub-Debts may be the appropriate solution for them, LBHI's *reductio ad absurdum* argument as to why a *pari passu* argument *must* be the solution for the PLC Sub-Debts and the PLC Sub-Notes is unpersuasive. LBHI asserts (§22(1)ii. Reply Position Paper) that it would be *"absurd"* if *"two loans drawn up on the FSA Standard Forms entered into by the same lender on the same day with the same borrower could never rank* pari passu.*"*[25] As to that:

49.1 Where the loans are with the same lender, the question of relative ranking probably does not matter much.

49.2 But, drawing on a principle of construction articulated in the company debenture context (concerning the priority between debenture holders of debentures in like terms), there is nothing absurd about the consequences of two identical debt instruments executed on the same day depending upon the precise timing of their execution:

> *"[W]hen two deeds are executed on the same day, the Court must inquire which was in fact executed first, but that if there is anything in the deeds themselves to shew an intention, either that they shall take effect pari passu or even that the later deed shall take effect in priority to the earlier, in that case the Court will presume that the deeds were executed in such order as to give effect to the manifest intention of the parties."*

(*Gartside v Silkstone & Dodworth Coal and Iron Company* (1882) 21 Ch.D 762 at 768-9, *per* Fry J)

49.3 Thus, it is not permissible to have recourse to *"absurdity"* to justify a *pari passu* ranking if that is not what the instruments provide for. Nor is it permissible to look at the broader commercial purpose to justify that conclusion: one has to look for something *"in the deeds themselves"* (not the surrounding commercial impetus) to compel a different result to the first in time approach.

49.4 Nor would such a first in time approach mean that the standard form did not have the same meaning in each situation (as was the concern of Lord Millett in the *AIB Group v Martin* [2001] UKHL 63 case cited by LBHI at §22(4)(ii) of its Reply Position Paper). Rather, the form would *mean* the same thing – but the *effect* would

[25] **[A/10/183]**

depend upon a determination of the factual position. There is nothing surprising or objectionable in that.

The PLC Sub-Notes

50. The PLC Sub-Notes are also *"subordinated to the Senior Liabilities"* (condition 3(a) of the offering circulars), but those *"Senior Liabilities"* are not the same *"Senior Liabilities"* that the PLC Sub-Debts are subordinated to.

51. The "Senior Liabilities" for the purposes of the PLC Sub-Notes are – again – *"all liabilities other than Subordinated Liabilities and Excluded Liabilities"*.

52. The definition of *"Excluded Liabilities"* is the same as under the PLC Sub-Debt.

53. The definition of *"Subordinated Liabilities"* is materially – and critically – different, in that it means *"all Liabilities to the Noteholders in respect of the Notes and all other Liabilities of the Issuer which rank or are expressed to rank* pari passu *with the Notes."*

54. Pausing there, it is to be noted that the addition of the underlined words has no obvious relevance to the fact that lending is in a note rather than a debt format. Thus, even if it were appropriate to have regard to the Allen & Overy confirmatory opinions, their explanation for the difference between the two forms of words does not appear to touch on these words. They explain:

> *"We have used this definition which better reflects borrowing in a bond, rather than a loan, format. In particular, no reference is made to the concept of "Advances" being made as, unlike a loan facility, there is no provision in the terms of the Notes to "draw-down" funds on an ongoing basis, but rather a disbursement of funds in full as at the issue date of the Notes followed by a "bullet" redemption in full of the Notes at maturity, or on such earlier date on which the Notes are redeemed."*[26]

55. That may explain the change in the definition of "Subordinated Liabilities" from *"all Liabilities to the Lender in respect of the Loan or each Advance made under this Agreement and all interest paid upon"* to *"all Liabilities to the Noteholders in respect of the Notes..."* – but it cannot serve to explain the addition of the words relating to a *"pari passu"* ranking. The objective bystander, noting the difference in the form between the two definitions of Subordinated Creditors, would assume that the words relating to a *pari*

[26] E.g. 15 April 2015 confirmatory opinion re. the €225m PLC Sub-Note at **[F2/-/767]**

passu ranking were intended to have some effect.

56. Thus, the PLC Sub-Notes are subordinated to all other Liabilities except:

    56.1 those which rank or are expressed to rank *pari passu* with the PLC Sub-Notes (from the definition of "Subordinated Liabilities"); and

    56.2 those which are expressed to be junior to the liabilities under the PLC Sub-Notes (from the definition of "Excluded Liabilities").

57. The effect is that the PLC Sub-Notes (but not the PLC Sub-Debts) are capable of ranking – on their terms – *pari passu* with other instruments which in fact rank at the same level. They are not locked in the same race to the bottom as the PLC Sub-Debts. Accordingly, as between themselves they can each accommodate each other on a *pari passu* ranking, will be entitled to prove at their face value at the same point in the 'waterfall' and in fact do rank *pari passu* between themselves.

Relative ranking of the PLC Sub-Notes and the PLC Sub-Debts

58. Starting from the perspective of the PLC Sub-Debts, they are *prima facie* subordinated to the PLC Sub-Notes. That is because the PLC Sub-Notes are not *"expressed to be junior"* to the PLC Sub-Debts (indeed, they make no reference to the PLC Sub-Debts at all).

59. From the perspective of the PLC Sub-Notes, it is not immediately apparent whether they purport to subordinate themselves to the PLC Sub-Debts. However, it is immediately apparent that they are not purporting to be as deeply subordinated as the PLC Sub-Debts.

    59.1 First, the PLC Sub-Debts are not *"expressed to be junior"* to the PLC Sub-Notes – in the sense of the former expressly making reference to the latter. If that was the end of the story, the same circularity problem which arises internally to the PLC Sub-Debts would apply as between the PLC Sub-Notes and Sub-Debts. I.e. each would be expressed to be subordinated to the other.

    59.2 But that is not the end of the analysis. Because it does not follow (for the PLC Sub-Notes) from the fact that another instrument is not expressed to be junior that the PLC Sub-Notes must be subordinated to it. That is because there is another option

according to the terms for the PLC Sub-Notes: a *pari passu* ranking in fact. That is imported from the definition of "Subordinated Liabilities".

59.3 From the perspective of the PLC Sub-Notes, therefore, it could accommodate the PLC Sub-Debts on a *pari passu* ranking. *If* in fact the PLC Sub-Debts might rank *pari passu* with the PLC Sub-Notes, then the PLC Sub-Notes would not (according to their terms) become more deeply subordinated.

59.4 However, the PLC Sub-Debts cannot (on their terms) endure a *pari passu* ranking with any other instrument. Because the other instrument – on a tentative *pari passu* ranking – would not be expressed to be junior to the PLC Sub-Debt, the PLC Sub-Debt must fall to be more junior still.

60. This argument requires an iterative thought process, which hinges on the device of recognising that – according to their terms – the PLC Sub-Notes *could* tolerate other instruments on a *pari passu* basis, whereas the PLC Sub-Debts cannot and must (so they say) be paid last.

60.1 That difference between the instruments provides a compelling and logical basis for concluding – in order to break what would otherwise be a 'race to the bottom' – that the PLC Sub-Notes must rank ahead of the PLC Sub-Debts.

60.2 In the race to the 'bottom of the pile', the terms of the PLC Sub-Debts anchor those instruments more firmly to the bottom than the PLC Sub-Notes are anchored. The PLC Sub-Notes can float on a level above the PLC Sub-Debts.

61. To make a similar argument in a slightly different way:

61.1 the subordination clause in the PLC Sub-Notes refers to *pari passu* subordination and therefore indicates an objective intention that those instruments were not to be subordinated below all other instruments, and the extent of the agreement to subordinate was to the same level as those who agreed to rank *pari passu*, or impliedly already did (i.e. the other PLC Sub-Note issues).

61.2 As the PLC Sub-Debt did not agree a *pari passu* ranking with the PLC Sub-Notes, and the PLC Sub-Notes did not agree to subordinate to the PLC Sub-Debt, the PLC Sub-Debt must rank lower.

62. A further way of considering the issue is as follows:

62.1 The PLC Sub-Debts are subordinated to all liabilities except those under each PLC Sub-Debt instrument itself and anything else expressed to be junior. As a result, from the perspective of the PLC Sub-Debt, the PLC Sub-Notes are not subordinated *unless* they are expressed to be junior (which they are not; as to which see immediately below).

62.2 The PLC Sub-Notes are subordinated to all liabilities except those which rank or are expressed to rank *pari passu*, or are expressed to be junior.

(i) So, from the perspective of the PLC Sub-Notes, they are not subordinated with (i.e. to the same extent as, or to the same level as) the PLC Sub-Debt because PLC Sub-Debts do not and are not expressed to rank *pari passu* (not least because the PLC Sub-Debt does not recognise that concept: from its perspective it cannot rank *pari passu* with anything).

(ii) So, the PLC Sub-Debt and PLC Sub-Notes cannot rank *pari passu* - and it is necessary to decide which comes first.

(iii) Because: (a) it is explicit in the terms of the PLC Sub-Notes that there *could* be other debt that ranked *pari passu* with the Sub-Notes; and (b) that other debt could also provide expressly that it is not subordinated to PLC Sub-Debt; then that must mean that the PLC Sub-Notes need not rank junior to, and therefore cannot be *expressed* to be junior to, the PLC Sub-Debts.

(iv) Otherwise it would not be possible for the PLC Sub-Notes to be *pari passu* with debt that was expressed to rank *pari passu*. As the PLC Sub-Notes are neither *pari passu* with the Sub-Debt nor junior, they must rank above.

62.3 The point is illustrated by considering a third hypothetical category of subordinated debt. It is possible to conceive of a debt that could be drafted to rank *pari passu* with the PLC Sub-Notes, but ahead of the PLC Sub-Debts. Accordingly, the PLC Sub-Notes must rank ahead of the PLC Sub-Debts.

63. LBHI's central opposition to such an analysis is to complain that the reference to the possibility of a *pari passu* ranking on the terms of the PLC Sub-Notes cannot make any

difference, because the PLC Sub-Debts *in fact* could also rank in the same way by operation of r.14.12. That response, however, begs the question:

63.1 R.14.12, as noted above, compels the outcome in an insolvency that all debts should be paid at the same time (and therefore *pari passu*) *on the assumption* that they are all entitled to prove at their full face value at the same time.

63.2 It is not, therefore, something that can be taken into account in seeking to determine whether another debt ought to be paid first. It is only once that issue has been determined that r.14.12 can be looked to at all.

63.3 In other words, the question of whether the PLC Sub-Debts rank behind the PLC Sub-Notes must be determined without reference to r.14.12, because r.14.12 can only compel a *pari passu* result if that former question is determined against GP1.

IV. CONCLUSION

64. A line of least resistance would be to treat the PLC Sub-Debts and the PLC Sub-Notes as ranking *pari passu* with one another. But that deceptively alluring path is not a legitimate route for a court to adopt.

65. The degree of subordination of a creditor's debt depends on the terms of the contract which created it. Here, the PLC Sub-Debts and PLC Sub-Notes were created by different contracts, which are differently worded. Where the former does not contemplate *pari passu* ranking with other liabilities, an outcome which achieved a *pari passu* ranking with the latter, that does, would be a surprising result.

66. The starting point should be careful scrutiny of the contractual language. That scrutiny offers a logically and legally coherent solution without the need to turn to the Insolvency Rules.

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31 October 2019

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