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 IN THE MATTER OF LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N:

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 A.G. (LONDON BRANCH)

PLC Respondents

—and—

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

LBHI2 Applicants

-AND-

(1) LEHMAN BROTHERS HOLDINGS SCOTTISH LP 3
(2) LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)
(3) DEUTSCHE BANK A.G. (LONDON BRANCH)

LBHI2 Respondents

SKELETON ARGUMENT ON BEHALF OF LEHMAN BROTHERS HOLDINGS INC. AND LEHMAN BROTHERS HOLDINGS SCOTTISH LP 3

For Trial: starting Monday 11 November 2019

CONTENTS

A. INTRODUCTION

1 This skeleton argument[1] is filed and served on behalf of Lehman Brothers Holdings Inc. (**"LBHI"**) and Lehman Brothers Holdings Scottish LP 3 (**"SLP3"**) in accordance with the Order of Mr Justice Hildyard dated 31 July 2019 (**"the Hildyard Order"**)[2], and incorporates their written trial submissions in relation to the hearing of two directions applications, namely:

(1) The application dated 16 March 2018 for directions within the administration of Lehman Brothers Holdings Plc (**"PLC"**, and the **"PLC Application"**)[3]. LBHI is a party to the PLC Application.

(2) The application dated 16 March 2018 for directions within the administration of LB Holdings Intermediate 2 Limited (**"LBHI2"**, the **"LBHI2 Application"**[4], together with the PLC Application **"the Applications"**). SLP3 is a party to the LBHI2 Application.

B. THE PARTIES

2. LBHI is the US parent company of the Lehman Brothers Group (**"the Lehman Group"**). On 15 September 2008, LBHI entered Chapter 11 proceedings in the US. SLP3 is a Scottish limited partnership formed on 25 April 2007. SLP3 is indirectly owned and ultimately controlled by LBHI. LBHI has held the **"PLC Sub-Debt"** (as described below) since 19 April 2017 and SLP3 has held the **"LBHI2 Sub-Notes"** (as described below) since 1 May 2007. LBHI and SLP3 are both represented by Weil, Gotshal & Manges (London) LLP (**"Weil"**).

3 The other parties are as follows:

(1) On the PLC Application:

(a) The Joint Liquidators of LB GP No 1 Limited (in liquidation) (**"GP1"**). GP1 is a subordinated creditor of PLC. GP1 is represented by Charles Russell Speechlys LLP (**"CRS"**).

(b) Deutsche Bank A.G. (London Branch) (**"Deutsche Bank"**). Deutsche Bank is a creditor of GP1 (and therefore an 'indirect' creditor of PLC). Deutsche Bank is represented by Sidley Austin LLP (**"Sidley"**).

(c) The Joint Administrators of PLC, who are represented by Hogan Lovells LLP (**"Hogan Lovells"**).

(2) On the LBHI2 Application:

(a) The Joint Administrators of PLC. PLC is a subordinated creditor of LBHI2.

(b) Deutsche Bank.[5] Deutsche Bank has an indirect economic interest in the subordinated debt of LBHI2 because it is an 'indirect' creditor of PLC (see above).

(c) The Joint Administrators of LBHI2, who are represented by Dentons UK and Middle East LLP (**"Dentons"**).

C. THE ISSUES TO BE DETERMINED

4 As set out in further detail below, there is a strong degree of overlap[6] between the two Applications, which raise common questions relating to whether dated subordinated debts issued by entities within the Lehman Group to other entities within the Lehman Group rank for distribution (a) before, (b) after or, (c) *pari passu* with each other. In the case of PLC, the relevant instruments where ranking needs to be assessed are the **"PLC Sub-Debt"** and **"PLC Sub-Notes"** (as described below); and in the case of LBHI2, the **"LBHI2 Sub-Debt"** and the **"LBHI2 Sub-Notes"** (as described below).

5 LBHI/SLP3 will address the issues in the following order:

(1) Issue 2 of the PLC Application (**"PLC Ranking Issue"**)[7]. This is the issue of whether the claims of LBHI under the PLC Sub-Debt rank for distribution before, after or *pari passu* with the claims of GP1 under the PLC Sub-Notes. On the PLC Ranking Issue:

1 References in this Skeleton Argument to the trial bundles are in the form **[Bundle letter/'V' Volume number** (*where applicable*)/**'T' Tab Number** (*where applicable*)/**Page number]**.

2 **[A/T12/226-229]**.

3 **[A/T3/21-23]**.

4 **[A/T1/1-3]**.

5 Deutsche Bank was joined to the LBHI2 Application on the Order of Mann J dated 24 July 2018 (the **"Mann Order"**) **[A/T11/216-225]** (see also at [2018] EWHC 2017 (Ch), at [1]): but on the basis that it would not duplicate arguments being advanced by PLC.

6 See Bruce 3, [6] **[A/T4/25]** ("*Given the overlap*"); [7] **[A/T4/25]** ("*There is a material overlap*").

7 **[A/T3/22]**.

(a) LBHI's position is that the PLC Sub-Debt and the PLC Sub-Notes rank ***pari passu***.

(b) GP1 and Deutsche Bank's[8] position is that (LBHI's) PLC Sub-Debt ranks **junior** to the PLC Sub-Notes.

(2) Issue 1 of the LBHI2 Application ("**LBHI2 Ranking Issue**")[9] (together with the PLC Ranking Issue, "**the Ranking Issues**"). This is the issue of whether the claims of SLP3 under the LBHI2 Sub-Notes rank for distribution before, after or *pari passu* with the claims of PLC under the LBHI2 Sub-Debt.

(a) SLP3's position is that the LBHI2 Sub-Notes and the LBHI2 Sub-Debt rank ***pari passu***.

(b) PLC and Deutsche Bank's position[10] is that (SLP3's) LBHI2 Sub-Notes rank **junior** to the LBHI2 Sub-Debt.

(3) Issue 1 of the PLC Application ("**Release Issue**")[11]. This is the issue of whether the PLC Sub-Debt has been released pursuant to the (New York law) Settlement Agreement entered into as of 24 October 2011 between, amongst others, LBHI and PLC ("**the Settlement Agreement**").

(a) LBHI's position is that the PLC Sub-Debt *has not* been released.

(b) Deutsche Bank's position is that the PLC Sub-Debt *has* been released in full or in part.

(4) Issue 4 of the PLC Application ("**Discounting Issue**")[12]. This is the issue of whether or not the quantum of PLC's liability under the PLC Sub-Notes falls to be discounted for distribution purposes under Rule 14.44 of the Insolvency (England and Wales) Rules 2016 ("**the 2016 Rules**"), or by reference to some other method (and, if so, by which method).

8 In its letter of 12 February 2018, Deutsche Bank's stated position in the alternative was that "*at the very least*" the PLC Sub-Notes rank *pari passu* with the PLC Sub-Debt (Bruce 3, [105] **[A/T4/45]**). LBHI agrees.

9 **[A/T1/2]**.

10 Despite not being a party to the LBHI2 Application and not having standing to make submissions in relation to the LBHI2 Ranking Issue, GP1 has nonetheless indicated that it supports the position advanced by PLC and Deutsche Bank in relation to the LBHI2 Ranking Issue: see GP1 PP, at [5] **[A/T9/156]**.

11 **[A/T3/21-22]**.

12 **[A/T3/22]**.

(a) LBHI's position is that the PLC Sub-Notes are provable future debts and that the quantum of PLC's liability under the PLC Sub-Notes for distribution purposes falls to be discounted under Rule 14.44 (which is mandatory).

(b) Deutsche Bank's position is that the PLC Sub-Notes are not provable future debts, and that they fall to be quantified by some other (currently unexplained) methodology.

(5) Issue 3 of the PLC Application ("**Guarantee Issue**")[13]. This is the issue of whether any liability of PLC under the PLC Guarantee given in favour of the ECAPS Holders (described below) ranks for distribution before, after or *pari passu* with each of the PLC Sub-Debt and the PLC Sub-Notes. All the parties agree that the PLC Guarantee is junior, and that it ranks after each of the PLC Sub-Debt/PLC Sub-Notes, and a declaration will be sought from the Court to that effect.

6. LBHI/SLP3 will address the issues in the above-mentioned order because:

(1) The PLC Ranking Issue both chronologically pre-dates as well as logically pre-figures the LBHI2 Ranking Issue.

(2) In this regard, a proper understanding of why the LBHI2 Sub-Debt and LBHI2 Sub-Notes rank *pari passu* starts with and is prefigured by an understanding of why the PLC Sub-Debt and the PLC Sub-Notes rank *pari passu*. The PLC Ranking Issue introduces IPRU(INV) (the relevant regulatory regime), the FSA Standard Forms (the relevant standard form contractual documentation) and the "Enhanced Capital Advantaged Preferred Securities" (or "**ECAPS**") (the transactional context relied on by Deutsche Bank) which are common to both Applications.

(3) Many of the same centralised decision-makers within the Lehman Group were involved in the transactions underlying the PLC Ranking Issue and the LBHI2 Ranking Issue; and it is both natural and appropriate for the transactions to be addressed in their actual sequence (as opposed to starting at the end of the story and "working backwards").

13 **[A/T3/22]**.

(4) Finally, the only reason identified by the other parties for taking the issues in a different order (i.e. taking the LBHI2 Ranking Issue *before* the PLC Ranking Issue) is that if the LBHI2 Application is decided in SLP3's favour then some of the issues on the PLC Application may not arise (so that the PLC Application may not need to be determined at all). That makes no procedural sense. The Applications are being heard concurrently, so all the issues will need to be addressed at trial in any event. The court is highly unlikely to give a judgment part way through a trial of this nature and complexity. To that extent, the sequencing of the issues does not need to be, nor should it be based on the prior outcome of the LBHI2 Application.

D. EXECUTIVE SUMMARY

7. In relation to both Ranking Issues, LBHI/SLP3 contend that a *pari passu* construction (**"the Pari Passu Construction"**) is the only construction that gives effect to the objective meaning which the relevant subordination provisions would convey to the reasonable reader, as well as being the only construction that accords with commercial common sense.

8. The PLC Sub-Debt and PLC Sub-Notes are subordinated to the same "Senior Liabilities", they will be entitled to prove at the same time and they will rank *pari passu* under the 2016 Rules. The same applies to the LBHI2 Sub-Debt and the LBHI2 Sub-Notes, which are subordinated to the same "Senior Liabilities"/"Senior Creditors", and again will be entitled to prove at the same time and therefore rank *pari passu* under the 2016 Rules.

9. The Pari Passu Construction provides the correct and consistent answer to both the PLC Ranking Issue and the LBHI2 Ranking Issue. The outcome of it is that LBHI/SLP3 would share rateably in the recoveries from PLC and LBHI2 with, respectively, GP1 and PLC, as opposed to receiving *no return at all*. By contrast, the construction advanced by the other parties (i.e. the senior ranking of the PLC Sub-Notes over the PLC Sub-Debt, and the senior ranking of the LBHI2 Sub-Debt over the LBHI2 Sub-Notes) would result in substantial sums flowing down to only one part of the Lehman Group's regulatory capital structure (as opposed to being shared rateably), resulting in an unintended windfall to,

among others, Deutsche Bank (which is a relatively recent purchaser of the ECAPS in the secondary debt markets)[14].

10. In each case, the subordinated instruments were issued for regulatory capital purposes. Whilst the directly applicable regulatory regime during the period in question changed, the overriding regulatory purpose underlying subordinated debt remained consistent: namely, to ensure the protection of the regulated firm's general creditors, primarily its clients and commercial counterparties. It was no part of the relevant regulatory regimes for dated subordinated debts forming part of a firm's Lower Tier 2 (**"LT2"**)/Tier 3 regulatory capital to subordinate to each other. That, however, is the construction the other Respondents seek to impose on the subordinated debt instruments in this case.

11. A further factor pointing towards the Pari Passu Construction is that the two sets of subordinated instruments engaged in both Ranking Issues were, for differing reasons, required or intended to replicate each other's terms:

(1) The PLC Sub-Notes were required to replicate the subordination provisions of the PLC Sub-Debt as closely as possible so that PLC could obtain a waiver from the requirement under IPRU(INV) to use FSA Standard Form 10 (as defined below). If PLC had not obtained the waiver, the PLC Sub-Notes would not have been able to qualify as regulatory capital.

(2) The LBHI2 Sub-Notes stated on their face that they were refinancing existing subordinated debt i.e. the LBHI2 Sub-Debt. It is common ground with PLC that the three existing tranches of the LBHI2 Sub-Debt ranked *pari passu* at the time of this refinancing. The LBHI2 Sub-Notes were on materially the same commercial terms as the LBHI2 Sub-Debt, with matters such as the coupon replicating the existing rate on the LBHI2 Sub-Debt. This is significant. The case against SLP3 requires that the issuance of the LBHI2 Sub-Notes actively *altered* the pre-existing *pari passu* ranking position of the refinanced LBHI2 Sub-Debt. This makes little sense in circumstances where the purpose of the issuance of the LBHI2 Sub-Notes was narrowly focussed on securing a discrete US tax advantage while continuing to comply with the applicable UK regulatory capital requirements.

14 This is clearly illustrated by the agreed Funds Flow Chart, which can be found at **[F/V10/5808]**.

12. Moreover, both of the subordinated instruments issued in bond format were either based on or related to existing standard forms or precedents:

(1) As regards the PLC Sub-Notes, the FSA was repeatedly informed by the Lehman Group that the PLC Sub-Notes were based on notes issued by Collins Stewart Tullett plc ("**Collins Stewart**"). Those notes contained a slightly modified version of the definition of "Subordinated Liabilities" used in FSA Standard Form 10 (the addition of the words "*and all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes*") upon which the case advanced by GP1/Deutsche Bank on the PLC Ranking Issue appears largely to turn. The fact that these words were taken from a bond precedent to ensure that the PLC Sub-Notes obtained an FSA waiver strongly suggests that the import the other Respondents seek to give them is misplaced.

(2) As regards the LBHI2 Sub-Notes, the key definition of "Senior Creditors" ("*unsubordinated creditors…or…..subordinated creditors….other than…..*") is in materially similar terms to that used in Form 5.1 as prescribed by Chapter 5 of IPRU(INV) ("**FSA Standard Form 5**"), which was applicable at the same time as FSA Standard Form 10, implemented the same core European subordination requirement and was designed to achieve exactly the same subordination outcome. This is another very strong indication that when considering the relative ranking of the LBHI2 Sub-Debt (which was drawn up on FSA Standard Form 10) and the LBHI2 Sub-Notes (which adopted materially similar subordination definitions to FSA Standard Form 5), the two instruments are subordinated behind the same "Senior Liabilities"/ "Senior Creditors" and therefore at the same level.

13 Underlying the correct legal analysis are two closely-related and fundamental principles which the other parties appear to ignore in their position papers. These are:

(1) *First*, for two subordinated debts to rank *pari passu*, it is not necessary for them to cross-refer to each other and/or expressly provide that they rank *pari passu* with each other. It is sufficient that they are subordinated to the same senior liabilities: if A subordinates its debt to C, and B subordinates its debt to C, A and B will prove at the same time.

(2) *Second*, where two subordinated debts are entitled to prove at the same time, they rank *pari passu* and they must be paid in full (unless the assets are insufficient to meet them, in which case they abate in equal proportions): see Rule 14.12 of the 2016 Rules; and Waterfall I, per Lord Neuberger, at [68]-[70].

14. In this context, the reasonable reader of the PLC Sub-Debt/PLC Sub-Notes and the LBHI2 Sub-Debt/LBHI2 Sub-Notes (who, for these purposes, would have all the knowledge reasonably available to the centralised decision-makers within the Lehman Group) would note that:

(1) In each case, to the extent there are any differences in the wording of the subordination clauses in issue (prior to the amendment of the LBHI2 Sub-Notes in 2008), these are minimal.

(2) In each case, *none* of the relevant agreements specifically cross-refers to the other subordinated debts which are said by the other parties either to rank senior or junior.

(3) In each case, the operative subordination provisions in all of the instruments defined the Borrower's or Issuer's "solvency" by reference to its ability to pay "Senior Liabilities"/"Senior Creditors".

(4) In each case, in both structure and substance, the definitions of the "Senior Liabilities"/"Senior Creditors" are materially the same for the purposes of each instrument.

(5) In each case, the relevant subordination provisions are either directly based on or materially similar to the subordination language of standard forms (i.e. FSA Standard Form 10 and FSA Standard Form 5) prescribed by the FSA in relation to regulatory subordinated debt (which were derived from the SFA Rules[15] and the IMRO Rules,[16] as defined below). Those standard forms were intended to rank behind the same "Senior Liabilities"/"Senior Creditors" and to achieve the same subordination outcome.

(6) In the case of the LBHI2 Sub-Debt and the LBHI2 Sub-Notes, it is common ground that the relevant instruments were either LT2 regulatory capital or Tier 3 regulatory capital. The only material difference between the two tiers was the requirement of longer maturity dates for LT2, and standard market practice at the

15 The Securities and Futures Authority.

16 The Investment Management Regulatory Organisation.

time provided that LT2 and Tier 3 regulatory dated subordinated debt ranked *pari passu*.

15. In the face of the above, the reasonable reader would conclude that the relevant instruments in relation to both the PLC Ranking Issue and the LBHI2 Ranking Issue rank behind the same "Senior Liabilities"/"Senior Creditors"; that they are entitled to prove at the same time; and, therefore, that they rank *pari passu*.

16. Moreover, the other Respondents have adduced evidence or accepted in their position papers that none of the centralised decision-makers within the Lehman Group applied their minds to the relative ranking of the relevant subordinated debts. Much the same was stated by David Richards J in Waterfall I[17] in relation to a different part of the same capital structure in issue here. The strong inference to be drawn from this is that there was no purpose to the transactions in question other than to ensure the ranking of the subordinated instruments behind the firm's general creditors, consistent with the overriding regulatory purpose referred to above.

17. Against the clear ordinary meaning of these subordinated instruments, Deutsche Bank (the only non-Lehman Group Respondent) is forced to posit generalised "commercial incentives" within the Lehman Group that cut across both Ranking Issues, and which allegedly motivated/caused LBHI, as the US parent, to arrange the entire regulatory capital structure of the Lehman Group in order to prioritise the interests of certain securities known as "ECAPS" (of which Deutsche Bank is now a large holder as a result of post-insolvency acquisitions in the secondary markets). These alleged incentives are supposedly based on the so-called "Dividend Stopper" and Deutsche Bank's mis-characterisation of the Lehman Group's tax concerns. They are analytically flawed and unsupported by the evidence.

18. The 2008 Amendments to the LBHI2 Sub-Notes do not affect these conclusions on the LBHI2 Ranking Issue:

(1) On a true construction these did not alter the ranking arising from the relevant subordination clause: both prior to and after the 2008 Amendments, SLP3's

17 See [2015] Ch 1, at [48]: "***There is no evidence to suggest that anyone in the Lehman Brothers group gave any consideration to how these provisions would operate in the event of an insolvency of LBIE and indeed the recollection of several witnesses in interviews which have been conducted suggests that it is highly unlikely that any such consideration was given***" (emphasis added).

claims under the LBHI2 Sub-Notes ranked for distribution *pari passu* with PLC's claims under the LBHI2 Sub-Debt.

(2) However, if that conclusion is incorrect as a matter of construction, then SLP3's case is that the LBHI2 Sub-Notes fall to be rectified for common mistake. The Court has the benefit of evidence from a key Lehman Group centralised decision-maker who planned, structured and supervised the 2008 Amendments, as well as the draftsmen at Allen & Overy LLP (**"A&O"**). This evidence overwhelmingly supports the case that there was no intention to alter the *pari passu* ranking.

19 The Release Issue is straightforward. The construction advanced by Deutsche Bank, namely that the effect of the Settlement Agreement (to which it was not a party) was to release all after-acquired claims, including all the PLC Sub-Debt is: (a) inconsistent with the ordinary meaning of the Settlement Agreement (for example: (i) the Recitals refer to the release of "outstanding claims" between the US Affiliates and the UK Affiliates; and (ii) the alleged release of the PLC Sub-Debt is inconsistent with Section 4.04(b) and/or Section 5.04(a) of the Settlement Agreement); (b) commercially absurd; and (c) inconsistent with the clear and unequivocal subsequent conduct of the parties. Deutsche Bank's construction of the Settlement Agreement is incorrect. Further, its suggestion that the PLC Sub-Debt has been part released as a result of the LBHI Guarantees (as defined below) is misconceived.

20. In relation to the Discounting Issue, Deutsche Bank has provided no adequate or legally cogent explanation for why Rule 14.44 of the 2016 Rules (which is a mandatory provision which discounts future debts for the purposes of proof) should not be applied to the PLC Sub-Notes. The PLC Sub-Notes are plainly provable future debts; they are not non-provable liabilities (and Deutsche Bank's reliance on the *obiter* remark of Lord Neuberger in Waterfall I is misconceived); and Deutsche Bank has not advanced a credible or coherent alternative to the Statutory Scheme which the Supreme Court has concluded cannot in any event be altered by judge-made rules.

21. Finally, in relation to the Guarantee Issue, the parties agree that the claims under the PLC Guarantee rank junior to the claims under the PLC Sub-Debt and the PLC Sub-Notes.[18] All the parties seek a declaration from the Court on that basis.

18 GP1 PP, [6.3] **[A/T9/156]**; DB PP, [68] **[A/T8/153]**.

E. HOUSEKEEPING AND PRE-READING

22. Pursuant to the Hildyard Order, the Court has been given 2 days' pre-reading. As well as the skeleton arguments, the Court is asked to pre-read the following:

(1) The terms of the PLC Sub-Debt,[19] the PLC Sub-Notes,[20] the LBHI2 Sub-Debt,[21] and the LBHI2 Sub-Notes (pre-2008 Amendments[22] and post-2008 Amendments[23]).

(2) The joint opening position paper of LBHI/SLP3 dated 11 January 2019 (**"the Joint PP"**)[24]; the responsive position paper of PLC dated 22 February 2019 (**"the PLC PP"**)[25]; the responsive position paper of Deutsche Bank dated 22 February 2019 (**"the DB PP"**)[26]; the responsive position paper of GP1 dated 22 February 2019 (**"the GP1 PP"**)[27]; and the joint reply position paper of LBHI/SLP3 dated 22 March 2019 (**"the Reply PP"**)[28].

(3) The second witness statement of Derek Howell dated 14 March 2018, at [3]-[23] (**"Howell 2"**) (LBHI2)[29].

(4) The third witness statement of Gillian Bruce dated 15 March 2018, at [13]-[88] (**"Bruce 3"**) (PLC)[30].

(5) The first witness statement of Jacqueline Dolby dated 16 April 2019 (**"Dolby 1"**) (PLC)[31]. Ms Dolby was the Lehman Group's Head of European Corporate Tax & Planning from 2006, having been part of the Lehman Group's European corporate tax team since 2000.

19 **[E/T6/81-93]**; **[E/T7/94-106]**; and **[E/T8/107-123]**.
20 **[E/T9/124-146]**; **[E/T12/295-317]**; **[E/T13/318-340]**; and **[E/T14/341-364]**
21 **[E/T1/1-15]**; **[E/T2/16-31]**; and **[E/T3/32-49]**.
22 **[E/T4/50-69]**.
23 **[E/T5/70-80]**.
24 **[A/T5/59-90]**.
25 **[A/T7/94-123]**.
26 **[A/T8/124-154]**.
27 **[A/T9/155-175]**.
28 **[A/T10/176-215]**.
29 **[A/T2/5-15]**.
30 **[A/T4/26-43]**.
31 **[C/T3/31-46]**.

(6) The first witness statement of Thomas Grant dated 19 March 2019 (**"Grant 1"**) (LBHI/SLP3)[32]. Mr Grant drafted the amendments to the LBHI2 Sub-Notes in 2008 while he was a Senior Associate at A&O.

(7) The expert report of Judge Allan L. Gropper dated 5 June 2019 (**"the Gropper Report"**) (LBHI/SLP3)[33].

(8) The expert report of Judge Robert S. Smith dated 6 June 2019 (**"the Smith Report"**) (Deutsche Bank)[34].

(9) The joint experts' report dated 25 July 2019 (**"the Joint Report"**) [35].

23. If time permits, the Court is also asked to pre-read:

(1) The first witness statement of Stephen Miller dated 19 March 2019 (**"Miller 1"**) (LBHI/SLP3)[36].

(2) The first witness statement of Sophie Hutcherson dated 18 April 2019 (**"Hutcherson 1"**) (LBHI/SLP3)[37]. Ms Hutcherson was Head of the Prudential Risk Group within the Lehman Group until June 2008, having previously been employed at the Securities and Futures Authority, a precursor to the Financial Services Authority.

(3) The second witness statement Ronald Geraghty dated 18 April 2019 (**"Geraghty 2"**) (LBHI/SLP3)[38].

(4) The first witness statement of Benjamin Katz dated 18 April 2019 (**"Katz 1"**) (Deutsche Bank)[39].

(5) The first witness statement of Christopher O'Meara dated 9 May 2019 (**"O'Meara 1"**) (LBHI/SLP3)[40].

32 **[C/T2/14-30]**.
33 **[D/T1/1]**.
34 **[D/T2/2]**.
35 **[D/T4/4]**.
36 **[C/T1/1-13]**.
37 **[C/T6/68-89]**.
38 **[C/T7/90-106]**.
39 **[C/T5/62-67]**.
40 **[C/T10/132-135]**.

(6) The second witness statement of Raymond O'Grady dated 9 May 2019 (**"O'Grady 2"**) (LBHI/SLP3)[41].

SECTION I: THE RANKING ISSUES

24. The Ranking Issues address the relative ranking within the administrations of PLC and LBHI2 of claims under subordinated debt instruments issued by entities within the Lehman Group to other entities in that same group. The issues relate to the ranking of claims in relation to the following subordinated debts:

(1) within the administration of PLC, the PLC Sub-Debt and the PLC Sub-Notes; and

(2) within the administration of LBHI2, the LBHI2 Sub-Debt and the LBHI2 Sub-Notes.

25. The PLC Ranking Issue relates to the ranking of claims in respect of the following subordinated debt instruments:

(1) The **"PLC Sub-Debt"**, which is made up of the following three facilities entered into between PLC (as borrower) and an intermediate holding company within the Lehman Group, Lehman Brothers UK Holdings Limited (**"LBUKH"**) (as lender) and now held by LBHI:

(a) a $4.5 billion long term subordinated loan facility entered into on 30 July 2004[42];

(b) a €3 billion long term subordinated loan facility entered into on 30 July 2004[43];

(c) an $8 billion short term subordinated loan facility entered into on 31 October 2005[44]; and

(2) The **"PLC Sub-Notes"**, which are made up of the following series of subordinated notes issued by PLC between 29 March 2005 and 20 February 2006 to the Partnerships (as defined below):

(a) €225,000,000 Fixed Rate to CMS-Linked Subordinated Notes due 2035 issued pursuant to an offering circular dated 29 March 2005[45];

(b) €200,000,000 Fixed Rate Subordinated Notes due 2035 issued pursuant to an offering circular dated 19 September 2005[46], which was consolidated with €50,000,000 Fixed Rate Subordinated Notes due 2035 issued pursuant to an offering circular dated 26 October 2005[47]; and

(c) €500,000,000 Fixed/Floating Rate Subordinated Notes due 2036 issued pursuant to an offering circular dated 20 February 2006[48].

26. LBHI's position is that its claims in respect of the PLC Sub-Debt rank for distribution ***pari passu*** with the claims of GP1 in respect of the PLC Sub-Notes.

27. The LBHI2 Ranking Issue relates to the ranking of claims in respect of the following subordinated debt instruments:

(1) The **"LBHI2 Sub-Debt"** made up of the following three facilities all entered into between LBHI2 (as borrower) and PLC (as lender) on 1 November 2006: (i) a $4.5 billion long term subordinated loan facility[49]; (ii) a €3 billion long term subordinated loan facility[50]; and (iii) an $8 billion short term subordinated loan facility[51]; and

(2) The **"LBHI2 Sub-Notes"** in the sum of US$6,139,000,000 due in 2017 issued by LBHI2 pursuant to an offering circular dated 26 April 2007 and now held by SLP3[52]. The LBHI2 Sub-Notes were amended pursuant to an extraordinary written resolution dated 3 September 2008 (the **"2008 Amendments"**)[53].

28. On this issue, SLP3's position is that the claims of SLP3 in respect of the LBHI2 Sub-Notes rank for distribution ***pari passu*** with the claims of PLC under the LBHI2 Sub-Debt.

41 **[C/T2/128-131]**.
42 **[E/T6/81-93]**.
43 **[E/T7/94-106]**.
44 **[E/T8/107-123]**.

45 **[E/T9/124-146]**.
46 **[E/T12/295-317]**.
47 **[E/T13/318-340]**.
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52 **[E/T4/50-69]**.
53 **[E/T5/70-80]**.

F. THE LEGAL FRAMEWORK

29. The PLC Sub-Debt, PLC Sub-Notes, LBHI2 Sub-Debt and LBHI2 Sub-Notes are all: (i) *subordinated* instruments which subordinate them to other liabilities in an insolvency of English-incorporated issuers; (ii) *regulatory* subordinated instruments issued with a view to meeting capital adequacy requirements set at a European level; (iii) *dated* regulatory subordinated instruments, i.e. with specified maturities as opposed to being perpetual, such that they met the requirements of either LT2 or Tier 3 capital; and (iv) governed by English law.

30. In view of the characteristics of the instruments in question, LBHI/SLP3's legal submissions address the following areas relevant to the determination of the Ranking Issues:

(1) The Statutory Scheme (at [31] to [37]).

(2) Operation of contractual subordination (at [38] to [48]);

(3) Regulatory framework: European law and IPRU(INV)/GENPRU (at [49] to [111]).

(4) Principles of Contractual Interpretation (at [112] to [139]).

(1) The Statutory Scheme

31. The operation of the Statutory Scheme under the Insolvency Act 1986 and the 2016 Rules ("**the Statutory Scheme**") is integral to the proper understanding of the Ranking Issues in this case. In the case of debts drawn up on FSA Standard Form 10, the Supreme Court's judgment in Waterfall I at [70] has already made clear that the subordination mechanism takes effect within the existing framework of the Statutory Scheme by prohibiting a subordinated creditor from being admitted to proof until after the senior creditors have been paid in full.

32. Accordingly, proper consideration of the Ranking Issues begins with the operation of the Statutory Scheme, which stipulates how debts are proved for, how they rank for the purposes of distribution and how dividends are paid in respect of proved debts. It is essential to remember that: (a) the 2016 Rules apply once a claim has been proved in the

insolvent estate; and (b) where the 2016 Rules deal expressly with some matter in one way, it is not open to the courts to deal with it in a different and inconsistent way.[54]

33. Contractual subordination (addressed in more detail in the next section) deals with a creditor's ability to agree, subject to certain limits, either with the borrower or other creditors to defer or not to enforce its rights.

34. It is axiomatic that where *any* two creditors (whether unsubordinated or subordinated) prove at the same time, their claims will rank *pari passu* in an insolvency. This does not depend on the relevant two creditors specifying in an agreement that their debts should rank *pari passu*. Rather, it is based on a fundamental principle of fairness, the *pari passu* principle, which has been put on a statutory footing.

35. The *pari passu* principle is put on a statutory footing in relation to administration by Rule 14.12(2) of the 2016 Rules.[55] This provides that: *"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."*[56]

36. The relevant provisions relating to proofs of debt and the ranking of proved debts for the purposes of distributions in an administration are set out below. They provide the context for the operation of the contractual subordination provisions in question in an administration:

(1) A creditor wishing to recover a debt must submit a proof to the administrator unless[57]: (i) the court orders otherwise; or (ii) the creditor is deemed to have proved pursuant to Rule 14.3(2) or 14.3(3). The creditor's proof must state the total amount of the creditor's claim as at the date of administration.[58]

(2) In support of the *pari passu* principle, the liquidation and distribution of the assets of the insolvent company are treated at least notionally as taking place simultaneously on the relevant date: in a winding-up, that date is the date on

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54 Lord Sumption in Waterfall I at [194].

55 Rule 14.12 also applies to compulsory liquidation.

56 As regards creditors' voluntary liquidation and members' voluntary liquidation, the *pari passu* principle is put on a statutory footing by Section 107 of the Insolvency Act 1986.

57 Rule 14.3 of the 2016 Rules.

58 Rule 14.4(d) of the 2016 Rules.

which the winding-up order is made, and in an administration, it is the commencement of the administration.[59]

(3) However, in practice, there needs to be a cut-off for when one can prove to enable the officeholder to ascertain the company's liabilities. In an administration, where the administrator intends to make a distribution to creditors or to declare a dividend, the administrator is required to deliver a notice of that fact to creditors.[60] That notice must state the last date for proof: Rule 14.30(a).[61]

(4) Rule 14.40(1)(b) of the 2016 Rules provides that where a creditor did not prove for a debt before the declaration of the dividend, the creditor is not entitled to disturb the payment of any dividend or the making of any distribution. However, pursuant to Rule 14.40(2) the creditor is entitled to be paid a dividend or receive a distribution which the creditor has failed to receive out of any money for the time being available for the payment of a further dividend. Such a dividend must be paid or distribution made before that money is applied to the payment of any further dividend or making of any further distribution.

37. If two creditors who have not proved prior to the last date for proof subsequently prove at the same time as each other their claims will rank *pari passu* by virtue of Rule 14.12(2). This is consistent with David Richards J's explanation in Waterfall IIA (first instance) at [201] as to the operation of the *pari passu* principle in relation to claims when they are admitted to proof: "***Once claims have been admitted to proof** for particular amounts, whether in respect of presently payable debts, future debts or contingent or unascertained claims, **those amounts rank pari passu for distributions in the administration***" (emphasis added).

(2) Operation of contractual subordination

38. The subordination of debt concerns the interplay between the Statutory Scheme, as described above, which is prescriptive and can only be altered by Parliament, and personal rights, which can be altered by agreement between the company and the creditor who holds or will hold those rights, provided that the agreement does not purport to adversely alter (without their consent) the rights of another creditor or creditors.

59 For the definition of the "relevant date" for the purposes of Part 14 of the 2016 Rules see rule 14.1(3).
60 Rule 14.29(1)(a) of the 2016 Rules.
61 Rule 14.30 of the 2016 Rules.

39. The creditor has a personal right to prove his debt. Once proved, the Statutory Scheme stipulates how that debt is to be treated, how it should be valued, whether it should be discounted, how any liability in a foreign currency should be converted, and on what basis interest should be paid. That is the application of the Statutory Scheme and it is mandatory. However, the creditor's right to prove his debt is a personal right that the creditor might choose to waive or defer. It is open to the creditor to agree that he should not prove his debt at all, or not until after other creditors have been paid (those other creditors being, by agreement, creditors who rank senior to him). It is open to the creditor to agree that he will only prove for a lesser sum. It is by the creditor agreeing to defer his claim to the claims of others that contractual subordination works.

40. What the company and its creditor cannot do is agree to *improve* the creditor's position. They cannot agree to subordinate the debts of others. They cannot agree to increase the creditor's claim in the event of an insolvency. Such agreements would be contrary to the Statutory Scheme because they would seek to alter the creditor's claim to his advantage or alter the application of the Statutory Scheme to the creditor's claim.

41. At the heart of all English insolvency processes (whether that be bankruptcy, liquidation or a distributing administration) is the collecting in and realisation of the debtor's assets and the sharing of those assets between the creditors entitled to prove their claims in the insolvency estate. The rule by which proved claims share equally, the *pari passu* rule, has at various times been described as a "rule of public policy".

42. To understand the relevance of this "rule of public policy" in the context of subordination it is necessary to consider: Ex Parte Mackay (1873) Ch App. 643; British Eagle International Air Lines Ltd v Compagnie Nationale Air France [1975] 1 WLR 758; and National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd [1972] AC 785. These cases (which are described in more detail in Appendix A to these written submissions) established that a contract purporting to give one party an advantage in an insolvency was void, because such a contract would purport to vary the Statutory Scheme. On the basis of these authorities, contracting out of *pari passu* (including through a subordination agreement) was historically thought to be forbidden.

43. In the more recent cases of Re Maxwell Communications Corp plc (No 2) [1993] 1 WLR 1402 and Re SSSL Realisations (2002) [2006] Ch 610, the Court has recognised that a

subordinated creditor can agree to the deferral of their ordinary rights as an unsecured creditor to prove and share in the distributions in an insolvency.

44. Notably, the subordinated debt in both those cases involved non-regulatory (rather than regulatory) subordinated debt: (i) in Re SSSL Realisations, the subordinated instrument in question was a deed of indemnity pursuant to which various indemnitors agreed that their claims against each other would be subordinated to the surety's claims against the indemnitors; and (ii) in Re Maxwell Communications Corp plc (No 2), the subordinated instrument in question was a subordinated guarantee provided by one Maxwell company to another. Vinelott J noted that subordinated loan capital might be included amongst a company's financial resources under the SFA Rules (as defined below), but *also* recognised the significance of non-regulatory (i.e. commercial) subordinated debt:

> *"It is not infrequently the case that a company can only continue to trade and incur credit with the financial support of a parent or associated company, or a bank which is willing to subordinate its debt to the debts owed to the other unsecured creditor"*.[62]

45. Most recently, in Waterfall I, Lord Neuberger confirmed the rights of creditors to subordinate their debts at [66], where he said that:

> *"In agreement with all the parties on this appeal,* ***I can see no objection to giving effect to a contractual agreement that, in the event of an insolvency, a contracting creditor's claim will rank lower than it would otherwise do in the "waterfall"****. James LJ's dictum in Ex p Mackay, Ex p Brown; In re Jeavons (1873) LR 8 Ch App 643, 647 that a person "is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides" is correct, albeit that* ***it should be treated as subject to two qualifications. First, that it does not apply where the "different distribution" involves the creditor in question ranking lower in the waterfall than the law otherwise provides. Secondly, even if the "different distribution" involves him ranking higher than he otherwise would, the dictum would not apply if all those who are detrimentally affected by his promotion have agreed to it*** *(unless there was some public policy reason not to accede to the "different distribution")"* (emphasis added).

46. In Waterfall I, the Supreme Court unanimously restored paragraph (i) of the Order made by David Richards J at first instance (**"the Order"**), which was in the following terms:

[62] At page 1416.

> *"The claims of [LBHI2] under its subordinated loan agreements with [LBIE] are subordinated to provable debts, statutory interest and non-provable liabilities, all of which (other than the claims of LBHI2 under its subordinated loan agreements and statutory interest thereon, if any) must be paid in full before (a) LBHI2 is entitled to prove and require the LBIE Administrators to admit such proof in respect of its claims under its subordinated loan agreements with LBIE and (b) such claims are available for insolvency set-off resulting from the giving of notice by the LBIE Administrators, on 4 December 2009, that they proposed to make a distribution to LBIE's unsecured creditors"*.

47. Overturning the Court of Appeal, where Lewison LJ (giving the leading judgment) had considered that the subordinated creditor in question could prove for its subordinated debt at any time, but that its debt would be a *contingent* debt until the "Senior Liabilities" had been paid in full, during which period a proof of debt in respect of it would be ascribed a value of *nil*, Lord Neuberger (giving the unanimous judgment of the Supreme Court on this point) said at [70] (emphasis added):

> *"It therefore follows that, in my view,* ***it would not be open to LBHI2 to lodge a proof in respect of the subordinated debt until the non-provable liabilities have been paid in full, or at least until it is clear that, after meeting that proof in full and paying any statutory interest due on it, the non-provable liabilities could be met in full.*** *As soon as that has happened, there would, subject to what I say in the next paragraph, be nothing to stop LBHI2 lodging a late proof."*

48. Accordingly, in the light of the Supreme Court's unanimous decision in Waterfall I, the operation of contractual subordination in the context of the Statutory Scheme involves a subordinated creditor submitting a proof of debt and being admitted to proof only after the relevant "Senior Liabilities" or "Senior Creditors" have been paid in full. As to this:

(1) by virtue of Rule 14.40(1)(b) of the 2016 Rules, the subordinated creditor is not entitled to disturb distributions to the senior creditors, who have received 100p in the pound, and statutory interest (where applicable);

(2) the subordinated creditor's claim is entitled to be admitted to proof in its full principal amount (subject to the discounting of claims that are not due as at the date of the declaration of the next dividend pursuant to Rule 14.44(1)); and

(3) by virtue of Rule 14.40(2), the subordinated creditor is entitled to be paid a dividend out of any money for the time being available for the payment of a further dividend:

(a) if there are sufficient assets in the insolvent estate to pay the admitted debts in full, the subordinated creditor will receive 100 pence in the pound; or

(b) if there are insufficient assets in the insolvent estate to pay the admitted debts in full, then by virtue of Rule 14.12 of the 2016 Rules, the admitted debt of the subordinated creditor, and the admitted debts of any other subordinated creditors proving at the same time will abate in equal proportions between themselves. Their debts rank *pari passu*.

(3) Regulatory Framework: European law and IPRU(INV)/GENPRU

49. As David Richards J said in Waterfall I (at [60]):

"In approaching the issues of construction of the subordinated facility agreements, it is clearly right to have regard to their regulatory context".

50. It appears to be common ground and is plain on the face of the subordinated instruments themselves that the PLC Sub-Debt, PLC Sub-Notes, LBHI2 Sub-Debt and LBHI2 Sub-Notes were all entered into with a view to meeting the regulatory capital requirements of the Lehman Group[63].

51. The principal elements of the capital adequacy rules were described by David Richards J in Waterfall I at [35]-[47] where he summarised the purpose of capital adequacy rules at [33]: *"The purpose of capital adequacy rules is so far as possible to ensure that firms provide financial resources to protect their customers and other stakeholders against failure and enable them to withstand some level of loss."*

52. At the material times, the relevant capital adequacy rules operated at both an international level and at a UK level. EU Directives implementing "Basel I" and subsequently "Basel II" set the minimum standards required for firms' capital adequacy. At a national level, the Lehman Group's regulator at all material times was the FSA. The FSA implemented

[63] See PLC PP, [33] **[A/T7/11]**; DB PP, [22(1)] **[A/T8/130]** and [51(2)] **[A/T8/145]**.

these European standards and set the relevant rules governing regulatory subordinated debt.

53. Two regulatory phases are relevant in this case:

(1) In the first phase, from 2004 to 31 December 2006, the Lehman Group was subject to the requirements of the "Interim Prudential Sourcebook for Investment Businesses" ("**IPRU(INV)**"),[64] specifically Chapter 10 of IPRU(INV)[65]. During the first phase, three sets of subordinated instruments were issued: (i) the PLC Sub-Debt, (ii) the PLC Sub-Notes, and (iii) the LBHI2 Sub-Debt.

(2) In the second phase, from 31 December 2006 to September 2008, the Lehman Group was subject to the General Prudential Sourcebook ("**GENPRU**")[66]. During the second phase, the LBHI2 Sub-Notes were issued.

54. In summary, and as set out below:

(1) The regulatory requirement under the relevant Directives was that subordinated debt relied on for the purposes of "*own funds*" be subordinated in a liquidation to "*all other creditors*" and "*not ...be repaid until all other debts outstanding at the time have been settled*": Article 4(3) of Directive 89/299/EEC[67]; Article 36(3) of Directive 2000/12/EC[68]; and Article 64(3) of Directive 2006/48/EC[69].

(2) IPRU(INV) implemented this regulatory requirement by prescribing the use of certain standard forms (including FSA Standard Form 10, as well as a number of other forms), all of which included subordination provisions giving effect to the relevant Directives. Subsequently, GENPRU did away with the requirement of template agreements which had applied to the Lehman Group under Chapter 10 of IPRU(INV).

[64] Bruce 3, [49] **[A/T4/33]**.
[65] Chapter 10 of IPRU(INV) is located at **[J/V2/T10/509-803]**.
[66] GENPRU Chapter 2 is located at **[J/V2/T11/804-892]**.
[67] **[J/V1/T3/67]**.
[68] **[J/V1/T5/123]**.
[69] **[J/V1/T6/181]**.

Phase I: European framework, Basel I and the Directives

55. A succession of European Directives gave effect to the terms of "Basel I"[70] at EU level from the late 1980s. A core distinction made by Basel I was between Tier 1 capital which included issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock and disclosed reserves[71] (i.e. equity), and Tier 2 capital. What Basel I described at [23] as "*subordinated term debt*" was included within tier 2 capital.

56. Basel I was first given effect within the EU by Directive 89/299/EEC of 17 April 1989, which applied to regulatory capital of credit institutions (defined as "*own funds*"), but not of investment firms. Directive 89/299 recognised the concept of subordinated loan capital. Article 4(3)[72] contained the core subordination requirement: "*Member States or the competent authorities may include fixed-term cumulative preferential shares referred to in Article 2(1)(8) and subordinated loan capital referred to in that provision in own funds, **if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled***" (emphasis added).

57. The wording in bold is significant. The reference to "*all other creditors*" was a reference to all of the credit institution's creditors other than its regulatory subordinated debt. It was cross-referenced by a number of other European Directives. The protection of these "*other creditors*" or, as David Richards J described them in Waterfall 1, the firms' "*customers and other stakeholders*"[73], was the principal focus of the European legislation from the outset.

58. Investment firms were dealt with by Directive 93/6/EEC, which applied to the Lehman Group.[74] Annex V provided that the "*own funds*" of investment firms and credit institutions were defined in accordance with Directive 89/299/EEC, subject to certain immaterial modifications.

70 In July 1988, the Basel Committee produced the "International Convergence of Capital Measurement and Standards" ("**Basel I**") [J/V1/T1/1-26]. This set out the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved.
71 At paragraph 12 **[J/V1/T1/3-4]**.
72 **[J/V1/T3/67]**.
73 See David Richards J's judgment in Waterfall I at [33].
74 **[J/V1/T4/69-94]**. See also David Richards J's judgment in Waterfall 1 at [38], describing Council Directive 93/6/EEC as being of "direct relevance" to LBIE.

59. On 20 March 2000, Directive 89/299/EEC was repealed and replaced by Directive 2000/12. Article 34 provided that the "own funds" of a credit institution consist of among other things, fixed term cumulative preferential shares and subordinated loan capital as referred to in Article 36(3).[75] Article 36(3)[76] was in very similar terms to Article 4(3) of Directive 89/299/EEC, set out above.

UK implementation: IPRU(INV)

60. In 2001, the FSA introduced IPRU(INV). It was noted in Appendix 63 to Chapter 10 of IPRU(INV) that the FSA was constrained in its rule-making by the requirements imposed upon it by the relevant EU Directives[77], and the purpose of IPRU(INV) was to implement the European legislation.

61. IPRU(INV) brought together a number of different handbooks which had previously been applied by different Self-Regulatory Organisations ("**SROs**") under the aegis of the Securities and Investments Board ("**SIB**"), prior to the establishment of the FSA in 2000.[78] As IPRU(INV) itself noted, the chapter numbers in IPRU(INV) correspond with those under the rulebooks of the firms' previous regulators.[79]

62. IPRU(INV) Chapter 1 described the purpose of the rulebook as being to assist the (newly formed) FSA "*to meet the statutory objectives of protecting consumers and maintaining market confidence.*" The purpose of IPRU(INV) was stated to be to set "*minimal capital and other risk management standards thereby **mitigating the possibility that firms will be unable to meet their liabilities and commitments to consumers and counterparties***": IPRU(INV) 1.1.2G[80].

75 Article 34(2)(8) **[J/V1/T5/121-122]**.
76 "*Member States or the competent authorities may include ... subordinated loan capital referred to in [Article 34(2)(8)] in own funds, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, **they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled***" (emphasis added) **[J/V1/T5/123]**.
77 At page 60 **[J/V2/T10/717]**: "*the FSA is constrained by the requirements of the Capital Adequacy Directive, and associated pieces of legislation*".
78 Under the Financial Services and Markets Act 2000.
79 IPRU(INV) 1.1.3G **[J/V2/T10/497]**.
80 **[J/V2/T10/497]**.

IPRU(INV) Chapter 10

63. The FSA capital adequacy rules which applied to the Lehman Group in the UK up until 31 December 2006 were set out in IPRU(INV) Chapter 10.[81]

64. Chapter 10[82] emerged out of the relebook formerly applied by the Securities and Futures Authority ("**SFA**" and the "**SFA Rules**") to securities and futures firms which were investment firms ("**SFA ISD Firms**") prior to the consolidation of the various rulebooks under IPRU(INV).

65. The SFA was one of the two SROs that are material for current purposes (the other being IMRO, which is referred to below).

66. While IPRU(INV) was in force, if a firm which was subject to Chapter 10 wished to use a subordinated loan as part of its "*financial resources*" (i.e. regulatory capital) it was required to use standard forms. Rule 10-63(4)[83] stated that subordinated loans had to be classified into long term subordinated loans and short term subordinated loans, and Annex D of IPRU(INV) contained a list of standard forms (including guidance notes) for former SFA ISD Firms (such as entities within the Lehman Group) (collectively "**FSA Standard Form 10**" and together with FSA Standard Form 5, "**the FSA Standard Forms**"):

(1) 10.1 Long Term Subordinated Loan Agreement[84].

(2) 10.2 Short Term Subordinated Loan Agreement[85].

(3) 10.6 Long Term Consolidated Supervision[86] Subordinated Loan Agreement[87].

(4) 10.7 Short Term Consolidated Supervision Subordinated Loan Agreement[88].

81 Hutcherson 1, [16] **[C/T6/72]**.
82 Chapter 3 applied to securities and futures firms which were not investments firms.
83 **[J/V2/T10/517-518]**.
84 **[J/V2/T10/729-743]**.
85 **[J/V2/T10/744-758]**.
86 Historically, only regulated entities were examined for capital adequacy and governance. After the 1990s, the UK regulators introduced consolidated supervision of entire groups, to ensure that capital adequacy of a group as a whole was sufficient. The introduction of consolidated supervision required the development of these two further forms 10.6 and 10.7 (Hutcherson 1, [24]-[27] **[C/T6/73-74]**).
87 **[J/V2/T10/765-779]**.
88 **[J/V2/T10/780-794]**.

67. The SFA Rules had also required the use of standard forms.[89] The forms prescribed by the SFA for these purposes were in materielly the same form as FSA Standard Form 10[90].

68. The manner in which IPRU(INV) Chapter 10 sought to ensure compliance with the requirements set at a European level relating to subordinated loan capital was highly prescriptive in this first phase. As to this:

(1) Pursuant to Rule 10-62(1)[91], the basic requirement was that investment firms were required to maintain "financial resources" in excess of their "financial resources requirement" ("**FRR**"). Pursuant to Rule 10-62(2) the investment firm was required to calculate its "financial resources" in accordance with a prescribed Table. In turn, the complex calculation of a firm's FRR was set out under Rule 10-70.

(2) Rule 10-63(1)[92] provided that "*A firm may take into account subordinated loan capital in its financial resources*".

(3) As noted, in order to be taken into account for the purposes of its "financial resources", a firm could only include a subordinated loan if it was drawn up in accordance with the standard forms obtained from the FSA, unless they sought a modification or waiver. IPRU Rule 10-63(2) and the guidance annotations thereto provided[93]:

"*10-63(2) R A firm may include a subordinated loan in its financial resources only:*

(a) if it is drawn up in accordance with the standard forms[94] obtained from the FSA;

89 Rule 10-63(2) of the SFA Rules provides "*A firm may include a subordinated loan in its financial resources only if it is drawn up in accordance with the standard forms obtained from SFA except to the extent that SFA otherwise permits.*" The SFA Rules were introduced as a direct response to Directive 93/6/EEC on capital adequacy requirements.
90 See FSA Consultation Paper 54 ("The Investment Business Interim Prudential Handbook") ("**CP54**"), at 7.4: "*the current [SFA] standard forms including those for subordinated loan agreements and qualifying undertakings will be maintained with minimum changes. The forms will be available shortly on the FSA website*".
91 **[J/V2/T10/513]**.
92 **[J/V2/T10/517]**.
93 **[J/V2/T10/517]**.
94 A note below explained that "***If a firm wishes to use a form which differs from the standard form it will need to seek a modification to, or waiver from, this rule***" (emphasis added).

(b) if it is signed by authorised signatories of all the parties; and

(c) to the extent that it is paid up by the lender.

69. The manner in which the core European requirement to *"rank after the claims of all other creditors"* was satisfied was to require firms to use FSA Standard Form 10, which was drafted to implement the requisite subordination.

70. As to FSA Standard Form 10:

(1) Under Paragraph 5, the rights of the Lender were subordinated to the "Senior Liabilities".

(2) FSA Standard Form 10 defined the "Senior Liabilities" to mean *"all Liabilities except the Subordinated Liabilities and Excluded Liabilities"*.

71. The mandatory requirement to use FSA Standard Form 10 had a number of consequences:

(1) It saved a great deal of time and money for both the FSA and the firm. [95]

(2) It ensured consistent treatment of firms by the FSA[96]. By requiring firms to use the same standard forms, the FSA could be sure that the core subordination requirement prescribed under the EU Directives was met. As to this:

(a) At first instance in Waterfall I at [75], David Richards J said of FSA Standard Form 10 that: *"The purpose of the template agreements, giving effect as they do to EU Directives, is to provide a uniform system of subordination."*

(b) In construing agreements drawn up on FSA Standard Form 10, in the Court of Appeal in Waterfall I Moore-Bick LJ said at [246]:

"Having regard to the regulatory context in which the agreement was made, I am satisfied that its purpose was to ensure that in an insolvency the subordinated creditors should rank behind all those whose claims would have to be recognised in the insolvency."

95 Hutcherson 1, [17] **[C/T6/72]**.

96 Ibid.

(c) In the Supreme Court, Lord Neuberger said at [64]: *"The purpose of the parties to those agreements was to ensure that all those with claims on LBIE would have priority over the holders of the subordinated debt."*

72. Significantly, it was no part of the subordination provisions in the FSA Standard Forms, IPRU(INV) more generally (see 1.1.2G), or the requirements of the European framework that certain subordinated debt forming part of a particular tier should be subordinated to other subordinated debt within the same tier.

IPRU(INV) Chapter 5

73. IPRU(INV) Chapter 5 emerged out of the rulebook of the Investment Management Regulatory Organisation (**"IMRO"** and the **"IMRO Rules"**)[97]. Like the SFA Rules (referred to at [64] above), the IMRO Rules were introduced to implement Directive 93/6/EEC on capital adequacy requirements. Chapter 5 applied to *investment management firms*, which were firms that were members of IMRO immediately prior to the commencement of IPRU(INV). Lehman was not an IMRO firm.

74. Both Chapter 5 and Chapter 10 of IPRU(INV) were intended to fulfil the basic purpose set out at IPRU(INV) 1.1.2G[98] as well as the core requirements relating to regulatory capital set out at a European level.

75. Unlike IPRU Chapter 10, Chapter 5 also specified the characteristics qualifying subordinated loans were required to have. In this regard, IPRU(INV) Rule 5.2.5(1)(b) set out the requirement that *"in the event of the winding up of the firm, the loan ranks after the claims of **all other creditors** and is not to be repaid until all other debts outstanding at the time have been settled."* This replicated the exact language of the core subordination requirement in the EU capital adequacy directives which were then in force: see Article 4(3) of Directive 89/299/EEC and its successor provisions[99].

76. IPRU(INV) Rule 5.2.5(4) required that "a *qualifying subordinated loan must be in the form prescribed by the FSA for the purposes of this rule*". Again, this was subject to

97 This is explained in CP54, [2.10], which described how IPRU(INV) would replace the prudential material from the SFA Rules and the IMRO Rules.

98 *"Setting minimal capital and other risk management standards thereby mitigating the possibility that firms will be unable to meet their liabilities and commitments to consumers and counterparties"* **[J/V2/T10/497]**.

99 **[J/V1/T10/67]**.

obtaining the FSA's approval to the use of a subordinated loan agreement other than in the prescribed form.

77. Annex D of IPRU(INV) contained the relevant "Prescribed Subordinated Loan Agreement" which gave effect to Rule 5.2.5(1)(b), namely, Form 5.1 ("**FSA Standard Form 5**"). This was in materially the same terms as the "Specimen Subordinated Loan Agreement" which had previously been prescribed under the IMRO Rules.[100]

78. Like FSA Standard Form 10, the purpose of FSA Standard Form 5 was to ensure that the regulatory subordinated debt ranked after the claims of "*all other creditors*".

(1) Under Paragraph 7, the rights of the Lender under the Loan were subordinated to the rights of the "*Senior Creditors*".

(2) FSA Standard Form 5 defined the "Senior Creditors" to mean:

"*all such persons who are:*

(a) ***unsubordinated creditors of the Borrower****; or*

(b) subordinated creditors of the Borrower other than those whose claims are expressed to rank and do rank, pari passu with or junior to the claims of the Lender hereunder" (emphasis added).

79. As set out in more detail below:

(1) Like FSA Standard Form 10, FSA Standard Form 5 was required to subordinate the regulatory subordinated debt after "*all other creditors*", and in order to do so subordinates the regulatory subordinated capital to the "Senior Creditors".

(2) The definition of "Senior Creditors" under FSA Standard Form 5 is materially similar to the definition of "Senior Creditors" under the LBHI2 Sub-Notes, in that it bifurcates that category so as to include expressly both (a) unsubordinated creditors and (b) subordinated creditors "*other than*" specified exceptions.

80. For present purposes, the key points are these:

[100] Table 2.5(5) of the IMRO Rules.

(1) Both FSA Standard Form 10 and FSA Standard Form 5 were intended to comply with the overriding purpose set out in IPRU 1.1.2G, and the overarching regulatory capital requirements imposed at a European level, which was to subordinate the regulatory subordinated debt after "*all other creditors*" (i.e. all creditors other than the regulatory subordinated debt).

(2) Both standard forms were derived from existing standard forms put in place under the SFA Rules and the IMRO Rules, which had been introduced in order to implement the capital adequacy requirements set by Directive 93/6/EEC.

(3) There were certain differences between the definitions and operative subordiuation provisions used in FSA Standard Form 10 and FSA Standard Form 5: for example, the latter provided for subordination to the "Senior Creditors" defined as "unsubordinated creditors" and "subordinated creditors" (other than certain carve-outs), whilst the former specified subordination to the "Senior Liabilities" defined as "*all Liabilities except the Subordinated Liabilities and Excluded Liabilities*".

(4) However, it is clear that both FSA Standard Form 10 (and the forms previously prescribed under the SFA Rules) and FSA Standard Form 5 (and the forms previously prescribed under the IMRO Rules) were intended to bring about the same subordination result and give effect to the overriding European requirement of subordinating the regulatory subordinated debt to "*all other creditors*" of the regulated firm.

81. In short, the two standard forms in Chapter 5 and Chapter 10 – though adopting different wording – were two methods prescribed by the FSA at the same time for achieving exactly the *same subordination outcome*.

82. That the different subordination language in FSA Standard Form 10 and FSA Standard Form 5 was intended to achieve the same result can be seen from a comparison of FSA Standard Form 5 and the "Prescribed Qualifying Undertaking"[101] also prescribed under Chapter 5 of IPRU(INV): both of which are in Annex D of IPRU(INV). Both documents

[101] This is a tri-partite undertaking between the Lender, the Borrower and the FSA under which the Lender undertakes to pay a Specified Amount to the Borrower on demand from the FSA (which undertaking can then be used to be taken into account when determining the Borrower's compliance with its FRR).

were prescribed by the IMRO Rules, became part of IPRU(INV) and are prescribed forms for the same transaction. They provide as follows:

(1) FSA Standard Form 5 defines "Senior Creditors" as "*all such persons who are (a) unsubordinated creditors of the Borrower; or (b) subordinated creditors of the Borrower other than those whose claims are expressed to rank and do rank, pari passu with or junior to the claims of the Lender hereunder*".

(2) The "Prescribed Qualifying Undertaking" defines "Senior Liabilities" as "*all Liabilities except all Liabilities in respect of any sums paid to the Principal under the terms of this Undertaking and Excluded Liabilities*". This is materially the same formulation of "Senior Liabilities" that is used in FSA Standard Form 10.

83. This again illustrates that the subordination language in FSA Standard Form 10 and FSA Standard Form 5 was intended to achieve the same subordination outcome.

Phase 2: Basel II

84. On 26 June 2004, Basel II was agreed by the members of the Basel Committee[102]. Basel II retained the same definition of regulatory capital as that set out in Basel I, but took account of the definition of Tier 3 capital as set out in the Basel Committee's 'Amendment to the Capital Accord to Incorporate Market Risks' dated January 1996 (as amended). Paragraph 49(xiii) defined "Tier 3" capital as consisting of "*short-term subordinated debt [] for the sole purpose of meeting a proportion of the capital requirements for market risks, subject to the following conditions*"[103].

85. Basel II was implemented by, amongst others, Directive 2006/48/EC on the taking up and the pursuit of the business of credit institutions, and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions. Directive 2000/12/EC was amended and recast by Directive 2006/48/EC.[104] Directive 93/6/EEC was repealed and replaced by Directive 2006/49.[105]

86. Whereas prior to 2006 the Lehman Group had been subject to a different regime from credit institutions, the effect of Directive 2006/49/EC was to bring the Lehman Group

102 **[J/V1/T2/27-63]**.
103 **[J/V1/T2/56]**.
104 Recital 1 **[J/V1/T6/154]** and Article 158 **[J/V1/T6/209]**.
105 Article 52 **[J/V1/T7/371]**.

under Directive 2006/48/EC, along with credit institutions. Thus Recital 11 to Directive 2006/49/EC provides[106]:

"*Since investment firms face in respect of their trading book business the same risks as credit institutions, it is appropriate for the pertinent provisions of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (1) to apply equally to investment firms.*"

87. Directive 2006/48/EC Article 64(3) provides[107]:

Member States or the competent authorities may include ... subordinated loan capital referred to in [Article 57(h)] in own funds, if binding agreements exist under which, in ***the event of the bankruptcy or liquidation*** *of the credit institution,* ***they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.*** *"* (emphasis added)

88. The core subordination requirement is in the same terms as that under Article 36(3) of Directive 2000/12. The regulatory subordinated loan capital was to rank after the claims "*of all other creditors*".

89. The deadline to implement Directive 2006/48/EC and Directive 2006/49/EC was 31 December 2006.[108]

UK implementation: GENPRU

90. On 31 December 2006, the FSA introduced GENPRU which set out the capital adequacy requirements applicable to the Lehman Group from that date until the date of the administration in September 2008. It gave effect to, among others, Directive 2006/48/EC and Directive 2006/49/EC.

91. The LBHI2 Sub-Notes were the only instrument for current purposes entered into after 31 December 2006, the date on which the new GENPRU regime came into effect.

92. As regards GENPRU, David Richards J said at [42] of the Waterfall I (first instance) judgment that: "*Based on Basel II and the relevant Directives, three tiers of capital were*

106 **[J/V1/T7/355]**.
107 **[J/V1/T6/181]**.
108 See Article 157 of Directive 2006/48/EC **[J/V1/T6/209]** and Article 49 of Directive 2006/49/EC **[J/V1/T7/370]**.

specified, which a firm was required to identify separately in its regulatory capital reporting to the FSA." GENPRU set out the characteristics required for instruments to fall within each of the three tiers of capital.

93. Under GENPRU, Tier 2 capital was divided into LT2 and Upper Tier 2 ("**UT2**") capital, with the requirements for UT2 being more onerous. It appears to be agreed that the subordinated debts in this case are either LT2 or Tier 3 debts for the purposes of GENPRU, and none were UT2 instruments (see PLC PP, at [51.4] **[A/T7/113]**).

94. As far as the regulation of the Lehman Group was concerned, a major departure from IPRU(INV) Chapter 10 was that subordinated loans no longer had to be drawn up on standard forms in order to qualify as Tier 2 or Tier 3 capital. Instead, GENPRU prescribed a series of requirements in relation to Tier 2 and Tier 3, which capital instruments were required to satisfy.

95. As to the requirements for Tier 2 capital instruments:

(1) GENPRU 2.2.159(1) required that Tier 2 capital instruments must provide that the claims of the Tier 2 creditors rank behind those of all unsubordinated creditors: "*(1) the claims of the creditors must rank behind those of all unsubordinated creditors*"[109]. The expression "*unsubordinated creditors*" bears the same meaning as the words "*all the other creditors*" that was used in the Directives.

(2) GENPRU 2.2.159(8) required that "*the terms of the capital instrument must be set out in a written agreement that contains terms that provide for the conditions set out in (1) to (7)*"[110].

(3) GENPRU 2.2.159(12) provided that "*the firm has obtained a properly reasoned independent legal opinion from an appropriately qualified individual stating that the requirements in (1) to (7) and (insofar as it relates to whether the capital instrument is unsecured) (9) have been met*"[111].

109 **[J/V2/T11/844]**.
110 **[J/V2/T11/844]**.
111 **[J/V2/T11/844]**.

(4) GENPRU 2.2.164 signalled an intentional shift from the FSA's previous policy of requiring the use of standard forms[112]:

> "*The FSA is more concerned that the subordination provisions listed in GENPRU 2.2.159 R should be effective than that they should follow a particular form. The FSA does not, therefore, prescribe that the loan agreement or capital instrument should be drawn up in a standard form.*"

96. The shift under GENPRU was based on a policy decision by the FSA, acknowledging the development of the different types of Tier 2 and Tier 3 capital instruments. It provided flexibility to firms to design their own documentation, rather than being required to use a prescriptive FSA Standard Form, provided the documentation was supported by a legal opinion.[113]

97. As regards Tier 3 capital, GENPRU required the relevant instrument to meet the general requirements applicable to Tier 2, with the modifications set out in the table under GENPRU 2.2.245[114]. The principal modifications involved amending references to the "fifth anniversary" in the Tier 2 provisions to the "second anniversary" in respect of maturity dates.

<u>FSA Standard Forms post-GENPRU</u>

98. The introduction of GENPRU raised the question as to what was to be done with all of the subordinated debts drawn up on the standard forms prescribed by IPRU(INV).

99. Ms Sophie Hutcherson was the key point of contact between the Lehman Group and the FSA at the material times. Her evidence is that:

(1) Many firms contacted the FSA to enquire whether existing loans documented using FSA Standard Form 10 would need to be redocumented.[115]

(2) A huge amount of time and money would have to be expended to re-write every loan that used the standard form documentation, such that the FSA decided to

112 **[J/V2/T11/845]**.
113 Hutcherson 1, [20] **[C/T6/73]**.
114 **[J/V2/T11/844]**.
115 Hutcherson 1, [21] **[C/T6/73]**.

"grandfather" subordinated loans drawn up on FSA Standard Form 10 (which were GENPRU-compliant) through into GENPRU.[116]

(3) The agreements previously executed on FSA Standard Form 10 remained valid and did not need to be re-written. In addition, waivers that had been granted by the FSA previously were also grandfathered with the introduction of GENPRU.[117]

100. It necessarily follows from this that the FSA considered that the FSA Standard Forms gave effect to the specific requirements under GENPRU. Otherwise, it would have required the FSA Standard Forms to be re-drafted so as to comply with the new regime.

101. The regulatory shift from IPRU(INV) to GENPRU provides key context to the LBHI2 Ranking Issue. The construction question involves construing one instrument drawn up on the standard forms applicable under the old regime (FSA Standard Form 10), and one instrument drafted by external lawyers under the new approach put in place by GENPRU (and which contained a definition of "Senior Creditors" that was materially similar as that in FSA Standard Form 5).

Relative Ranking of LT2 and Tier 3 Regulatory Capital

102. It is common ground between SLP3 and PLC that the LBHI2 Sub-Debt was LT2 capital, alternatively Tier 3 capital, and the LBHI2 Sub-Notes were LT2[118].

103. As set out above, there is no requirement or expectation under GENPRU that Tier 3 capital and LT2 capital need to rank differently. The principal difference was the minimum original maturity and the period of notice for repayment (2 years for Tier 3 and 5 years for LT2).

104. However, as a general rule, at all material times Tier 3 and LT2 dated subordinated debts usually ranked *pari passu* amongst themselves (and, by necessary inference, LT2 capital debt instruments ranked *pari passu* as between themselves).

105. This is explained in various materials (including Basel working papers, as well as textbooks in this area):[119]

116 Hutcherson 1, [22] **[C/T6/73]**.
117 Hutcherson 1, [22] **[C/T6/73]**.
118 See PLC PP, [51(4)] **[A/T7/113]**.

(1) Basel Committee on Banking Supervision, Working Paper Number 12 (2003, page 6): ***"Tier 3 debt** is not amortised and it **ranks pari passu with "lower Tier 2" debt**"*.

(2) Managing Bank Risk: An Introduction to Credit Engineering (Glantz, 2003, page 403): *"[Tier 3 is] subordinated to senior, but **pari passu with lower Tier 2** instruments"*.

(3) Investing in Corporate Bonds and Credit Risk (Hagenstein, Mertz and Seifert, 2004, page 169): *"**Tier 3 debt** can exclusively support market risk in the trading book. **It ranks pari passu with Lower Tier 2** and is dated with a minimum maturity of 2 years"*.

106. Moreover, a contemporaneous client briefing paper by A&O entitled "Regulatory Capital" dated November 2008 stated at page 4: "*Tier 3 ranks pari passu with Lower Tier 2*".[120]

107. Accordingly, the general position is that Tier 3 and LT2 dated subordinated debts will rank *pari passu* as between themselves.

Post-GENPRU and beyond

108. The regulatory regime continues to evolve. The EU has recently introduced a new class of subordinated senior debt in the hierarchy of creditors, which ranks above own funds instruments and subordinated liabilities that do not qualify as "own funds", but below other general creditors.

109. In this regard the Financial Stability Board's[121] 'Total Loss-Absorbing Capacity (TLAC) Term Sheet' now requires global systemically important banks to meet a new requirement for Minimum External Total Loss-Absorbing Capacity (Minimum TLAC). This is

119 LBHI/SLP3 initially indicated that they may seek to rely upon expert evidence of market practice to make this point good. This suggestion was opposed in correspondence by PLC in its letter dated 7 May 2019 **[H/254]** on the basis that such evidence was not relevant or necessary for the purpose of determining the LBHI2 Application or the PLC Application. However, the main point i.e. that LT2 and Tier 3 capital rank *pari passu* as a general rule is apparent from open source materials.
120 Page 5 of the briefing paper provided contact details for Mr Miller, who was involved in drafting both the PLC Sub-Notes and the LBHI2 Sub-Notes.
121 The Financial Stability Board is an international body that monitors and makes recommendations about the global financial system. It was established after the G20 London summit in April 2009 as a successor to the Financial Stability Forum.

intended as "*an additional requirement to minimum regulatory capital requirements*" already set out in European law (page 11).[122]

110. The "TLAC" standards were in part implemented in the EU by Directive EU 2017/2399[123], which introduced a new layer of non-preferred senior subordinated debt. In relation to this:

(1) Recital 10 provides that "*this Directive should...require Member States to create a new class of non-preferred senior debt that should rank in insolvency above own funds instruments and subordinated liabilities that do not qualify as own funds instruments, but below other senior liabilities*".

(2) Recital 12 provides that "*Member States should also ensure that the new non-preferred senior class of debt instruments has a higher priority ranking than the priority ranking of own funds instruments and the priority ranking of any subordinated liabilities that do not qualify as own funds.*"

111. The effect of this new regime is that some "TLAC" would be treated as a form of subordinated senior debt for these purposes and would, accordingly, sit between general creditors and subordinated "own funds" (whether as a result of statute or contract).

(4) Principles of Contractual Interpretation

112. It is a notable feature of this case that the parties contending for constructions other than the Pari Passu Construction adopt diametrically opposite approaches to the interpretation of the relevant instruments.

113. On the one hand, GP1 (the PLC Ranking Issue) and PLC (the LBHI2 Ranking Issue) rely on a narrow textual approach which appears to verge on positing that the instruments in question should be interpreted in a vacuum.

114. On the other, in relation to both the PLC Ranking Issue and the LBHI2 Ranking Issue, Deutsche Bank adopts a broad purposive approach which seeks to impute certain commercial "incentives" to the Lehman Group which purportedly motivated it to ensure

[122] See the TLAC "Term Sheet", dated 9 November 2015.
[123] This was implemented in this jurisdiction by The Banks and Building Societies (Priority on Insolvency Order) 2018.

that the ECAPS (of which Deutsche Bank is the largest holder) be paid in priority, with an impact at each level of the capital structure.

115. Neither approach is correct.

<u>Starting Point: Objective Meaning</u>

116. The applicable principles have been stated and restated many times by the House of Lords/Supreme Court in recent years (<u>Investors Compensation Scheme v West Bromwich Building Society [1998] 1 WLR 896</u>; <u>Chartbrook v Persimmon [2009] 1 AC 1173</u>; <u>Re Sigma Finance Corp [2009] UKSC 2</u>; <u>Rainy Sky v Kookmin Bank [2011] 1 WLR 2900</u>; <u>Arnold v Britton [2015] AC 1619</u>; <u>Wood v Capita Insurance Services [2017] AC 1173</u>). Most recently, the Supreme Court said in <u>Wood v Capita Insurance Services</u> at [10]:

"*The court's task is to ascertain the objective meaning of the language which the parties have chosen to express their agreement. It has long been accepted that this is not a literalist exercise focused solely on a parsing of the wording of the particular clause but that the court must consider the contract as a whole and, depending on the nature, formality and quality of drafting of the contract, give more or less weight to elements of the wider context in reaching its view as to that objective meaning*".[124]

117. The court must consider the language used and ascertain what a reasonable person, that is a person with all the background knowledge which would reasonably have been available to the parties in the situation they were in at the time of the contract, would have understood the parties to have meant[125]. If there are two possible outcomes, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other.[126] The greater the ambiguity, the more persuasive may be an argument based on the apparently greater degree of common sense of one version over the other (LB Re Financing No 3 Ltd <u>v Excalibur Funding No 1 Plc</u> [2011] EWHC 2111 (Ch), at [46]).

<u>Factual Matrix: General Rule</u>

118. The courts will look at all the circumstances surrounding the making of the contract and available to the parties which would assist in determining how the language of the

[124] Per Lord Hodge, with whom Lord Neuberger, Lord Mance, Lord Clarke and Lord Sumption all agreed.
[125] <u>Lukoil Asia Pacific Pte Ltd v Ocean Tankers (Pte) Ltd</u> [2018] EWHC 163 (Comm), per Popplewell J.
[126] See <u>Chitty on Contracts</u> (33rd edition), at 13-077.

document would have been understood to a reasonable person (<u>Chitty on Contracts</u>, 33rd edition, 13-049).

119. Crucially, "*Textualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation*" (<u>Wood v Capita</u>, at [13]). The balance between textualism and contextualism will vary according to the circumstances of the case. However, the textual approach is never absolute or exclusionary, and the case law has established the following principles.

120. <u>First</u>, the starting point is that "*contracts are not made in a vacuum: there is **always** a setting in which they have to be placed*" (emphasis added) (<u>Reardon Smith Line Ltd v Yvgar Hansen-Tangen</u> [1976] 1 WLR 989, 995 per Lord Wilberforce)[127]: it is not correct (even in the case of "tradeable instruments", see at [129] to [139] below) that the contractual language can be construed without putting it in its setting.

121. <u>Second</u>, as regards the scope of the factual matrix, the starting point is that this includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man (but is limited by the rule that it should have been reasonably available to the parties).[128]

122. <u>Third</u>, the evidence of the factual matrix can include evidence of the 'genesis' and objectively the 'aim' of the transaction (<u>Prenn v Simmons</u> [1971] 1 WLR 1381, per Lord Wilberforce). Given that the Court should know the commercial purpose of the contract in question, evidence of the genesis and objectively the aim of the transaction is admissible.[129] This also presupposes knowledge of the background, the context and the market in which the parties are operating.

123. <u>Fourth</u>, in construing a document, "*the court is entitled (and, indeed, bound) to enquire beyond the language of the document and see what the circumstances were with reference to which words were used, and the object appearing from those circumstances which the*

[127] <u>Reardon Smith Line Ltd v Yvgar Hansen-Tangen</u> [1976] 1 WLR 989, 995. See also <u>Canmer International Inc v Mutual Steamship Assurance Association (Bermuda) Ltd</u> [2005] EWHC 1694 (Comm), [2005] 2 Lloyd's Rep 49 at [22] per Gloster J.

[128] <u>Investors Compensation Scheme Ltd v West Bromwich Building Society</u> [1998] 1 WLR 896, 912-913, with this proposition specifically approved in <u>Wood v Capita Insurance Services</u> at [10].

[129] <u>Reardon Smith Line Ltd v Yvgar Hansen-Tangen</u> [1976] 1 WLR 989, 995; <u>Crema v Cenkos Securities plc</u> [2010] EWCA Civ 1444 at [43].

person using them had in view".[130] In other words, an instrument should be construed consistently with its purpose as objectively identified[131]:

(1) In <u>Waterfall I</u> the Supreme Court expressly relied at [64] on the purpose of FSA Standard Form 10 in order to resolve the ranking issue in that case:

> "*Looking at the issue from a broader, purposive, perspective, the conclusion that both statutory interest and non-provable liabilities have priority over the subordinated debt seems to me to accord both with the eponymous nature of the subordinated debt, and with what a reasonable reader would expect from the general thrust of the terms of the Loan Agreements. **The purpose of the parties to those agreements was to ensure that all those with claims on LBIE would have priority over the holders of the subordinated debt. In summary terms, the perception of the reasonable reader would be that the holders of the subordinated debt were to be at the end of the queue - and, in the event of an insolvency, at the bottom of the waterfall***" (*emphasis added*).

(2) In <u>Re Sigma Finance Corp</u> [2009] UKSC 2 (which is addressed further below), Lord Collins said: "***In complex documents of the kind in issue there are bound to be ambiguities, infelicities and inconsistencies. An over-literal interpretation of one provision without regard to the whole may distort or frustrate the commercial purpose***" (emphasis added).

(3) In <u>Sirius International Insurance (Publ) v FAI General Insurance Ltd</u> [2004] 1 WLR 3251 at [19] Lord Steyn[132] noted that the tendency of the law "*should therefore generally speaking be against literalism*". At [20], his Lordship considered the surrounding circumstances and considered "*that the parties had two major immediate objectives*" before proceeding to construe the agreements in light of them.

124. <u>Fifth</u>, the Court should be wary, when interpreting a complex set of commercial documents, of focusing too narrowly on a single phrase, but rather should look at such phrases in the commercial landscape of the instrument as a whole. Thus the proper

[130] <u>Chitty on Contracts (33rd edition)</u>, 13-050 and the authorities at the footnote thereto.

[131] See <u>Reardon Smith Line Ltd v Yvgar Hansen-Tangen</u> [1976] 1 WLR 989, 996.

[132] See also Lord Steyn in <u>Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd</u> [1997] AC 749, 768, where he said that it was "*important not to lose sight of the purpose of a notice under the break clause. It serves one purpose only: to inform the landlord that the tenant has decided to determine the lease in accordance with the right reserved.*"

unitary exercise involves an iterative process by which each suggested interpretation is checked against the provisions of the contract and its commercial consequences are investigated.[133]

125. Sixth, the background reasonably available to the parties may include precedents used in previous transactions.[134] Where there are provisions in a professionally drawn contract which lack clarity, the Court may be particularly helped by considering the purpose of similar provisions in contracts of the same type (Wood v Capita Insurance Services at [13]). In Static Control Components (Europe) Ltd v Egan [2004] 2 Lloyd's Rep 429 at 435, Arden LJ considered the admissible background evidence to include a previous guarantee, concluding that the reasonable person *"would draw the conclusion that the previous guarantee might have been used simply because it was a convenient precedent"*. Similarly, *"where parties have used language which means one thing in a contract to which they were parties, and they use the same language in another, it is likely that it will have the same meaning"* (Shell UK Ltd v Total UK Ltd [2010] 3 All ER 793 at [16] per Waller LJ).

126. Seventh, in construing contracts incorporating standard forms, the Court should adopt a uniform approach *"that seeks to respect the parties' choice, to understand the commercial context, and to provide certainty and consistency in matters of business"* (GSO Credit-A Partners LP v Barclays Bank Plc GSO Credit—A Partners LP v Barclays Bank Plc [2016] EWHC 146 (Comm) at [27] per Knowles J), relying on[135] Lord Diplock's words in Pioneer Shipping Ltd v BTP Tioxide Ltd ("The Nema") [1982] AC 724, 737:

"… it is in the interests alike of justice and of the conduct of commercial transactions that those standard terms should be construed … as giving rise to similar legal rights and obligations in all [cases] in which the events [that] have given rise to the dispute do not differ from one another in some relevant respect. It is only if parties to commercial contracts can rely upon a uniform commercial construction being given to standard terms that they can prudently incorporate them in their contracts without the need for detailed negotiation or discussion …".

133 Wood v Capita Insurance Services at [12]; Arnold v Britton at [77]; Re Sigma at [12].

134 Bogg v Raper 1 I.T.E.L.R. 267 per Millett LJ, who had regard to a clause *"clearly taken directly or indirectly from a precedent book"* (page 279).

135 At [26].

127. Eighth, the regulatory context plainly forms part of the relevant background to the subordinated debts in question, forming part of the legal environment in which the parties concluded their contracts:[136]

(1) This was specifically confirmed in Waterfall I (first instance) in relation to debts drawn up on FSA Standard Form 10. David Richards J's starting point was the regulatory background, both at an international level and at a national level (*"Before addressing these issues directly, I will set out the circumstances in which the subordinated loan debt was created, the regulatory background against which it was created and its material terms"* at [26]). Later on, his Lordship confirmed at [60] that:

*"In approaching the issues of construction of the subordinated facility agreements, **it is clearly right to have regard to their regulatory context**"* (emphasis added).

(2) In BNY Mellon Corporate Trustee [2016] UKSC 29 at [33], in the context of instruments which were intended to be broadly traded, Lord Neuberger held that FSA regulatory material could be taken into account, on the assumption that even not necessarily sophisticated purchasers may have received advice from advisors prior to purchase:

*"In the present case, **the Trust Deed**, and in particular those parts of clauses 7, 8 and 19 of the T&Cs which fall to be construed, **cannot be understood unless one has some appreciation of the regulatory policy of the FSA at and before the time that the ECNs were issued… Accordingly, I consider that at least the general thrust and effect of the FSA regulatory material published in 2008 and 2009 can be taken into account when interpreting the T&Cs**. That would also accord with good sense: while the individual purchasers of the ECNs may not by any means all have been sophisticated investors, it is appropriate to assume that most of them would have had advice from reasonably sophisticated and informed advisers before they purchased such moderately complex financial products."* (emphasis added).

136 See Chitty on Contracts (33rd edition) at 1-001 on the distinction between *"laws which create the legal environment within which parties conclude their contract (which may broadly be termed market regulation) and laws which relate specifically to the conclusion of contracts, their terms, the relative rights and obligations which they create and the remedies which arise on breach (contract law in the narrow and usual sense)."*

128. Ninth, the *pari passu* principle itself forms part of the relevant background in which the agreement is reached and will be borne in mind by the Court:

(1) In Re Golden Key Ltd [2009] EWCA Civ 636 at [6], Arden LJ said:

"*Given its importance, the concept of pari passu distribution can be taken to be part of the background to the issue of the CP that would have been known to the parties ... The concept of pari passu distribution may also be a factor which makes one interpretation more plausible than another*".

(2) In Re Lehman Brothers International (Europe) [2010] EWCA Civ 917 at [76]-[77], in interpreting CASS7, the Court of Appeal said that: "*The principle of pari passu distribution also forms part of the legal background which the court must keep well in mind*".

Factual Matrix: General Negotiable Instruments

129. PLC and GP1 both contend that the extent to which the available background is admissible in this case is limited because the PLC Sub-Notes and the LBHI2 Sub-Notes are tradeable securities: see PLC PP, [19.1] **[A/T7/99-100]** ("*very narrow factual matrix*"); GP1 PP, [11] **[A/T9/159]** ("*that fact serves to limit the extent of admissible background*").

130. Both rely on Lord Collins in Re Sigma Finance Corp [2009] UKSC 2, where he said that:

"*36. Sigma financed its investments over a 13-year period by debt securities issued or guaranteed by it. It entered into liquidity facilities intended to hedge against market liquidity risks. It entered into financial instruments intended to hedge against currency and interest rate risk. Others provided liquidity facilities or entered into financial hedging instruments. The security trust deed secures a variety of creditors, who hold different instruments, issued at different times, and in different circumstances.*

37. 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. I do not consider therefore that there is much assistance to be derived from the principles of interpretation re-stated by Lord Hoffmann in the familiar passage in Investors Compensation Scheme Ltd v West Bromwich Building Society……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".

131. LBHI/SLP3's position is that the starting point on the relevance of the factual matrix is not to consider whether an instrument is theoretically tradable but rather the *nature* of the intended addressee of the instrument.

132. In the present case, the instruments were only addressed to internal entities forming part of the Lehman Group, and it was never intended to transfer them outside of the Lehman Group: see below at [204] to [205] (PLC Sub-Notes) and at [313] to [316] (LBHI2 Sub-Notes). Accordingly, the factual matrix in this case is the knowledge reasonably available to the centralised decision-makers within the Lehman Group, who structured and implemented the transactions.

133. Alternatively, if this is incorrect, and the instruments were addressed to the world at large, the factual matrix is the knowledge available to sophisticated institutional investors, who would have been in a position to acquire the subordinated liabilities of another financial firm, and who would have been familiar with the regulatory framework (including the FSA Standard Forms, and the operation of the relevant regulatory regimes).

134. PLC/GP1 are incorrect in their narrow approach for at least the reasons set out below. However, on any view, the regulatory background to the subordinated instruments in question as well as their commercial purpose was stated on their face and are, therefore, part of the background available to the reasonable reader.

135. First, bilateral contracts are ordinarily addressed to the parties alone. That is the case even though there is generally a possibility that any contract might be assigned. The possibility of assignment does not impact the general principles of interpretation as set out above. In Chartbrook v Persimmon Homes [2009] UKHL 38 at [40] Lord Hoffmann said:

"*Ordinarily, however, a contract is treated as addressed to the parties alone and an assignee must either inquire as to any relevant background or take his chance on how that might affect the meaning a court will give to the document*".

136. Second, when it comes to certain types of documents, it will be necessary to identify the **relevant audience** or addressee of the document. As Briggs J said in In LB Re Financing No 3 Ltd v Excalibur Funding No 1 Plc [2011] EWHC 2111 (Ch) at [43]: "*Identification of the relevant audience is important, because it serves to identify the range of*

background facts relevant to interpretation." This is but an example of the approach that the factual matrix extends to the background materials reasonably available to the parties (as set out above).

137. Third, in determining the relevant audience, the Court is entitled to have regard to the evidence concerning *the purpose* of the instrument. The following two cases are instructive in this regard.

(1) In LB Re Financing No 3 Ltd v Excalibur Funding No 1 Plc itself (on which PLC also relies):

(a) The instrument being construed was a securitisation Trust Deed in respect of two series of notes.

(b) Briggs J considered at [42] that "*[a]lthough devised and initially put in place internally within the Lehman group, its function is to constitute and define the terms of the Notes, and the Class A Notes (in particular) were **intended to be used by way of sale or (more likely) security for borrowing, such that the relevant audience for present purposes must be taken to include entities considering buying or lending upon the security of the Class A Notes***" (emphasis added).

(c) As part of the background, prior to the group's insolvency in late 2008, a Lehman entity had "*pledged the vast majority of the Class A Notes as security to DBB, as part of the pool of collateral securing the bank's funding to LBB*".

(d) Accordingly, in the circumstances of that case, it was appropriate to limit the background to that reasonably available to entities considering buying or lending upon the security of the Class A Notes.

(2) In Dominion Corporate Trustees Ltd v Capmark Bank Europe Plc [2010] EWHC 1605 (Ch), there was a ranking issue as between the trustees' right to be indemnified in respect of expenditure under a trust deed creating the trust, and the

bank's rights as chargee under a debenture.[137] David Richards J considered arguments on the scope of the admissible matrix:

(a) The Trustees submitted that the priority issues should be approached by reference to a wider set of documents in place at the time the arrangements were put in place, as well as having regard to the purpose for which the trust in question had been put in place.

(b) David Richards J said:

> "*[i]n circumstances where the facility agreement provides expressly for the assignment or syndication of the loan with its security, I was concerned whether all these factors, some of which involve knowledge of quite specific facts, could properly be brought into account in the construction of the debenture or in determining the existence of implied terms when they would or might not be known to assignees or participants in a syndication.*"

(c) The judge noted[138] Lord Collins's comments in the Sigma case but continued: "*This is not one of those cases*", noting that: "*The loan was relatively short-term and if there had been any assignment or syndication, which there was not, basic enquiries would have disclosed the interest of the bank's group in Glenmac and hence in Cantabria.*"

138. For the reasons set out below, it is plain that the theoretically tradeable instruments in this case (the PLC Sub-Notes and the LBHI2 Sub-Notes) would not and (likely) could not have been traded out of the Lehman Group.[139] They were internal subordinated debt put in place on the basis of detailed tax and structuring advice: they formed part of the regulatory capital structure of the Lehman Group. It was not reasonably foreseeable that any third-party transferee outside of the Lehman Group would need to construe the relevant documents (Cherry Tree Investment Ltd v Landmain [2012] EWCA Civ 736, at [128], citing Phoenix Commercial Enterprises v City of Canada Bay Council [2010] NWSCA 64). Accordingly, it necessarily follows that the relevant audience for these instruments was the Lehman Group itself – and no-one else.

137 At [6].
138 At [29].
139 See below at [204] – [205] (PLC Sub-Notes) and at [313] – [316] (LBHI2 Sub-Notes).

139. Further and in any event, even if LBHI/SLP3 are wrong about the applicable scope of the relevant matrix in this case, it simply does not follow (as PLC and GP1 appear to suggest) that even where a document is concluded to have been addressed to a wide audience, the factual matrix is automatically inadmissible or rendered irrelevant:

(1) The question as to the weight to be attributed to surrounding documents is a highly fact sensitive one. In BNY Mellon [2016] UKSC 29 at [30], a case involving an issuance of securities which were acquired by private individuals, while considering that "*considerable circumspection is appropriate*" in respect of other documents construing the Trust Deed in that case, the starting point was nevertheless as follows: "*[w]hat, 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*".

(2) Even where a document is addressed to a wide audience and, on the evidence, 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*"[140] it is still plainly the case that the Court should have regard to the commercial purpose, and is not limited (as PLC suggests) to deducing it from the face of the instrument:

"*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. Detailed semantic analysis must give way to business common sense*".[141]

G. THE PLC RANKING ISSUE

140. The parties' respective positions on this issue are set out as follows:

(1) LBHI: Joint PP, [9]-[16] **[A/T5/58-66]**; Reply PP, [13]-[30] **[A/T10/179-190]**.

(2) GP1 PP: [8]-[75] **[A/T9/158-174]**.

(3) DB PP: [34]-[52] **[A/T8/141-145]**.

141. In summary:

140 Sigma at [37].
141 Ibid.

(1) The operative subordination provisions under the PLC Sub-Debt and the PLC Sub-Notes are *materially the same*. This is because they are either drawn up or based on FSA Standard Form 10. The purpose of the standard forms was to implement the relevant EU Directives, the requirement of which was for subordinated loan capital to be subordinated to the claims of "*all other creditors*" in an insolvency. The PLC Sub-Notes were intended to conform to the wording of FSA Standard Form 10.

(2) The broad drafting of both sets of instruments envisaged subordination to *all* of PLC's "Senior Liabilities". These included unsubordinated creditors and could also include (to the extent that debts in this category already existed or were ever created in the future) subordinated senior creditors.

(3) On a proper construction the PLC Sub-Debt and the PLC Sub-Notes are subordinated to the same "Senior Liabilities", which on the facts of this case are the unsubordinated creditors (including claims to statutory interest and non-provable liabilities) and they rank *pari passu*.

(4) Consistent with this conclusion, and with the thousands of documents reviewed as part of the disclosure exercise in the case, there was no commercial or regulatory rationale for subordinating the PLC Sub-Debt to the PLC Sub-Notes or *vice versa* and such subordination formed no part of the purpose of the transactions pursuant to which the instruments were created.

PLC Sub-Debt: Background

142. PLC is an English incorporated company within the Lehman Group (Bruce 3, [13]-[20] **[A/T4/26-27]**). It has been in administration since 15 September 2008, and the administration has recently been extended until November 2020. In the latter years of the Lehman Group's operations, PLC's role was principally as an intermediate holding company. It did not trade. It was instead involved in certain of the arrangements by which the Lehman Group financed its affairs, involving both the borrowing and lending of money to other group entities.

143. PLC is in a distributing administration. As at 13 September 2018 PLC had already declared and paid an aggregate interim dividend of 87.63% to its unsecured, unsubordinated creditors, and had further admitted but unpaid unsecured, unsubordinated

liabilities of £317 million, and accrued but unpaid statutory interest of £750 million (Bruce 3, [21]-[22] **[A/T4/27]**). On 15 March 2019 it declared and paid a fifth interim dividend of 12.37 pence in the £, plus a share of statutory interest (roughly 2.5% of the claim value), to all unsecured, unsubordinated creditors.

144. In 2004 and 2005, PLC, as borrower, entered into three subordinated debt agreements with Lehman Brothers UK Holdings Limited ("**LBUKH**"). These were drawn up on FSA Standard Form 10 (Hutcherson 1, [33]-[42] **[C/T6/75-77]**). Ms Hutcherson was involved in all three issuances.

145. The PLC Sub-Debt formed part of a regulatory chain which flowed down from LBHI, the US parent company, to LBIE, the regulated entity. LBIE borrowed on a subordinated basis from PLC, which in turn borrowed from LBUKH on a subordinated basis through the PLC Sub-Debt. LBUKH borrowed on a subordinated basis from Lehman Brothers Luxembourg Investments S.A.R.L ("**LBLIS**"), which in turn borrowed on a subordinated basis from Lehman Brothers UK Delaware Inc ("**LBDI**"). Finally, LBDI borrowed from LBHI (Hutcherson 1, [34] **[C/T6/75]**). The funds used to finance the PLC Sub-Debt were ultimately derived from a mixture of debt and equity issued by LBHI to the public markets.

146. The catalyst for the first two tranches of the PLC Sub-Debt on 30 July 2004 appears to have been the need to refinance and replace pre-existing facilities which were "*approaching the end of their economical (sic) life*"[142]. This refinancing was achieved by executing agreements "*throughout the chain*" of Lehman entities referred to above. The first two tranches were drawn up on the same Long Term Subordinated Loan Agreements on FSA Standard Form 10.1. Similar agreements drawn up on FSA Standard Form 10 were used throughout the regulatory chain. The FSA was updated at each stage of the process (Hutcherson 1, [36]-38] **[C/T6/76]**).

147. The third tranche of the PLC Sub-Debt was issued to meet additional subordinated debt requirements for 2005-6. This was a short-term facility. Given that the Lehman Group had become subject to consolidated supervision by October 2005, FSA Standard Form 10.7 agreement was used (as opposed to Form 10.1) (Hutcherson 1, [39]-[41] **[C/T6/76-77]**). Again, the same agreements were entered down the chain of companies, and the FSA was kept fully appraised of the new issuance.

142 See the email exchange of 19 July 2004 to this effect **[F/V1/26]**.

PLC Sub-Debt: Terms

148. As set out above, the PLC Sub-Debt[143] was created on FSA Standard Form 10. Schedule 2 to the forms contained standard terms, which included the operative subordination provisions. Schedule 1 contained variable commercial terms.

149. It is plain on the face of FSA Standard Form 10 that the forms were intended to reflect a regulatory purpose. For instance, Paragraph 1(2) of Schedule 2 provided that "*Any reference to any rules of the FSA is a reference to them as in force from time to time*". Further, the term "Financial Rules" was defined to mean "*the rules in IPRU(INV) 10 in the FSA handbook*".

150. Paragraph 1(1) of FSA Standard Form 10 contains a number of definitions. "Financial Resources Requirement" is defined as having the meaning given to it in the FSA Handbook. "Insolvency" is defined to mean and include liquidation, administration and other similar procedures.

<u>Payment Condition</u>

151. Paragraph 5(1) provides:

> "*Notwithstanding the provisions of paragraph 4, the rights of [PLC] in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities and* ***accordingly payment of any amount*** *(whether principal, interest or otherwise) of the Subordinated Liabilities is* ***conditional upon –***
>
> *(a) (if an order has not been made or an effective resolution passed for the Insolvency*[144] *of [PLC] ...) [PLC] being in compliance with not less than [100%/120%]*[145] *of its Financial Resources Requirement immediately after payment by [PLC] and* ***accordingly no such amount which would otherwise fall due for payment shall be payable*** *except to the extent that –*
>
> *(i) paragraph 4(3) has been complied with; and*

143 See **[E/T6/81-93]**; **[E/T7/94-106]**; and **[E/T8/107-123]**.

144 "Insolvency" is defined by to mean and include "*liquidation, winding up, bankruptcy, sequestration, administration, rehabilitation and dissolution...or the equivalent in any other jurisdiction to which [PLC] may be subject*".

145 See **[E/T6/89]**; **[E/T7/102]**; and **[E/T8/118]**).

(ii) [PLC] could make such payment and still be in compliance with such Financial Resources Requirement;..."

152. Where no insolvency process for PLC has begun, the payment condition in Paragraph 5(1)(a) must be satisfied. Outside of an "Insolvency", payment of any amount of the "Subordinated Liabilities" is conditional upon PLC being in compliance with the relevant percentage of its Financial Resources Requirement.[146]

153. Whether or not an insolvency process has begun, the payment condition in Condition 5(1)(b) must be satisfied. Paragraph 5(1)(b) provides that payment of any amount (whether principal, interest or otherwise) is also conditional upon:

"*"[PLC] being "solvent" at the time of, and immediately after, the payment by [PLC] and* ***accordingly no such amount which would otherwise fall due for payment shall be payable*** *except to the extent that [PLC] could make such payment and still be "solvent"*"." (emphasis added).

<u>Solvency Requirement</u>

154. Condition 5(2)[147] provides that PLC is "*solvent*" if it is able to pay its "Liabilities" other than its "Subordinated Liabilities" in full, disregarding (a) obligations which are not payable or capable of being established or determined in PLC's insolvency; and (b) the "Excluded Liabilities". In short, payment of any amount of the "Subordinated Liabilities" is conditional on PLC's ability to pay its "Senior Liabilities" in full.

<u>"Liabilities", "Senior Liabilities", "Subordinated Liabilities", "Excluded Liabilities"</u>

155. The relevant terms are defined as follows:[148]

(1) "Liabilities" are defined to mean "*all present and future sums, liabilities and obligations payable or owing by the Borrower (whether actual or contingent, jointly or severally or otherwise howsoever)*".

(2) "Senior Liabilities" are defined to mean "*all Liabilities except the Subordinated Liabilities and Excluded Liabilities*".

[146] The same condition under the third PLC Sub-Debt Agreement provides that payment of any amount of the Subordinated Liabilities is conditional upon PLC being in compliance with not less than 100% of its Financial Resources Requirement.

[147] See **[E/T6/90]**; **[E/T7/103]**; and **[E/T8/119]**.

[148] See (**[E/T6/88]**; **[E/T7/101]**; and **[E/T8/116]**).

(3) "Subordinated Liabilities" are defined to mean "*all Liabilities to the Lender in respect of [the Loan or] each Advance made under this Agreement and all interest payable thereon.*"

(4) "Excluded Liabilities"[149] are defined to mean "*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*".

156. The "Senior Liabilities" are all "Liabilities" *other than* "Subordinated Liabilities" and "Excluded Liabilities". This broadly drafted definition includes unsubordinated "Liabilities", but would include (to the extent that such a category ever existed) subordinated "Liabilities" that are not expressed to rank nor do rank either *pari passu* or junior to the "Subordinated Liabilities".

157. Paragraph 6(e) of FSA Standard Form 10 provides that the Borrower shall not without the written consent of the FSA "*take or omit to take any action whereby the subordination of the Subordinated Liabilities or any part thereof to the Senior Liabilities might be terminated impaired or adversely affected.*" Paragraph 7(e) is in materially the same terms but applies to the Lender.

PLC Sub-Notes: Background

158. As with the PLC Sub-Debt, the primary commercial purpose of the PLC Sub-Notes was to qualify as regulatory capital (whilst also obtaining a tax benefit).

159. PLC issued four series of subordinated notes to Lehman Brothers UK Capital Funding LP, Lehman Brothers UK Capital Funding II LP and Lehman Brothers UK Capital Funding III LP (**"the Partnerships"**) on 29 March 2005, 19 September 2005, 26 October 2005 and 20 February 2006, each with a 30-year maturity date.

160. In turn, each Partnership issued perpetual preferred securities (known as **"ECAPS"**) to external investors. The ECAPS were Tier 1 capital. The Partnerships applied the funds from the issue of the ECAPS in certain "Eligible Investments", so that the funds raised by

[149] In <u>Waterfall I</u>, at [75], David Richards J said that "*It seems to me that the obvious purpose of the exclusion of such [Excluded] Liabilities is to cater for the situation in which a Borrower issues further debt on terms that it is expressed to rank junior to the subordinated liabilities created by these subordinated debt agreements. It is, and was at the date of these agreements, a real possibility that a Borrower might wish to issue such debt and the purpose of this provision is simply to ensure that such junior subordination is effective*".

the Partnerships were predominantly used to purchase the PLC Sub-Notes (Hutcherson 1, [43] **[C/T6/77-78]**; Miller 1, [17] **[C/T1/4-5]**). Interest payable to the Partnerships was in turn to be used to make distributions to the ECAPS Holders in respect of the ECAPS (Miller 1, [17] **[C/T1/4-5]**).

161. The three relevant Partnerships[150] were (Miller 1, [15] **[C/T1/4]**):

(1) LP I, which issued €225,000,000 Fixed Rate to CMS-Linked ECAPS by way of a prospectus dated 29 March 2005[151].

(2) LP II, which initially issued €200,000,000 Fixed Rate ECAPS by way of a prospectus dated 30 August 2005 and a further €50,000,000 Fixed Rate ECAPS by way of Final Terms dated 26 October 2005[152].

(3) LP III, which issued €500,000,000 of Fixed/Floating Rate ECAPS by way of a prospectus dated 20 February 2006[153].

162. A common entity acted as a "General Partner" in respect of each Partnership. That entity was an English incorporated company i.e. GP1. GP1 was struck off the Companies Register on 20 June 2010, and then restored and wound up pursuant to a "double-barrelled order" on 28 February 2017 (Bruce 3, [67] **[A/T4/37]**).

163. The structure was a more tax efficient way of raising regulatory capital than LBHI issuing perpetual preference shares (Hutcherson 1, [44] **[C/T6/78]**).

<u>Waiver Applications</u>

164. To secure the tax benefit, the PLC Sub-Notes needed to be in Note/Bond form, and therefore could not be drawn up on FSA Standard Form 10.

165. This meant that, for the PLC Sub-Notes to qualify as regulatory capital, the Lehman Group had to make waiver applications to the FSA. This was necessary where a firm wanted to include subordinated debt as part of its regulatory capital, but the instrument

150 Two other Partnerships, Lehman Brothers UK Capital Funding IV LP (**"LP IV"**) and Lehman Brothers UK Capital Funding V LP (**"LP V"**) issued two other series of ECAPS. However, they are not relevant for current purposes (Miller 1, [18] **[C/T1/5]**).

151 **[E/T10/147-200]**.

152 **[E/T11/201-294]**.

153 **[E/T15/365-456]**.

was not on FSA Standard Form 10 (Hutcherson 1, [46] **[C/T6/78]**; Miller 1, [22]-[28] **[C/T1/6-7]**).

166. To this end, on 23 March 2005[154], Mr Dave Rushton (of the Treasury department) sent an internal email which indicated that:

(1) The approval of the FSA *"will be needed if [PLC] is to issue Subordinated Debt in Bond format and this is to be recognised for regulatory capital purposes."*

(2) A&O should be instructed as external counsel to provide an explanation of the proposed structure *"which they have already put in place with another FSA regulated competitor."*

(3) A&O had previously obtained recognition *"for a similar deal for Collins Stewart and do not anticipate any material issues."*

(4) The subordinated debt agreement *"is internal to Lehman (between [PLC] and [GP1]) and does not feature in any external document"*.

167. The Lehman Group submitted a waiver application (**"the Waiver Application"**)[155] in April 2005 in respect of IPRU(INV) Rule 10-63(2) i.e. a waiver from the requirement for the subordinated debt to be on FSA Standard Form 10.

168. The Waiver Application was submitted to the FSA via email by Mr Paolo Tonucci on 28 April 2005[156], including: (a) a cover letter and the Waiver Application[157], (b) a copy of FSA Standard Form 10.6 (with cross-references to the relevant terms in the PLC Sub-Notes)[158], (c) a copy of a confirmatory opinion from A&O[159], and (d) a covering email which further noted that:

"You had asked whether there was any precedent that we could point to and we have been advised by Allen & Overy that they successfully filed a similar application for Collins Stewart Tullett plc. This has been noted in the waiver application form."

169. As regards [168] **(a)**, above, the Waiver Application itself:

154 **[F/V1/537-538]**.

155 Located at **[F/V10/5907-5918]**.

156 **[F/V2/770]**.

157 **[F/V10/5907-5918]**.

158 **[F/V10/5795-5807]**.

159 **[F/V2/766-768]**.

(1) Stated that the application related to IPRU(INV) Rules 10-63(2)(a) and 10-63(3).[160]

(2) Ticked the 'yes' box in connection with the question "*Is your application based on a precedent*". It also specified the direction reference number in relation to the precedent at question 17(a). In answer to the question "*please explain why you think this precedent is relevant to your application*", it stated: "*Relevant since in **the case of Collins Stewart Tullett plc the transaction was documented in a bond format***" (emphasis added)[161].

(3) In its explanation, the Waiver Application specified that "*[t]he issue by [PLC] of dated subordinated eurobonds will augment the regulatory capital resources of the Lehman Brothers Holdings plc Group on a consolidated basis.*[162]"

170. In relation to paragraph [168] **(b)**, above, the annotated copy of FSA Standard Form 10 confirmed paragraph by paragraph the way in which the language of the PLC Sub-Notes tracked the language of FSA Standard Form 10, and explained the rationale behind any differences in language:

(1) Next to definitions for "Liabilities" and "Senior Liabilities", the annotation stated: "SEE CONDITION 1"[163].

(2) Next to the definition to "Subordinated Liabilities", the annotation stated: "*SEE CONDITION 1 – DEFINITION ADJUSTED SLIGHTLY TO REFLECT BOND FORMAT*"[164].

(3) The annotations to Paragraph 5 of FSA Standard Form 10 simply referred the FSA to Condition 3(a), 3(b), 3(c) and 3(f) of the PLC Sub-Notes. Next to certain sub-paragraphs of Paragraph 5, it was said "*NOT APPLICABLE FOR BEARER BONDS*"[165].

171. In relation to paragraph [168] **(c)**, above, the A&O confirmatory opinion said (see also Miller 1, [23]-[24] **[C/T1/6-7]**) that:

[160] See at Page 4 **[F/V10/5910]**.
[161] **[F/V10/5911]**.
[162] **[F/V10/5912]**.
[163] **[F/V10/5802]**.
[164] **[F/V10/5802]**.
[165] **[F/V10/5804-5]**.

(1) The terms and conditions of the PLC Sub-Notes "*are materially identical to the corresponding Standard Terms in the Financial Services Authority's Form 10.6*"[166] subject to specified differences.

(2) As regards the modification of the term "Subordinated Liabilities", "*[w]e have used this definition which better reflects borrowing in a bond, rather than a loan format...*"[167].

(3) The terms and conditions of the PLC Sub-Notes "*provide equivalent subordination to that in the FSA Standard Form and that each Note is similarly and identically bound by the subordination requirements.*[168]"

172. In relation to paragraph [168] **(d)**, above, the Collins Stewart issuance is relevant for the following reasons:

(1) The Collins Stewart notes ("**the Collins Stewart Notes**") were also subordinated notes in Eurobond form.

(2) Even on a cursory review, it is obvious that the Collins Stewart Notes were structured in materially the same way as the PLC Sub-Notes. Significantly, the following appear to be materially identical.

(a) Under the Collins Stewart Notes, "Subordinated Liabilities" were defined as "*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*" That is the same definition used in the PLC Sub-Notes for the "Subordinated Liabilities".

(b) Condition 3, the subordination provision, is both in content and form the same as the PLC Sub-Notes.

173. As stated in correspondence and the formal application with the FSA, the Collins Stewart precedent appears to have been relied on in order to secure the approval of the FSA to the Waiver Application.

[166] **[F/V2/766]**.
[167] **[F/V2/767]**.
[168] **[F/V2/768]**.

174. The FSA granted a formal waiver direction in respect of the first series of the PLC Sub-Notes on 26 May 2005 (**"the Waiver Direction"**)[169]. The Waiver Direction approved the Waiver Application, with the covering letter stating: "*The direction will be published in full on the FSA's website.*" The Waiver Direction was publicly available.

175. The specified rules under IPRU(INV) were disapplied with stated modifications:

(1) Pursuant to paragraph 3 of the Waiver Direction, Rule 10.63(2)(a) (i.e. the requirement to use the FSA Standard Forms) was replaced with the words "*if it is drawn up in accordance with the requirements set out at the end of this rule 10-63(2)*" continuing "*and the text set out in the schedule to this direction is inserted at the end of the rule*"[170].

(2) The language inserted into Rule 10-63(2) included the new words:

"(A) *the degree of subordination of the loan capital is no less than that provided for by form 10 6.*[171]"

(3) The Schedule also inserted provision (E) which stated that "*the loan documents are* ***in substance (if not in form) the same as form 10-6 except as set out in the following table***". The permitted differences table in turn stated: "*The definition of 'Subordinated Liabilities' may be changed to reflect borrowing in a bond rather than a loan.*[172]"

176. Mr Miller's evidence in this regard is that the PLC Sub-Notes were drafted "*to follow the wording in the FSA Standard Forms as closely as possible*".[173]

177. It was significant that the FSA agreed to the waiver. As Ms Hutcherson notes, if the FSA had disagreed then the capital adequacy ratios which the PLC Sub-Notes supported would have been affected and the Lehman Group would potentially have been in breach of them.[174]

178. When each of the two subsequent series of the PLC Sub-Notes were issued, the waiver application to the FSA was on each occasion materially in the same form, as were the subordination provisions of the notes. Thus, a similar process was repeated for the PLC Sub-Notes issued to LP II and LP III in order to ensure that they qualified as regulatory capital. Moreover, the terms of the subsequent PLC Sub-Notes were materially the same for each issuance, save that some were based on Form 10.6 and others Form 10.7.

179. The Waiver Directions issued by the FSA in respect of the subsequent two series were materially the same and were also publicly available, save that the Waiver Direction in respect of the final series also stated in connection with the 'permitted differences' that "*[t]he definition of 'Subordinated Liabilities' may be changed* ***only*** *to the extent required to reflect borrowing in a bond rather than a loan*"[175] (emphasis added).

PLC Sub-Notes: ECAPS and the "Dividend Stopper"

180. As set out above, in each case PLC issued a series of PLC Sub-Notes to the relevant Partnership, and in turn the Partnership itself issued its own "ECAPS" securities to investors. In each case there was an ECAPS offering circular that was separate to the offering circular which supported the PLC Sub-Notes (Bruce 3, [68]-[69] **[A/T4/37-38]**).

181. The terms of the ECAPS prospectuses which were issued to third party investors contained a provision known as a "No Payment Notice" and another known as a "Dividend Stopper".

182. The No Payment Notice is in Condition 2.4 of the ECAPS' terms.[176] It provides that:

"*Further, notwithstanding the existence of such resources legally available for distribution by the Issuer, the Holders will not be entitled to receive Distributions if the General Partner has published a No Payment Notice in respect of such Distribution, in which case there will be no payment due under the Preferred Securities. The General Partners will have the full discretion to publish the No Payment Notice in respect of any Distribution at any time and for any reason*".

183. The Dividend Stopper under the ECAPS is an undertaking given by LBIH and recorded in Condition 2.6 of the ECAPS' terms.[177] It provides that:

169 **[F/V2/777-780]**.
170 **[F/V2/778]**.
171 **[F/V2/780]**.
172 **[F/V2/780]**.
173 Miller 1, [23] **[C/T1/6]**.
174 Hutcherson 1, [50] **[C/T6/79]**.

175 FSA's Waiver Direction dated 21 March 2006 **[F/V3/1571]**.
176 See, e.g., **[E/T10/164]**. This is Condition 2.5 of the ECAPS terms for LP III **[E/T10/387]**.
177 Condition 2.7 of the ECAPS terms for LPIII **[E/T10/388]**. The Dividend Stopper is also explained in the Summary (at page 6) and the Risk Factors section (page 14).

"LBHI has undertaken that, in the event that any Distribution is not paid in full, it will not: (a) declare or pay any dividend on its shares or common stock; or (b) repurchase or redeem any of its non-cumulative preferred stock of common stock at its option, until [...][178] *such time as Distributions on the Preferred Securities have been paid in full for one year*".

184. These "Dividend Stoppers" were a feature of certain types of capital instruments and were common in raising capital for banks (Hutcherson 1, [59] **[C/T6/81-2]**). Dividend Stoppers were used where there was no legal obligation under the instruments to pay interest or coupons. If the interest or coupon was not paid, then a Dividend Stopper would prevent any dividend being paid on ordinary stock or stock that ranked junior. In this regard, the ECAPS were not the only instruments which affected LBHI's ability to pay dividends in certain circumstances. As of 2007, excluding the three series of ECAPS, there were at least 9 instruments issued within the Lehman Group which contained similar dividend stoppers.[179] It is unclear why the Lehman Group would prioritise the ECAPS Dividend Stopper over all the other dividend stoppers.

185. Ms Hutcherson presumed that the Dividend Stopper was put in place to ensure that ratings agencies considered the ECAPS to be the equivalent to perpetual non-cumulative securities. She does not recall any conversation in the Lehman Group in relation to a Dividend Stopper being a driver as to the priorities of payments or ranking as between the different subordinated debts (ibid, [60] **[C/T6/82]**).

186. Contrasting evidence has been provided, on behalf of Deutsche Bank, by Mr Benjamin Katz. Mr Katz's evidence is that from January 2005-September 2008 he was the managing director of the Structured Capital Solutions Group within the Lehman Group and, in this regard, had oversight of the teams who structured the ECAPS. Mr Katz also states that he reported directly to the CFO of the Lehman Group, Erin Callan (Katz 1, [6] **[C/T5/63]**. Mr O'Meara, the current CEO of LBHI (O'Meara 1, [6]-[9] **[C/T10/133-134]**)[180], points out that Ms Callan was not (as Mr Katz suggests) the CFO at the time the ECAPS were issued (when he, Mr O'Meara, was in fact the CFO).

187. LBHI does not dispute the following factual propositions from Mr Katz's evidence:

178 Additional wording is included in the ECAPS terms for LP III.
179 See the 2007 Hybrid Issuance Plan at **[F/V10/5900]**.
180 LBHI agrees with some aspects of Mr Katz's overview of the ECAPS transaction: see Katz, 1 [7]-[15].

(1) The objective of issuing the ECAPS was to raise capital for the Lehman Group in a manner that would provide LBHI with innovative Tier 1 equity for regulatory capital purposes and to provide up to 100% equity credit at LBHI for ratings agencies' purposes (at [8] **[C/T5/64]**).

(2) From a UK perspective, by structuring the funding into PLC as a form of debt, the interest payments on that debt would be a deductible expense for UK tax purposes. The net effect was that a form of funding into the Lehman Group that provided equity like benefits to LBHI also gave rise to a deductible expense for UK tax purposes (at [9]-[10] **[C/T5/64]**).

(3) The equity-like features included a right (and full discretion) for LBHI, through its control of GP1, to cause a "No Payment Notice" to be published at any time and for any reason, following which the holders were not entitled to receive distributions based on the coupon payments received by the LP from PLC (and instead the coupon payments would be paid to an entity controlled by LBHI) (at [13] **[C/T5/65]**).

188. The following assertions will be explored with Mr Katz in cross-examination:

(1) In addition to the "No Payment Notice", Mr Katz claims it was important that the ECAPS featured a "Dividend Stopper" that would prohibit LBHI from making distributions on its own stock if any scheduled ECAPS distribution was not paid (at [15] **[C/T5/65]**).

(2) As a commercial matter, it would have been extremely damaging to the Lehman Group if the Dividend Stopper had been triggered (at [16] **[C/T5/65]**).

(3) It was important in the Lehman Group that there was sufficient flexibility in capital that operating companies could upstream available funds (at [17] **[C/T5/66]**). This would include avoiding Dividend Stoppers (for example those associated with ECAPS) being triggered.

(4) In the case of the ECAPS, LBHI would have been strongly commercially incentivised to ensure that PLC was able to make its interest payments on the PLC Sub-Notes (at [18] **[C/T5/66]**) to avoid the triggering of the Dividend Stopper.

(5) Mr Katz concludes (at [18]) that "*I recall that the PLC Sub-Note (being the subordinated notes that provided cash-flows to the ECAPS issuer partnerships and their only contractual source of funds) would have been prioritised over PLC's other subordinated debt payments to entities in the Lehman group. Furthermore, I do not recall there to have been any commercial reason for the PLC Notes to compete with purely internal subordinated debt*".

189. Mr O'Grady has already addressed many of these points in his evidence (O'Grady 1, [93]-[96] **[C/T8/126-7]**)[181]. He notes that PLC's ability to source cash to make payments in relation to the ECAPS was not dependent on it being paid by LBHI2. It was dependent solely on the London branch of LBHI ("**LBHI UK**") having cash, as LBHI UK made payments to Euroclear directly, which funded the distributions on the ECAPS.

190. Mr Katz replies to Mr O'Grady at Katz 2, [9]-[23] **[C/T11/138-141]**. His main points are these:

(1) Mr O'Grady's analysis assumes a going concern basis, as opposed to scenarios that contemplated insolvency or skipped coupons.

(2) Mr O'Grady's suggestion of borrowing from LBHI UK would not have enabled PLC to make the required payments in a scenario where PLC had sufficient assets to pay its Senior Liabilities, and sufficient assets to pay interest on either, but not both, of the PLC Sub-Notes and the PLC Sub-Debt. This is because, if PLC were to borrow from LBHI UK, the loan would not have improved PLC's ability to pay the coupon and remain "solvent" after the payment, because the borrowing would simply have increased PLC's "Senior Liabilities" by the amount borrowed.

(3) In those circumstances, it *would* have been necessary for the PLC Sub-Notes to have been prioritised ahead of the PLC Sub-Debt.

191. Ultimately these are matters for cross-examination. However, LBHI notes that Mr Katz focuses on concerns that LBHI might be stopped from paying dividends on its common stock. As Mr O'Meara (LBHI's current CEO and its CFO at the relevant time) points out, LBHI acted as the central repository for cash liquidity in the group (O'Meara 1, [11] **[C/T10/135]**). If LBHI was unable to pay funds to the ECAPS Holders, then he would not

[181] These respond to the arguments raised about the Dividend Stopper in the DB PP, [22] and [52] **[A/T8/130-132;145-146]**.

expect it to be in a position to pay dividends to shareholders anyway (O'Meara 1, [12] **[C/T10/135]**). For these reasons, the entire argument based on the Dividend Stopper is based on a false premise.

PLC Sub-Notes: Terms

192. The operative subordination provisions and definitions under the PLC Sub-Notes[182] were materially the same as those under FSA Standard Form 10, *save that* the terms were adapted to a bond format and not contained in two schedules divided between Schedule 2 and the variable commercial terms.

193. Like the PLC Sub-Debt, it is plain on the face of the PLC Sub-Notes that they were intended to reflect a regulatory purpose. Condition 1 defines the term "Financial Rules" to mean "*the rules in IPRU(INV) 10 in the FSA handbook, as the same may be modified, supplemented, amended or replaced from time to time by the FSA*"; Condition 4 is headed "FSA Provisions"; and page 15 of the Offering Circular headed "Use of Proceeds" provides that "*The net proceeds of the issue of the Notes…will be used by the Issuer to strengthen the regulatory capital base of the Group, to pay off existing loans and for general corporate purposes*".

<u>Payment Condition</u>

194. Consistent with FSA Standard Form 10 (in relation to which, see at [151] to [153] above), Condition 3(a)[183] provides:

"*The rights of the Noteholders in respect of the Notes are subordinated to the Senior Liabilities and* ***accordingly payment of any amount*** *(whether principal, interest or otherwise)* ***in respect of the Notes is conditional upon****:*

(i)(if an order has not been made or an effective resolution passed for the Insolvency[184] *of the Issuer) the Issuer being in compliance with not less than 100 per cent. of its Financial Resources Requirement immediately after such payment, and* ***accordingly no such amount which would otherwise fall due for payment shall be payable*** *except to the extent that (a) Condition 3(d) or Condition 6(g), as the case may be, has been complied*

[182] See **[E/T9/124-146]**; **[E/T12/295-317]**; **[E/T13/318-340]**; and **[E/T14/341-364]**.
[183] **[E/T9/129]**; **[E/T12/299-300]**; **[E/T13/323]**; and **[E/T14/346]**.
[184] As with the PLC Sub-Debt, "Insolvency" is defined by Condition 1 to mean and include "*liquidation, winding up, bankruptcy, sequestration, administration, rehabilitation and dissolution…or the equivalent in any other jurisdiction to which [PLC] may be subject*".

with; and (b) the Issuer could make such payment and still be in compliance with such Financial Resources requirement" (emphasis added)

195. Where no insolvency process for PLC has begun, the payment condition in Condition 3(a)(i) must be satisfied. Outside of an Insolvency, payment of any amount in respect of the Notes is conditional upon PLC being in compliance with the relevant percentage of its Financial Resources Requirement.

196. Also consistent with FSA Standard Form 10 (in relation to which see at [153] above), whether or not an insolvency process has begun, the payment condition in Condition 3(a)(ii) must be satisfied. Condition 3(a)(ii) provides that payment of any amount (whether principal, interest or otherwise) in respect of the PLC Sub-Notes is conditional upon:

"*[PLC] being solvent at the time of, and immediately after, such payment, and* ***accordingly no such amount which would otherwise fall due for payment shall be payable*** *except to the extent that the Issuer could make such payment and still be solvent*". (emphasis added)

Solvency Requirement

197. Consistent with FSA Standard Form 10 (in relation to which see at [154] above), Condition 3(b)[185] provides that PLC is "*solvent*" if it is able to pay its "Liabilities" other than its "Subordinated Liabilities" in full, disregarding: (a) obligations which are not payable or capable of being established or determined in PLC's insolvency; and (b) the "Excluded Liabilities". In short, payment of any amount of the "Subordinated Liabilities" is conditional on PLC's ability to pay its "Senior Liabilities" in full.

"Liabilities", "Senior Liabilities", "Subordinated Liabilities", "Excluded Liabilities"

198. Consistent with FSA Standard Form 10 (in relation to which see at [155] to [156] above), the relevant terms[186] are defined as follows:

(1) The definitions of "Liabilities", "Senior Liabilities" and "Excluded Liabilities" under the PLC Sub-Notes are materially identical to those under PLC Sub-Debt.

[185] [E/T9/129]; [E/T12/300]; [E/T13/323]; and [E/T14/346]).

[186] [E/T9/127-128]; [E/T12/289-299]; [E/T13/321-322]; and [E/T14/344-345].

(2) The definition of "Subordinated Liabilities" is also materially the same but provides some additional wording to better reflect borrowing in a bond, rather than a loan format:

"*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***" (emphasis added).

(3) Accordingly, "Liabilities" of PLC are "Subordinated Liabilities" where they either "*rank*" or are "*expressed to rank*" *pari passu* with the PLC Sub-Notes.

199. "Liabilities" will be "*expressed to rank pari passu*" with the particular series of PLC Sub-Notes where the relevant subordinated debts express themselves in clear words to rank *pari passu* either with the particular series, with a class of instrument that includes the particular series, or with subordinated debt ranking *pari passu* with the particular series. No series of PLC Sub-Notes does so with respect to the others. By contrast, "Liabilities" will "*rank pari passu*" with the particular series of PLC Sub-Notes where they are subordinated to the same "Senior Liabilities" and prove at the same time such that, by the application of the 2016 Rules, they rank *pari passu*.

200. The subordination mechanism under the PLC Sub-Notes operates in the same way as under FSA Standard Form 10.

201. The "Senior Liabilities" are all "Liabilities" *other than* "Subordinated Liabilities" and "Excluded Liabilities". This broadly drafted definition includes unsubordinated "Liabilities", but would include (to the extent that such a category ever existed) subordinated "Liabilities" that are not expressed to rank nor do rank either *pari passu* or junior to the "Subordinated Liabilities".

202. Condition 4(a)(iv) provides that no person shall without the consent of the FSA "*take or omit to take any action whereby the subordination of the Notes or any part thereof to Senior Liabilities might be terminated, impaired or adversely affected*". This is in materially the same terms as Paragraphs 6(e) and 7(e) of FSA Standard Form 10.

203. As can be seen from the above, the only relevant difference at all between the terms of the PLC Sub-Debt and PLC Sub-Notes is the inclusion in the definition of "Subordinated Liabilities" of the words "***and all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes***".

PLC Sub-Notes were neither publicly available nor intended to be traded

204. The PLC Sub-Notes were listed on the Channel Islands Stock Exchange (**"the CISX"**). However, their terms were not publicly available. As to this:

(1) In his email to Lehman Group personnel of 23 March 2005, Mr Dave Rushton, who worked in the treasury department, emailed his colleagues some action points stating in relation to the first series of PLC Sub-Notes[187]: ***"The sub debt agreement is internal to Lehman** (between LBHoldings Plc and LBGno1 Ltd) and does not feature in any external document"* (emphasis added).

(2) On 24 March 2006[188], a Ms Fran Foster, a researcher for europrospectus.com, emailed Ms Shaun Butler of the Lehman Group with an inquiry requesting the prospectus for the third series of the PLC Sub-Notes. Copied on a subsequent email in the chain, Mr Rushton wrote to Ms Butler and Mr Tonucci in relation to this request that *"I am a little reticent about providing the requested documents"*. This was because *"The note in question is not a public issuance. This note forms part of our Euro-ECAPS funding structure and acts as the mechanism for releasing the proceeds from the public offering of perpetual preferreds from the Capital Funding Trust back to Lehman Brothers Holdings Plc"* (emphasis added).

205. Accordingly, the PLC Sub-Notes were not 'public' documents. Moreover, as confirmed by Ms Dolby, there was no intention to transfer the PLC Sub-Notes out of the Lehman Group[189].

PLC Ranking Analysis

PLC Sub-Debt: *pari passu* inter se

206. LBHI's position is that the three tranches of subordinated debt making up the PLC Sub-Debt rank *pari passu* for distribution amongst themselves.

207. By way of summary:

[187] **[F/V1/537-538]**.

[188] **[F/V3/1573-4]**.

[189] See the interview with Ms Dolby page 7, lines 12-13 **[C/T21/270]**.

(1) The PLC Sub-Debt was issued on FSA Standard Form 10. The subordination provisions and definitions under each of the PLC Sub-Debt agreements are materially identical, and the three tranches do not refer to each other in any way.

(2) The Lender's claims under the three tranches of the PLC Sub-Debt are subordinated to the same "Senior Liabilities" and are not "Senior Liabilities" for each other's purposes.

(3) The Lender is entitled to prove in respect of each tranche at the same time once those "Senior Liabilities" have been paid in full.

(4) Accordingly, by operation of the 2016 Rules, the Lender's claims in respect of the three tranches rank *pari passu* and abate in equal proportions between themselves.

208. Stepping back, this is obviously correct. Two tranches of the PLC Sub-Debt were issued by the same issuer on the same date and on the same prescribed form i.e. FSA Standard Form 10. Any other outcome than a *pari passu* ranking would be commercially absurd: and agreements should be construed in a manner that avoids absurdity (Chitty on Contracts, 33rd edition, 13-081, 13-083) and flouting business common sense (ibid., 13-084).

209. Against this, GP1 contends that an "*impasse*" or "*conundrum*" arises pursuant to which (on its case) each of the PLC Sub-Debts is subordinated to *different* senior liabilities, which liabilities include the other PLC Sub-Debts,[190] i.e. each of the PLC Sub-Debts is subordinated to the other two.

210. GP1 is wrong to assert that this so-called "*conundrum*" need not be resolved.[191] The question of the relative ranking of subordinated debts drawn up on FSA Standard Form 10 is significant not least because:

(1) The PLC Sub-Notes were intended to be materially identical to FSA Standard Form 10. It is therefore necessary to understand how the subordination mechanism under the PLC Sub-Debts operates and how those debts rank among themselves.

[190] GP1 PP, [56]-[58] **[A/T9/171]**.

[191] GP1 PP, [58] **[A/T9/171]**.

(2) The issue also touches the LBHI2 Ranking Issue where the LBHI2 Sub-Debt was also drawn up on FSA Standard Form 10: in relation to which, it is noteworthy that PLC (unlike GP1 and Deutsche Bank) does acknowledge and accept that loans on FSA Standard Form 10 rank *pari passu* with each other (DB PP, [38] **[A/T8/142]**).

211. GP1's (and possibly also Deutsche Bank's) position[192] appears to be based on the contention that the definition of "Subordinated Liabilities" under FSA Standard Form 10 is restricted to "Liabilities" arising under *one* particular facility. It follows, it is said, that each tranche of the PLC Sub-Debt is a "Senior Liability" for the purposes of another tranche: "*each is subordinated, on a literal interpretation of the clauses, to liabilities which include the other PLC Sub-Debts*" (GP1 PP, [56] **[A/T9/171]**).

212. This narrow "*literalist interpretation*" is obviously incorrect:

(1) FSA Standard Form 10 was a market wide instrument that was intended "***...to provide a uniform system of subordination***" (David Richards J in Waterfall I, at [75]).

(2) FSA Standard Form 10 was put in place, in three tranches, at every level of the Lehman Group's capital structure in a well-planned and systematic fashion (see e.g. LBLIS v LBUKH [2016] EWHC 617 (Ch), Henderson J, which addressed the next level of subordinated debt up the regulatory chain from the PLC Sub-Debt, and where the judge said at [16] that the three subordinated debts ranked behind the same "Senior Liabilities", and "*which in the present context means **all other liabilities of LBUKH***", without suggesting that they ranked behind each other).

(3) The necessary consequence of contending that despite being drawn up on identical forms an institution's subordinated debts on FSA Standard Form 10 could never rank *pari passu* with each other, nor, for that matter, with any other subordinated debt instrument, would be a regulatory regime which prescribed the piecemeal subordination of all a firm's subordinated debts to each other. That is an absurd conclusion that strongly militates against GP1's (and possibly Deutsche

192 GP1 PP, [51] **[A/T9/171]**. See DB PP, [40] **[A/T8/143]** ("*... the PLC Sub-Debt allow no scope for any other liability to rank pari passu*"). It is not clear whether Deutsche Bank is saying that (i) no tranche of the PLC Sub-Debt can rank *pari passu* with another tranche or (ii) the PLC Sub-Debt cannot rank *pari passu* with any other debt: Reply PP, [23] **[A/T10/185]**.

Bank's) arguments (and is, unsurprisingly, not one that has been reached by any Court that has considered the Lehman Group's subordinated debt).

(4) In this regard, as set out above, FSA Standard Form 5 was applicable and in use at the same time as FSA Standard Form 10 and gave effect to the same EU Directives. FSA Standard Form 5 (like the PLC Sub-Notes themselves) expressly envisaged that there might be other subordinated creditors of the Borrower with which the subordinated debts created by it might rank *pari passu*.[193] It would be absurd if *pari passu* ranking were *possible* under one FSA Standard Form, but was *impossible* in relation to another FSA Standard Form which was intended to achieve the same result.

(5) Finally, the particular facts of this case highlight the sheer improbability of such an outcome. The first two tranches of the PLC Sub-Debt were issued at the same time by the same two parties as part of a refinancing of an existing facility, and were drawn up on two forms which used exactly the same subordination wording. A reasonable reader would have a clear expectation that the two agreements ranked *pari passu* when they were entered into.

213. As a matter of contractual construction, each PLC Sub-Debt cannot be sensibly characterised as a "Senior Liability" in relation to the other two PLC Sub-Debts. The law does not require judges to attribute to the parties an intention that they plainly could not have had (Investors Compensation Scheme, page 913, Lord Hoffmann).

214. At the outset, the PLC Sub-Debt needs to be construed purposively against the regulatory framework in which it was created[194]:

(1) As set out above, under the relevant EU Directives each of the PLC Sub-Debts was created to be subordinated to "*all other creditors*" (i.e. the creditors other than the regulatory subordinated debt).

(2) The purpose of each "Subordinated Liability" was to protect the same "*customers and other stakeholders against failure and enable them to withstand loss*" (David

193 See the definition of "subordinated creditors" at Paragraph 1 of Standard Form 5.

194 In this regard, a contract of a public or regulatory nature which has been drafted with a view to implementing a European Directive should be construed in a manner compatible with that Directive: White v White [2001] UKHL 9; Chitty on Contracts (32nd edition), 13-055; see also The Interpretation of Contracts (6th edition, Lewison) at 4.06 (citing Phoenix Commercial Enterprises Pty Ltd v City of Canada Bay Council [2010] NSWCA 64, at [176]).

Richards J in Waterfall I, at [33]) (i.e. it was not the purpose of each "Subordinated Liability" to protect other "Liabilities" that were "Subordinated Liabilities")

215. In this context, it would be flatly at odds with these objectives for each PLC Sub-Debt to qualify as a "Senior Liability" to the others and vice-versa.

216. There is support for this in Paragraph 5(1)(a), which provides that "*Subordinated Liabilities are subordinated to the Senior Liabilities*", and that as a result payment of an amount of the "Subordinated Liabilities" is conditional upon (where the Borrower is still a going concern) "*the Borrower being in compliance with not less than 100% of its Financial Resources Requirement immediately after payment by the Borrower*". This condition of payment draws a clear distinction between, on the one hand, the "Subordinated Liabilities" – which drive the calculation of the debtor's "Financial Resources" under Chapter 10 of IPRU(INV) – and, on the other, the "Senior Liabilities" – which form part of the debtor's "Financial Resources Requirement". The two are separate and distinct.

217. Further, under Paragraph 5(2) the PLC Sub-Debts are not "Liabilities" that need to be to be taken into account for the purposes of the "solvency" condition. In this regard:

(1) Until the unsubordinated "Senior Liabilities" have been paid in full, the PLC Sub-Debts are "*obligations which are not payable or capable of being established or determined in the Insolvency of the Borrower*", such that they are disregarded for the purposes of each other's solvency condition.

(2) Paragraph 5(1)(b) makes it clear that the PLC's solvency is a condition to payment and that "***no such amount** which would otherwise fall due for payment **shall be payable** except to the extent that the Borrower could make such payment and still be 'solvent'*".

(3) In Waterfall I, the Supreme Court held that this condition to payment takes effect as a prohibition on the Borrower's ability to prove and require such a proof to be admitted to proof while the "Senior Liabilities" remain unpaid.

(4) Accordingly, until the "Senior Liabilities" are paid in full, the PLC Sub-Debts are not "*payable*" nor (given the prohibition in relation to proof) are they capable of "*being established or determined in the Insolvency of the Borrower*" within the

meaning of Paragraph 5(2)(a). Thus, each of the PLC Sub-Debts would be excluded from each other's solvency tests until the "Senior Liabilities" are paid in full.

(5) When all the "Senior Liabilities" are paid in full, the PLC Sub-Debts become "*payable*", it is open for them to be admitted to proof and they become capable of being established or determined in PLC's Insolvency.

(6) At that point, therefore, the PLC Sub-Debts would become entitled to prove at the same time and, by operation of the 2016 Rules, rank *pari passu*.

218. Accordingly, the purposive (as well as commercial common-sense) interpretation points overwhelmingly towards the position advanced by LBHI and against the "*conundrum*" posited by GP1.

219. As a further alternative, this construction can be achieved by the implication of words to the effect that "*all other Liabilities of the Lender which rank or are expressed to rank pari passu with the Liabilities of the Lender under this Agreement*" are included within the meaning of "Subordinated Liabilities"[195].

220. This would achieve the same outcome[196] that was achieved by the inclusion of the words "*and all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes*" in the definition of "Subordinated Liabilities" in the PLC Sub-Notes themselves, which merely made express what was obviously and necessarily possible under the PLC Sub-Debt, and which the PLC Sub-Notes were intended to replicate as closely as possible.

221. The addition of these words would, firstly, prevent the "*literal interpretation*" which makes each of the PLC Sub-Debts rank senior to the other PLC Sub-Debts and, secondly, allow each of the PLC Sub-Debts to rank *pari passu* with other subordinated debts. It would break the commercially absurd "impasse" and "circularity" posited by GP1 (GP1 PP, [56]) and Deutsche Bank (DB PP, [40]).

195 It would also be necessary to substitute the words "the" with "these" before the defined term "Subordinated Liabilities" in Conditions 5(a), 6, 7 and 12.
196 See Reply PP, footnote 6 **[A/T10/189]**.

222. To the extent that such supplementary wording needs to be implied into FSA Standard Form 10, it would satisfy the tests of obviousness and business efficacy (see Marks and Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2016] AC 742).

223. Moreover, the implication is consistent with the regulatory purpose of subordinating any debts drawn up on FSA Standard Form 10 to all of the Lenders' other creditors, and not to each other. And it would avoid the entirely circular and unsupported argument advanced by Deutsche Bank (DB PP, [46]-[47] **[A/T8/144]**) that a term should be implied into the PLC Sub-Debts to ensure the *seniority* of the PLC Sub-Notes in respect of them.

224. Accordingly, by any one of the approaches set out above, each of the PLC Sub-Debts ranks behind the same "Senior Liabilities", they prove at the same time and they rank *pari passu*. Each of these points is an answer to the "*impasse*" or "*conundrum*" posited by GP1 (and possibly Deutsche Bank) and avoids the commercially absurd consequences of GP1's construction i.e. that FSA Standard Form 10 created an unworkable regulatory system.

225. Finally, the solutions GP1 posits in order to escape from the "*impasse*" only serve to emphasise that the premise giving rise to the impasse is wrong:

(1) GP1 proffers some "*[p]otential answers*" to its impasse, including that "*the first in time should rank ahead of the second in time and so forth, or vice versa*". Tellingly, it acknowledges that one solution is that they might even rank *pari passu* between themselves,[197] which of course would mean that no impasse arises in the first place.

(2) As to the purported timing solution, there is nothing in FSA Standard Form 10 to support the speculative view that the first subordinated debt in time should rank ahead of the second in time, or that the last in time should rank ahead of the penultimate and so forth. It is directly at odds with FSA Standard Form 10's nature as a standard form to contend that its meaning and effect should depend on the time the agreement was entered into, such that it could never be relied upon as having the same meaning on all occasions: see AIB Group (UK) Ltd v Martin [2001] UKHL 63 at [7].

197 GP1 PP, [57] **[A/T9/171]**.

(3) Moreover, in circumstances where two FSA Standard Form 10 agreements were executed simultaneously (as is the case here where the first two PLC Sub-Debts were executed on 30 July 2004), the timing solution is no answer at all to the difficulty that would arise in this case if GP1's construction were correct.

PLC Sub-Notes: *pari passu* inter se

226. LBHI's position is that on a proper construction, the three series of subordinated notes making up the PLC Sub-Notes rank *pari passu* for distribution among themselves. The analysis appears to be agreed at least with GP1, as is the mechanism LBHI relies on.[198]

227. Applying materially the same primary analysis as in relation to the PLC Sub-Debt, as a matter of construction, the Noteholders' claims under the different series of PLC Sub-Notes are provable and payable after the same "Senior Liabilities", such that claims in respect of different series of PLC Sub-Notes rank *pari passu* with each other.

228. The wording of the relevant definitions is materially identical. Moreover, the PLC Sub-Notes contain express wording that the "Subordinated Liabilities" extend beyond the PLC Sub-Notes themselves to "*all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes*".

229. GP1 is wrong to contend that the presence of those words in the PLC Sub-Notes is a key differentiating factor from the PLC Sub-Debt. All the additional words under the PLC Sub-Notes do is to make express what is obviously and necessarily the case under FSA Standard Form 10 itself, namely, that debts that rank or are expressed to rank *pari passu* with debts drawn on the same forms are not "Senior Liabilities" which require payment in full ahead of the PLC Sub-Debt.

230. The regulatory background strongly militates against the suggestion that somehow the operative subordination wording under the PLC Sub-Notes differed materially from the PLC Sub-Debt. In relation to this:

(1) It was repeatedly represented by the Lehman Group to the FSA that the definition of "Subordinated Liabilities" had been adjusted "*slightly*" in order "*to reflect bond format*".[199]

198 GP1 PP, [62] **[A/T9/172]**: "*on that point of logic and principle, LBGP1 agree with LBHI*".
199 Annotated FSA Standard Form 10 **[F/V10/5802]**; see also A&O's confirmatory opinion **[F/V2/767]**.

(2) It is not surprising that the adjusted wording of "Subordinated Liabilities" did not materially alter that term's meaning as compared to its use in the FSA Standard Form 10. As GP1 itself has put it *"[t]he regulatory context was such that these [FSA Standard Forms] had to be used (or a waiver obtained, **which no doubt would have been easier the closer to the standard form the revised draft** was)"*.[200]

(3) The FSA in turn only permitted a derogation from the wording of "Subordinated Liabilities" as defined under FSA Standard Form 10 *"to reflect borrowing in a bond rather than a loan."* In the case of one Waiver Direction of 21 March 2006, it was expressly said that *"[t]he definition of 'Subordinated Liabilities' may be changed **only** to the extent required to reflect borrowing in a bond rather than a loan"*[201] (emphasis added).

(4) If GP1 were correct that the effect of the adjusted definition had an impact on *ranking* then PLC would have been in contravention of the Waiver Directions and (it must follow) have misrepresented the extent of the differences in the definition to the FSA.

(5) As the FSA were told on the Waiver Application, the PLC Sub-Notes were based on the Collins Stewart Notes because those notes had already obtained a waiver from the FSA and were *"[r]elevant since in the case of Collins Stewart Tullett plc the transaction was documented in a bond format"*.[202] In circumstances where the Lehman Group also wished to issue regulatory subordinated debt in a bond (as opposed to standard loan) format, the Collins Stewart Notes were relied on as a convenient precedent. Under the terms of the Collins Stewart Notes, "Subordinated Liabilities" were defined as *"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"*. The same definition under the PLC Sub-Notes was, in other words, identical to that under the Collins Stewart Notes, and was not drafted to subordinate the PLC Sub-Debt to the PLC Sub-Notes.

(6) GP1's case therefore seeks to ascribe a significance to the additional words in the definition of "Subordinated Liabilities" which they do not have. They were not

200 GP1 PP, [73.2] **[A/T9/173-4]**.

201 **[F/V3/1571]**.

202 **[F/V10/5911]**.

some form of bespoke drafting resulting in the subordination of the PLC Sub-Debt below the PLC Sub-Notes; they were merely words taken verbatim from a convenient precedent which had already achieved the same waiver the Lehman Group was also seeking to obtain.

231. As such, the Noteholders' claims under the different series of PLC Sub-Notes are "Subordinated Liabilities" which *"rank pari passu...with the Notes"* in respect of each other series of PLC Sub-Notes.

PLC Sub-Debt and PLC Sub-Notes rank *pari passu*

232. LBHI's position is that its claims under the PLC Sub-Debt rank for distribution *pari passu* with the claims of GP1 under the PLC Sub-Notes (Joint PP, [16] **[A/T5/65-66]**).

233. As set out in the Joint Reply, given that the three tranches of the PLC Sub-Debt must rank *pari passu* among themselves, and the three series of the PLC Sub-Notes are agreed to rank *pari passu* among themselves, the relevant question is whether (i) the PLC Sub-Debt and the PLC Sub-Notes are subordinated to the same "Senior Liabilities" such that they are entitled to prove at the same time and rank *pari passu* (as LBHI contends), or whether (ii) the PLC Sub-Debt is subordinated to the PLC Sub-Notes (as GP1 and Deutsche Bank contend, albeit through contradictory arguments).[203]

<u>LBHI: Ordinary Meaning</u>

234. On a true construction, it is plain that the PLC Sub-Debt and the PLC Sub-Notes are subordinated to the same "Senior Liabilities". As such, they are entitled to prove at the same time and, by operation of the 2016 Rules, rank *pari passu* with each other.

235. *First*, the PLC Sub-Debt and the PLC Sub-Notes do not expressly refer to each other in any way, and there is nothing in the language of the PLC Sub-Debt or the PLC Sub-Notes which otherwise evinces an intention to subordinate one to the other. The reasonable reader would <u>not</u> conclude, against the admissible regulatory background, that the addition to the PLC Sub-Notes of the words *"and all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes"* would <u>in and of themselves</u> have the effect of causing the PLC Sub-Notes to be subordinated to different "Senior Liabilities" to those to which the PLC Sub-Debts are subordinated. To the contrary, they

203 See Reply PP at [28] **[A/T10/187]**.

make it clear that the PLC Sub-Notes rank *pari passu* with the PLC Sub-Debt.

236. *Second*, the structure and substance of the operative subordination provisions under the PLC Sub-Debt and the PLC Sub-Notes are materially the same:

(1) In order for the "solvency" condition under Paragraph 5(1)(b) of the PLC Sub-Debt and Condition 3(b) of the PLC Sub-Notes to be satisfied, PLC must be able to pay its "Senior Liabilities" in full.

(2) For the purposes of the PLC Sub-Debt, the following are not "Senior Liabilities" which must be capable of being paid prior to the payment of the PLC Sub-Debt in order for the solvency condition to be satisfied:

(a) Subordinated "Liabilities" which rank or are expressed to rank *pari passu* with the PLC Sub-Debts. This follows from the fact that the PLC Sub-Debts must themselves rank *pari passu* for the reasons above. It is a conclusion accepted in principle by PLC itself.

(b) Subordinated "Liabilities" which are "*expressed to...rank junior to the Subordinated Liabilities*" under the definition of "Excluded Liabilities".

(3) For the purposes of the PLC Sub-Notes, the following are not "Senior Liabilities" which must be paid prior to the payment of the PLC Sub-Notes in order for the solvency condition to be satisfied:

(a) Subordinated "Liabilities" which "*rank or are expressed to rank pari passu with the Notes*" under the definition of "*Subordinated Liabilities*".

(b) Subordinated "Liabilities" which are "*expressed to rank...junior*" to the Subordinated Liabilities under the definition of "Excluded Liabilities".

(4) For the purposes of both the PLC Sub-Debt and the PLC Sub-Notes, the "Senior Liabilities" which *do* require payment in priority are:

(a) The unsubordinated creditors. This is not stated expressly in the definition of "Senior Liabilities" in either instrument, nor under the solvency condition under Paragraph 5(2) of the PLC Sub-Debt or Condition 3(b) of the PLC Sub-Notes. But it is necessarily correct, it being a core purpose of the EU Directives that an institution's regulatory subordinated debt be subordinated to the claims of "*their customers and other stakeholders*" (David Richards J Waterfall I at [33]), or as IPRU(INV) put it "*liabilities and commitments to consumers and counterparties*".

(b) Statutory interest: Waterfall I (Supreme Court).

(c) Non-provable liabilities: Waterfall I (Supreme Court).

(5) For the purposes of both the PLC Sub-Debt and the PLC Sub-Notes, the "Senior Liabilities" could also (but on the facts did not) potentially include any subordinated "Liabilities" which (i) do not rank *pari passu* nor are expressed to rank *pari passu* with the PLC Sub-Debt/PLC Sub-Notes and (ii) which are not expressed to rank junior to the PLC Sub-Debt/PLC Sub-Notes. This category of subordinated senior debts is a potential category which could have included, to the extent that they already existed or would be created at some point in the future, non-regulatory subordinated debt such as commercial subordinated debt (see paragraph [44] above) and/or could have preserved flexibility[204] (see Miller 1, [45]).

(6) Accordingly, the structure and substance of the subordination provisions under the PLC Sub-Debt and the PLC Sub-Notes are materially the same. The reasonable reader would conclude that both the PLC Sub-Debt and the PLC Sub-Notes rank behind the same Senior Liabilities such that they are entitled to prove at the same time and, therefore, the claims in respect of them rank *pari passu*.

237. *Third*, a construction that the PLC Sub-Notes are subordinated to different "Senior Liabilities merely because of the amended definition of "Subordinated Liabilities" flies in the face of what was said to the FSA, the FSA's public Waiver Directions, and the A&O confirmatory opinion (provided to the FSA by the firm that drafted the PLC Sub-Notes), namely that the slight modifications was being made (without more) to reflect a bond format.

204 As set out in the section "Post-GENPRU and beyond", above, the "TLAC" regime introduced by European law into English law does in fact now recognise a form of subordinated senior debt which ranks for insolvency purposes below general creditors, but above regulatory subordinated capital.

LBHI: Factual Matrix/Commercial Considerations

238. The Pari Passu Construction above is the only construction consistent with the objective purpose of these instruments and which makes sense against the relevant background that would have been reasonably available to their relevant audience.

239. The Court is entitled to consider the factual matrix/available background. The "*audience*" of the PLC Sub-Debt and the PLC Sub-Notes is limited to entities within the Lehman Group. GP1 contends that the PLC Sub-Notes were "*addressed to and would be relied upon by a potentially wide number of third-party investors*" (GP1 PP, at [11] **[A/T9/159]**). This is incorrect (Reply PP, [18(2)] **[A/T10/182-3]**).

240. The factual matrix is what was reasonably available to the Lehman Group centralised decision-makers. As to this:

(1) As regards the PLC Sub-Debt, these were bilateral subordinated debt facilities entered into between PLC and another Lehman Group entity, LBUKH. Following insolvency, they were assigned to LBHI, the US parent company of the Lehman Group.

(2) As regards the PLC Sub-Notes, these were part of a carefully designed structure put in place in order to meet regulatory capital requirements. Their transfer out of the Lehman Group would have defeated the very regulatory objectives which they were intended to achieve.

(3) The terms of both the PLC Sub-Debt and the PLC Sub-Notes were not publicly available, and the evidence is that there was an unwillingness within the Lehman Group at sharing the terms on the basis that this was an internal transaction.[205]

(4) In the event, the PLC Sub-Notes were never transferred out of the Lehman Group.

241. The objective meaning the instruments would have conveyed to the reasonable reader with the knowledge that was reasonably available to the centralised decision-makers within the Lehman Group was of subordination behind the same "Senior Liabilities":

[205] See above at [204] - [205].

(1) The PLC Sub-Notes were drafted at a time when the PLC Sub-Debt was known to exist. Despite this they did not cross-refer to each other in any way to suggest subordination of one to another.

(2) The PLC Sub-Notes were drafted to be materially identical to the PLC Sub-Debt and that much was represented to the FSA by (i) the covering email to the FSA[206]; (ii) A&O's confirmatory opinion[207]; and (iii) the annotated version of FSA Standard Form 10.[208] In all of these documents, it was represented to the regulator that a key definition in the PLC Sub-Notes' operative subordination provision was only slightly adjusted due to the bond format.

(3) The Waiver Direction,[209] which was a publicly available document, provided that the difference related to the form of the PLC Sub-Notes and not their subordination in substance.

(4) The FSA was told that the PLC Sub-Notes were based on the Collins Stewart precedent. That precedent contained materially the same subordination wording as the PLC Sub-Notes. The Court is entitled to have regard to that precedent to construe the definition of "Subordinated Liabilities" under the PLC Sub-Notes.[210] Any difference in wording between the PLC Sub-Debts and PLC Sub-Notes would not be understood to be attributable to a difference in ranking, but rather to the practical exigency of obtaining an FSA waiver in respect of a bond instrument as opposed to a loan.

(5) The principal purpose of both issuances (which is clear on their face in any event) was regulatory. That regulatory purpose only required subordination behind all creditors who were not regulatory subordinated creditors: Waterfall I. Accordingly, it would play no meaningful regulatory purpose to subordinate the PLC Sub-Debt to the PLC Sub-Notes.

(6) The insolvency of the Lehman Group and the relative priorities of subordinated debt in that event were not within anyone's contemplation at the relevant time. The strong inference from this is that there was no purpose to the transactions

[206] **[F/V2/770]**.
[207] **[F/V2/760]**.
[208] **[F/V10/5795-5807]**.
[209] **[F/V2/777-780]**.
[210] See above at [125] and the sixth proposition of contractual construction referred to therein.

other than to ensure the ranking of the subordinated instruments behind the firm's general creditors, consistent with the overriding regulatory purpose.

(7) The standard market practice provided that LT2 and Tier 3 dated subordinated debts ranked *pari passu*: see the materials referred to at [102] – [107] above.

Other Respondents' Ordinary Meaning Arguments

GP1

242. GP1 starts from the false premise (at GP1 PP, [64.1] **[A/T9/172]**) that the PLC Sub-Debt cannot rank *pari passu* with anything, and that it is subordinated to everything other than debts which are expressed to be junior. This is wrong for the reasons already stated above:

(1) It is unnecessary for two subordinated debts to cross-refer to each other for them to rank *pari passu*.

(2) Each of the PLC Sub-Debts ***can*** rank *pari passu* with other subordinated debt. Plainly the PLC Sub-Debts rank *pari passu* amongst themselves. Further, as a matter of construction, they are able to rank *pari passu* with other debts that are either expressed to rank or do rank *pari passu* with them.

(3) It is commercially absurd to posit that an instrument executed on FSA Standard Form 10 cannot rank *pari passu* with anything at all (especially in circumstances where another standard form in IPRU(INV), FSA Standard Form 5, contained express language envisaging this).

(4) The PLC Sub-Debts rank *pari passu* with other subordinated debts that rank after the same "Senior Liabilities".

243. Second, it is said that the PLC Sub-Debts are "Excluded Liabilities" for the purposes of the PLC Sub-Notes. In relation to this:

(1) The rationale (at GP1 PP, [65] **[A/T9/172]**) is that "*the PLC Sub-Debts are "expressed to" be junior to the PLC Sub-Notes because the PLC Sub-Notes are not expressed to be junior to the PLC Sub-Debt*".

(2) This is wrong. The PLC Sub-Debt is not "*expressed to*" be junior to the PLC Sub-Notes. Indeed, GP1's criticism is that the PLC Sub-Debt and the PLC Sub-Notes *do not expressly refer to each other at all*. Unsurprisingly, Deutsche Bank disagrees with the GP1 analysis (DB PP, at [43]-[44] **[A/T8/143]**).

(3) GP1's reasoning appears to be as follows: the PLC Sub-Debt must rank after everything other than debts expressed to be junior; the PLC Sub-Notes do not rank after everything (because they rank *pari passu* with other debts which are expressed to be or do rank pari passu); so that the PLC Sub-Debt necessarily "***falls to the bottom of the pile***" (GP1 PP, at [67] **[A/T9/172-3]**).

(4) This is absurd. *First*, GP1 does not articulate how, if the PLC Sub-Debt falls to the "***bottom of the pile***" because it cannot rank *pari passu* with anything, it could rank *below* deeply subordinated regulatory debt e.g. UT2 or Tier 1 capital (notwithstanding the fact that it is Lower Tier 2 capital) and, pertinently, the PLC Guarantee – which is agreed by all the parties to rank *below* the PLC Sub-Debt and the PLC Sub-Notes. *Second*, on the same analysis the LBHI2 Sub-Debt would fall to "*the bottom of the pile*" and rank below the LBHI2 Sub-Notes, since they are on materially the same terms as the PLC Sub-Debt.

Deutsche Bank

244. Deutsche Bank's position (at DB PP, [46] **[A/T8/144]**) is that the PLC Sub-Notes rank senior to the PLC Sub-Debt. Its starting point is the premise that the PLC Sub-Debt **cannot** rank *pari passu* with the PLC Sub-Notes (DB PP, at [38]-[41] **[A/T8/143]**) because:

(1) The terms of the PLC Sub-Debt allow no scope whatsoever for any other liability to rank *pari passu* with the PLC Sub-Debt.

(2) The effect of the different definition of "Subordinated Liabilities" in the PLC Sub-Debt is that the PLC Sub-Debt cannot rank *pari passu* with the PLC Sub-Notes because its terms preclude *pari passu* ranking with any other debt.

245. As a preliminary point, it should be noted that Deutsche Bank starts by conceding that "*Which of the PLC Sub-Notes and the PLC Sub-Debt ranks senior and which ranks junior*

is not immediately clear on the face of their terms".[211] That in itself is strongly suggestive that the two in fact rank after the same senior liabilities and not junior/senior to each other.

246. Further, as explained above, Deutsche Bank's position is a profoundly uncommercial approach to the construction of an industry-wide standard form and leads to an (easily avoided) absurdity.

247. As set out above, the correct starting point is to ask whether the PLC Sub-Debt and the PLC Sub-Notes are subordinated to the same "Senior Liabilities". If they are so subordinated, they prove at the same time, and they rank *pari passu* upon insolvency.

248. However, to the extent that Deutsche Bank argues that the PLC Sub-Debt does not allow scope for any other liability to rank *pari passu* alongside it, this is incorrect: first, it is unnecessary for two subordinated debts to cross-refer expressly to each other for them to rank *pari passu*; and second, as a matter of construction or implication, it is possible for subordinated debts created on FSA Standard Form 10 to rank *pari passu* with other subordinated debts by any one of the approaches suggested above.

249. Deutsche Bank's starting point i.e. that the PLC Sub-Debt and the PLC Sub-Notes cannot rank *pari passu* is therefore wrong.

250. The rest of Deutsche Bank's analysis is also wrong:

(1) Deutsche Bank cites a so-called "circularity" and commercial absurdity that, on a literal interpretation, the PLC Sub-Debts are "Senior Liabilities" for the purposes of the PLC Sub-Notes, and the PLC Sub-Notes are "Senior Liabilities" for the purposes of the PLC Sub-Debt (at [42]-[45] **[A/T8/143-4]**).

(2) The simple answer to the "circularity" is that it does not exist, for the reasons already set out above at [210]-[225]; and that the proper construction of the both the PLC Sub-Notes and the PLC Sub-Debt is that they rank *pari passu*.

251. Putting that to one side, Deutsche Bank then seeks to "break the circularity" either (a) by "*construing the PLC Sub-Debt and the PLC Sub-Notes to give effect to what the parties objectively intended*" or (b) through "*implying a term into one or both of the PLC Sub-Debt and the PLC Sub-Notes*" (at [46]-[47] **[A/T8/144]**).

[211] DB PP, [42] **[A/T8/143]**.

(a) *First*, Deutsche Bank seeks to do this by mere assertion only: "*to give effect to what the parties would have objectively intended, it is necessary to construe the terms of the PLC Sub-Debt and the PLC Sub-Notes such that the PLC Sub-Notes rank ahead of the PLC Sub-Debt*". This states a conclusion without providing analysis. The argument merely assumes the construction it seeks to justify. It is not "necessary" to construe the PLC Sub-Debt and the PLC Sub-Notes in the manner stated.

(b) *Second*, it is said that a term needs to be implied "*into one or both of the PLC Sub-Debt and the PLC Sub-Notes*", such that the PLC Sub-Notes rank ahead of the PLC Sub-Debt, on one of two bases: (i) that such a term is obvious or necessary in order to make the contracts work and give them commercial and practical coherence (relying on Marks and Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2016] AC 742); or (ii) on the basis that such a term must be implied to avoid the contract being incomplete in the absence of a term (relying on Liverpool City Council v Irwin [1977] AC 239). As to these arguments:

(i) As to the former, there are no grounds to imply such a term in fact. Such a term is far from obvious and it is not necessary for the business efficacy of the contracts.

(ii) As to the latter, incompleteness in and of itself is no basis to imply a term in law into a class of contracts. Moreover, it is self-evidently wrong to seek to imply a term in law as a legal incident of the parties' relationship that the PLC Sub-Notes should rank senior. It cannot be seriously suggested that it is appropriate where one is dealing with standard form contracts and contracts based on standard forms to imply a term in law giving one such contract priority over the other.

252. Deutsche Bank's attempts to break the "circularity" are misconceived. Indeed, they emphasise the correctness and common sense of the approach suggested by LBHI.

Other Respondents' Factual Matrix/Commercial Arguments

Deutsche Bank

253. Deutsche Bank contends that, among other matters, "***the context of the Lehman Group as a whole, and its tax and commercial objectives***" (DB PP, at [49(iii)] **[A/T8/144-5]**) are relevant to determining "*what would have been agreed on the issue of ranking by reasonable persons in the position of the parties to the PLC Sub-Debt and the PLC Sub-Notes*".

254. *First*, Deutsche Bank relies, in connection with this overarching commercial theory, on the Dividend Stopper (DB PP, [52] **[A/T8/145-6]**). It is said that the "*Lehman Group had strong commercial reasons to prioritise payments to the issuers of the ECAPS under the PLC Sub-Notes over payments under the PLC Sub-Debt to avoid the mandatory operation of the Dividend Stopper and to retain the flexibility and discretion on funding intended under the ECAPS*" (DB PP, [52(1)] **[A/T8/146]**) and that "*[t]he ECAPS were listed and rated securities held by external (non-Lehman) investors, including both institutional and individual investors*" **[A/T8/130]**.

255. As a preliminary point, Deutsche Bank's overarching argument to the effect that the Lehman Group's capital structure needed to be arranged specifically to ensure that distributions would be made in priority to the ECAPS Holders crucially ignores: (i) the fact that there were at least 9 other instruments which contained Dividend Stoppers affecting LBHI's ability to pay dividends in certain circumstances during the relevant period[212]; and (ii) the fact that the funds used to finance the chain of regulatory subordinated debt flowing down from LBHI – of which the PLC Sub-Debt was a part – were themselves ultimately derived from a mixture of debt and equity issued by LBHI to the public markets.[213]

256. Deutsche Bank is wrong for the reasons set out at Reply PP [16] **[A/T10/180-1]** and above. In relation to this:

(1) In the solvent scenario, there was no absolute obligation under the ECAPS (which were deeply subordinated Tier 1 capital) to make any "Distributions" to the ECAPS Holders at all: any obligation to do so was always subject to (i) the availability of funds received by the Issuer (Condition 2.3) and (ii) the unfettered discretion of GP1 not to pay "at any time and for any reason" (Condition 2.4). By contrast, payment of the Tier 2/Tier 3 subordinated instruments relevant to the Ranking Issue was mandatory, subject to the satisfaction of the payment condition.

(2) The commercial incentive on LBHI to avoid the effect of the Dividend Stopper is based on a false premise. If the Dividend Stopper had been triggered by a liquidity issue at PLC, that in turn would have been because of a liquidity issue at LBHI. This would have indicated a much wider problem with the Lehman Group and LBHI would not have been in a position to pay dividends to shareholders in any event (O'Meara 1, [12] **[C/T10/135]**).

(3) Accordingly, in the insolvent scenario, the Dividend Stopper under the ECAPS ceased to be of any significance. This is because in that scenario no dividends would be payable on LBHI's common stock irrespective of the operation of the Dividend Stopper.

(4) Finally, if there was a commercial imperative to prioritise the PLC Sub-Notes over the PLC Sub-Debt so as to ensure the ECAPS Holders were paid, it would be non-sensical for the ECAPS Holders' rights under the PLC Guarantee to be so deeply subordinated in an insolvency of PLC that their claims rank *pari passu* with the non-cumulative preference shares[214]. That, however, is the agreed position.

257. *Second*, Deutsche Bank relies on so-called tax incentives. It claims that the Lehman Group "*received detailed tax advice that PLC should take all commercially reasonable steps to avoid the suspension of interest on the PLC Sub-Notes*" (DB PP, [52(2)] **[A/T8/146]**). As to the tax argument:

(1) Deutsche Bank is understood to be referring to the A&O opinion dated 30 March 2005 in relation to US federal income tax[215].

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212 See the 2007 Hybrid Issuance Plan at **[F/V10/5900]**.

213 See in this regard Ms Dolby's letter to HMRC dated 30 March 2007 **[F/V4/1897-1900]**: "*the funds that LBHI currently uses to finance LB SLP1 and going forwards the funds it will use to finance LB SLP2 are ultimately derived from a mixture of debt and equity issued to the market by LBHI*" (at paragraph 18 to the "Background"). This was confirmed in her Interview, page 3, lines 21-25 **[C/T21/266]**.

214 "*The Subordinated Guarantee will rank pari passu with the non-cumulative perpetual preferred securities of preference shares of the Guarantor [PLC] (whether or not in issue)*" **[E/T10/154]**.

215 **[F/V2/668-715]**.

(2) The statement Deutsche Bank paraphrases is not tax advice of any kind, but merely records PLC's intentions on a best endeavours basis to remain commercially in a position to pay interest. The analysis section of the opinion considered that the suspension of interest would not cause a tax issue provided that interest continued to accrue, such that the opinion does not proffer the tax advice that Deutsche Bank asserts.

258. The commercial considerations contended for by Deutsche Bank are unsupported by the evidence.

259. For all these reasons, Deutsche Bank is wrong to state (at DB PP, [52(3)] **[A/T8/146]** that *"the only way to enable PLC to prioritise payments under the PLC Sub-Notes was for the PLC Sub-Notes to rank in priority to the PLC Sub-Debt, and any other ranking would jeopardise the commercial and tax planning objectives of the Lehman Group"* and that *"in all the circumstances, the only commercially reasonable structure is that the PLC Sub-Notes rank in priority to the PLC Sub-Debt, and that is what reasonable parties to the LBHI2 Sub-Debt and the LBHI2 Sub-Notes would have agreed"* (DB PP, at [52(6)] **[A/T8/146]**). This assertion is based on a false premise and is inconsistent with the evidence.

260. *Third*, Deutsche Bank relies on *"the timing of the issuing of the PLC Sub-Debt and PLC Sub-Notes"* as an additional argument (DB PP [49] **[A/T8/144]**). It contends (at DB PP, [51] **[A/T8/145-6]**) that the first series of the PLC Sub-Notes was issued after the first two PLC Sub-Debts were entered into and that *"[h]owever, no express reference was made to then existing PLC Sub-Debt as being debt that ranked pari passu with, or senior to the PLC Sub-Notes"*. Deutsche Bank asserts that the logical conclusion is that the PLC Sub-Debt was thought to be the most deeply subordinated debt issued. The timing argument is based on various fallacies:

(1) It assumes that the *"only logical conclusion"* to be drawn from the fact that the PLC Sub-Notes do not refer to the PLC Sub-Debt is that the PLC Sub-Debt is *"the most deeply subordinated"* (at [51(3)]). There is no basis for this assumption. The argument merely assumes (without more) the construction it seeks to justify. If applied to the LBHI2 Ranking Issue, the same logic would result in the LBHI2 Sub-Notes ranking *senior* to the LBHI2 Sub-Debt, given that the former makes no reference whatsoever to the latter.

(2) It presupposes that two regulatory subordinated debts have to refer to each other "expressly" in order to rank *pari passu*. That is incorrect. The PLC Sub-Notes were closely based on FSA Standard Form 10 and were subordinated after the same "Senior Liabilities" as the PLC Sub-Debt so as to rank *pari passu* with it.

(3) Deutsche Bank argues that when the final PLC Sub-Debt was entered into, *"PLC and LBUKH chose not to include any language in the third PLC Sub-Debt facility agreement to allow it to rank pari passu with other subordinated debt"*. That is said to be consistent with an intention to maintain the deeply subordinated status of the PLC Sub-Debt (DB PP at [51(4)]). Again, this seeks to ascribe far too much significance to the slightly amended "Subordinated Liabilities" definition under the PLC Sub-Notes which, as was represented to the FSA, did not differ materially from that under FSA Standard Form 10. Moreover, modifying that definition in the third tranche of the PLC Sub-Debt would have necessitated a waiver application to the FSA, serving no purpose whatsoever where the subordination provisions under FSA Standard Form 10 and the PLC Sub-Notes had the same meaning and effect.

Conclusions

261. The PLC Ranking Issue is straightforward. The Pari Passu Construction is the correct answer to this issue. This is strongly supported by the drafting of the relevant instruments, the factual matrix and commercial considerations. The interpretations advanced by GP1 and Deutsche Bank are obviously wrong.

H. THE LBHI2 RANKING ISSUE – PART I

262. The LBHI2 Ranking Issue divides into two separate sub-issues: the position in relation to the original LBHI2 Sub-Notes (**"Part I"**); and the position in relation to the LBHI2 Sub-Notes as amended in 2008 (**"Part II"**):

(1) During the period relevant to Part I (running from November 2006 to May 2007), the LBHI2 Sub-Notes were issued as part of an internal Lehman Group restructuring, the objective of which was to obtain a US tax benefit. This was achieved by (i) refinancing part of the LBHI2 Sub-Debt (drawn up on FSA Standard Form 10) with further dated regulatory subordinated debt in the form of the LBHI2 Sub-Notes on the same commercial terms as the LBHI2 Sub-Debt, and

(ii) transferring the LBHI2 Sub-Notes out of the existing regulatory structure to SLP3. Contrary to what the other Respondents' cases necessarily imply, none of these steps envisaged let alone required an alteration to the *pari passu* ranking of the LBHI2 Sub-Debt.

(2) As to Part II, on 3 September 2008 the LBHI2 Sub-Notes were amended. The purpose of the 2008 Amendments was (as set out in LBHI2's Board Minutes) "*to allow [LBHI2] to defer cash settlement of the interest on the Notes at its discretion*", which in turn was intended to create a US tax planning benefit. Contrary to what the other Respondents' cases suggest, to the extent the 2008 Amendments are engaged at all in LBHI2's administration, they do not alter the *pari passu* ranking of the LBHI2 Sub-Notes and the LBHI2 Sub-Debt. If they do have that legal effect, then they fall to be rectified for common mistake.

263. It is necessary first to ascertain what the status quo on ranking was when the LBHI2 Sub-Notes were first issued in May 2007, prior to the amendments.

264. The parties' respective positions in relation to Part I are set out as follows:

(1) SLP3: Joint PP, [17]-[24] **[A/T5/66-72]**; Reply PP, [31]-[42] **[A/T10/190-196]**.

(2) PLC: [25]-[48] **[A/T7/102-110]**.

(3) Deutsche Bank: [16]-[18] **[A/T8/128]**.

265. In summary:

(1) The operative subordination provisions under the LBHI2 Sub-Debt and the LBHI2 Sub-Notes are *materially the same*. This is because the former was drawn up on FSA Standard Form 10 (specifically, Form 10.7) and the latter's definition of "Senior Creditors" was materially similar to that used on FSA Standard Form 5: both of which forms were designed by the FSA to achieve the same subordination outcome.

(2) The broad drafting of both sets of instruments envisaged subordination to all of LBHI2's creditors (whether unsubordinated or subordinated), save for certain carve-outs which include subordinated liabilities that are expressed to rank/do rank *pari passu* with them or are expressed to rank/do rank junior to them.

(3) As PLC acknowledges, the subordination provisions in the LBHI2 Sub-Notes could encompass *existing* subordinated debt as well as *future* subordinated debts (PLC PP, [47.2] **[A/T7/108]**). SLP3's position is that there were no subordinated "Senior Creditors" in this case, and that the potential *future* category of subordinated senior debt was never engaged on the facts. PLC's (narrow) interpretation requires that (a) the subordinated "Senior Creditors" is necessarily a reference solely to *existing* subordinated debt i.e. the LBHI2 Sub-Debt and (b) that the LBHI2 Sub-Debt does not fall within the broadly drafted "*other than*" language, despite being a regulatory subordinated debt drawn up on materially identical commercial terms as the LBHI2 Sub-Notes.

(4) On a proper construction, the LBHI2 Sub-Debt and the LBHI2 Sub-Notes are subordinated to the same "Senior Liabilities"/"Senior Creditors", which on the facts of this case are the unsubordinated creditors, including the claims to statutory interest as well as non-provable liabilities, and they rank *pari passu*.

(5) Consistent with this conclusion, there was no commercial or regulatory rationale for subordinating the LBHI2 Sub-Debt to the LBHI2 Sub-Notes or *vice versa*, and such subordination formed no part of the purpose of the transactions pursuant to which the instruments were created.

LBHI2 Sub-Debt: Background

266. LBHI2 is an intermediate holding company of LBIE (Howell 2, [3]-[11] **[A/T2/5-6]**). LBIE was one of the main trading entities of the Lehman Group in Europe. LBHI2 has been in administration since 14 January 2009. Its principal purpose was to make capital available to LBIE, including by way of subordinated loans.

267. LBHI2 is in a distributing administration. As a result of the LBIE Scheme, LBHI2 has been able to discharge all of the unsecured, unsubordinated claims against its estate in full, together with statutory interest. It has a substantial surplus to pay its subordinated creditors.

268. In early November 2006, the Lehman Group underwent a restructuring ("**the 2006 Restructuring**"). Several of the steps taken were intended to reduce the consolidated overall profit and loss tax charge of LBHI, the Lehman Group parent company, from a US tax perspective.

269. Prior to the restructuring, LBIE – the UK group's broker-dealer – borrowed approximately $4.8 billion of subordinated debt from PLC. PLC was, immediately before the restructuring, the immediate parent of LBIE (Dolby 1, [17] **[C/T3/34]**). The majority of LBIE's subordinated debt was funded through the Group from LBHI i.e. the subordinated debt was funded by LBHI and loaned from one corporate entity to another down the corporate chain until it reached LBIE (Dolby 1, [18] **[C/T3/34]**).

270. The 2006 Restructuring was undertaken in two phases (Hutcherson 1, [62]-[63] **[C/T6/82]**):

(1) Phase 1, which took place in November 2006, involved the incorporation of LBHI2, its interposition in the structure between PLC and LBIE and the replacement of part of the subordinated debt borrowed by LBIE with preference shares. Phase 1 was undertaken mainly for tax purposes.

(2) Phase 2, which took place in January 2007, and is less relevant for the purposes of these proceedings, involved the replacement of Lehman Brothers Spain Holdings Limited at the top of the European Lehman Group structure.

271. The 2006 Restructuring related to an "APB23" tax accounting election.

272. APB23 tax elections concerned the way in which overseas profits and US taxes were accounted for in the US. The 2006 Restructuring[216] was one of a series of projects since 2001 relating to APB23 whose purpose was to achieve tax efficiencies. The aim of the APB23 project was to structure the Lehman Group in such a way as to enable UK profits to be accounted for by LBHI without recording a charge for the 5% differential between US and UK tax rates. This provided the Lehman Group with more attractive published profits (Hutcherson 1, [64] **[C/T6/82-3]**).

273. On 1 November 2006 the facilities between PLC and LBIE were terminated. On the same day, LBHI2 entered into three subordinated loan agreements with PLC on materially the same terms (i.e. drawn up on FSA Standard Form 10) and which comprise the LBHI2 Sub-Debt. LBHI2 in turn entered into three subordinated loan agreements with LBIE on materially the same terms. These agreements were considered in Waterfall I.

216 The background to the 2006 Restructuring is described by David Richards J in Waterfall I, at [29]

274. Ms Dolby, who worked in the European Tax Department, was the European tax lead on these restructurings (Hutcherson 1, [66] **[C/T6/83]**). As it was tax-focused, she led the various Lehman Group teams involved with the planning and implementation of the 2006 Restructuring.[217]

275. There was usually a small cross-departmental team that worked on the transactions. This included Mr Gareth Bowen, who worked in the regulatory reporting team; and Ms Hutcherson, who worked in compliance and who worked very closely alongside Mr Bowen (Hutcherson 1, [66] **[C/T6/83]**). The team also included a representative from the Treasury department (e.g. Mr Rushton or Mr O'Callaghan).

276. These transactions were intra-group and were considered for the benefit of the Lehman Group entities involved. This meant that the same cross-departmental group negotiated and advised acting for both sides in relation to any transaction (Hutcherson 1, [68] **[C/T6/83]**).

277. In this regard, on 2 November 2006 Ms Dolby emailed a number of Lehman Group personnel including Ms Hutcherson and Mr Ray O'Grady[218] to thank them for the involvement in Phase 1 of the 2006 Restructuring. She stated that Phase 1 alone would benefit the tax line by $30m p.a. in 2007 and subsequent years (1-month benefit in 2006 = $2.5m).

FSA Approvals

278. Given that the 2006 Restructuring contemplated the prepayment and refinancing of subordinated facilities as between PLC and LBIE, the FSA's approval was required. In this regard:

(1) On 14 September 2006[219], Mr Bowen emailed the FSA, describing the two phases of the restructuring. The email stated:

"The first part of the restructuring would on a net basis, result in $2bn of subdebt ($1,876m TII/ $124m TIII) being prepaid and $2bn of Lower Tier 2 subdebt being issued to New Co 2. Overall this would have no impact to LBIE capital position at

217 See Ms Dolby's email dated 2 November 2006 to Lehman Group personnel at the conclusion of Phase 1 **[F/V4/1858]**.

218 Mr O'Grady worked within the Financial Control Function of the Lehman Group.

219 **[F/V3/1751]**.

any level as the entity already has an excess of TII subdebt that exceeds the leverage limits and the excess is treated as TIII.

[...]

To implement the various components of this change new subdebt agreements will need to be executed between the new companies that are being incorporated in the company structure, we will provide copies to you on the standard FSA forms."

(2) On 6 October 2006[220], Ms Hutcherson sent a letter to the FSA setting out the structure in detail. The letter also reflected on the imminent introduction of GENPRU:

"As we move towards 1 January 2007 and prepare for the implementation of the GENPRU & BIPRU rules, we have considered what changes we need to make to the capital structure of the LBSH UK group. At the same time, and as a matter of routine, our Tax department has reviewed the optimal group structure for the purposes of tax efficiencies."[221]

(3) The final approval for Phase 1 of the 2006 Restructuring was received from the FSA on 30 October 2006[222]. This stated that:

"*Under the current rules, as set out in IPRU (INV) 10-63 and in the Approved Forms of Subordinated Loan Agreements (forms 10.1 and 10.2), repayment or prepayment of such facilities in advance of the relevant repayment date requires the prior permission of the FSA. Therefore, please accept this letter as confirmation of our permission for the proposed prepayments.* ***This permission is granted on the understanding that the facilities in question will be simultaneously replaced with three identical facilities from LBH Plc to LBIH 2 and from LBIH 2 to LBIE (as described in your letter), and therefore the prepayments will not have an adverse effect on the firm's UK capital structure***" (emphasis added).

279. Following some discussions as to the appropriate forms on which to draw the subordinated facilities, three agreements drawn up on Forms 10.6 and 10.7 of FSA

220 **[F/V3/1778-80]**.
221 **[F/V3/1779]**.
222 **[F/V3/1786]**.

Standard Form 10 were executed and dated 1 November 2006. These were forwarded to the FSA on the same date (Hutcherson 1, [78] **[C/T6/86]**).

280. In summary, the Phase 1 arrangement (Dolby 1, [21]-[22] **[C/T3/34-5]**):

(1) had the effect of reducing LBIE's interest obligations, as after the restructuring LBIE had an interest obligation on less subordinated debt than before. It was intended that by making LBIE profitable on a cumulative basis, LBHI would be able to access foreign tax credits previously trapped within LBIE. Once accessed, these foreign tax credits could be used to reduce LBHI's US tax liability.

(2) had the effect of creating a tax loss in LBHI2, because LBHI2 was now receiving interest on only $2.8 billion of subordinated debt from LBIE, but owed interest on $4.8 billion of subordinated debt. The tax loss in LBHI2 could be used to offset taxable profits in the UK tax group (which in turn resulted in a reduction of LBHI's consolidated overall profit from a US tax perspective).

LBHI2 Sub-Debt: Terms

281. The different tranches of LBHI2 Sub-Debt were all drawn up on FSA Standard Form 10. Accordingly, the LBHI2 Sub-Debt is in materially the same form as the PLC Sub-Debt, with some immaterial differences.

LBHI2 Sub-Notes: Background

<u>2007 Restructuring</u>

282. The Lehman Group underwent a further restructuring in mid-2007, the objective of which was to reduce LBHI's consolidated overall profit and loss charge from a US tax perspective (**"the 2007 Restructuring"**).[223]

283. By January 2007, the subordinated debt extended to LBHI2 had increased to approximately $7.1 billion through drawdowns on the LBHI2 Sub-Debt facilities. The reason for the increase was that the business in Europe had grown considerably, resulting in the need for LBIE to increase its regulatory capital to support its growing business (Dolby 1, [30] **[A/T3/30]**).

223 Dolby 1, [29] **[C/T3/36]**.

284. There were two parts to the 2007 Restructuring that occurred around the same time. The first part involved the replacement of part of the LBHI2 Sub-Debt with the $6.139 billion quoted Eurobond issued by LBHI2, i.e. the LBHI2 Sub-Notes. The second part (which is not relevant to these proceedings) involved the replacement of further subordinated debt borrowed from LBHI2 by LBIE with preference shares (Hutcherson 1, [81] **[C/T6/86]**).

285. The 2007 Restructuring was intended to secure a discrete US tax benefit. It involved re-routing part of the Lehman Group subordinated debt through two new Scottish partnerships established outside of the regulatory chain (Hutcherson 1, [82] **[C/T6/86]**). A Scottish limited partnership (which was ultimately owned by LBHI) would be viewed as a "tax transparent entity" for UK tax purposes, such that it would not be subject to any UK tax on any interest which it received (Dolby 1, [32] **[C/T3/36]**). However, by treating the Scottish limited partnership as a corporation for US tax purposes, and by making an APB23 election on it, to the extent that the Scottish limited partnership did not repatriate its profits to the US, the interest income in the Scottish limited partnership would not be subject to any current year US tax either (Dolby 1, [33] **[C/T3/36]**).

286. The process for planning and implementing the 2007 Restructuring was similar to that for the 2006 Restructuring. It was a cross-departmental effort, and within the UK it was overseen and coordinated by Ms Dolby in the European tax department (Hutcherson 1, [80] **[C/T6/86]**).

287. As with the 2006 Restructuring, the central Lehman Group team on the 2007 Restructuring was composed of tax, regulatory, compliance and legal. Sarah McMorrow assisted with the legal aspects of the project (Dolby 1, [40] **[C/T3/37-8]**), and Mr Bowen/Ms Hutcherson were involved from a regulatory/compliance perspective.

Refinancing the LBHI2 Sub-Debt

288. On 26 March 2007[224], Ms Dolby emailed Mr Bowen stating that "*[c]urrently $6.139bn of T2 (1.339bn) and T3 (4.8bn) subdebt flows down chain to UK Holdings. My intention would be to convert this $6.139bn into the hybrid note issued by SLP2/3.*"

289. Ms Dolby recalls a subsequent meeting with the regulatory capital team (i.e. Mr Bowen and Mark Richardson) in early April 2007 to discuss how much of the LBHI2 Sub-Debt should be replaced by the LBHI2 Sub-Notes. Mr Bowen recommended to Ms Dolby that

224 **[F/V4/1892]**.

c. $6 billion of the LBHI2 Sub-Debt be replaced (though she does not recall the reason) (Dolby 1, [35] **[A/T3/37]**). As set out below, the issue of ranking and priorities was not discussed.

290. As a result of this, Ms Hutcherson wrote a letter to the FSA which referred to the LBHI2 Sub-Notes discharging "*$1.339 billion under its long term subordinated debt facility and $4.8 billion under its short term subordinated debt facility*" (Dolby 1, [49] **[C/T3/49]**).[225]

291. As set out in Ms Dolby's memorandum of 1 May 2007,[226] there remained some $1.3 billion of the LBHI2 Sub-Debt which was not refinanced (Dolby 1, [47] **[C/T3/38-9]**).

A&O: Regulatory Approval and Subordination

292. Ms Dolby instructed A&O to draft the LBHI2 Sub-Notes and to obtain the regulatory approval for them. A&O misunderstood the transaction to be a 100% refinancing of the LBHI2 Sub-Debt (rather than a substantial refinancing of circa $6 billion of it). As Mr Miller states in his evidence, he was not aware at the time of any subordinated debt of LBHI2 which would remain in existence and would co-exist with the LBHI2 Sub-Notes (Miller 1, [36]-[37] **[C/T1/9]**).

293. The regulatory approval and execution of the LBHI2 Sub-Notes included the following steps by A&O:

(1) Ms Dolby (Dolby 1, [50] **[C/T3/39]**) explains that A&O were first instructed by Ms McMorrow on 30 March 2007, and then again by Ms Dolby on 2 April. The instruction was that "*the direct parent of LBIE, LB Holdings Intermediate No 2 Ltd, will issue a quoted Eurobond to replace its current subdebt liability*". Ms McMorrow noted that "*I'm assuming by **transferable** Jackie just means it can be **transferred between Lehman entities***". This reflected the fact that, as part of the Lehman Group's regulatory capital structure, it was never intended to transfer the LBHI2 Sub-Notes outside of the group.

(2) Ms Dolby explains (Dolby 1, [50] **[C/T3/39]**) that A&O were instructed to produce a regulatory opinion to confirm that the LBHI2 Sub-Notes complied with the regulatory capital requirements of GENPRU: "*Subordination: Likely to be Lower Tier 2 (but will need an A&O reg opinion on this which I can follow up*

225 See Ms Hutcherson's letter dated 12 April 2007 **[F/V4/2045]**.

226 **[F/V4/2096-8]**.

on)". Since the LBHI2 Sub-Notes were dated, the relevant regulatory capital requirements were those for **LT2** capital (Miller 1, [40]-[41] **[C/T1/10]**), and A&O produced an opinion confirming that the LBHI2 Sub-Notes would qualify as LT2 capital under the relevant rules (Dolby 1, [51] **[C/T3/39]**).

(3) Ms Dolby confirms that A&O did not provide any confirmation on insolvency/priority issues (or the relative ranking of the LBHI2 Sub-Debt and the LBHI2 Sub-Notes) (Dolby 1, [52]-[53] **[C/T3/39-40]**); see also Waterfall I per David Richards J, at [48][227]). This was not a scenario that anyone considered or contemplated (ibid.). So much has been confirmed by:

(a) Ms Hutcherson (Hutcherson 1, [90]-[91] **[C/T6/88-89]**), who remembers no discussions in the cross-departmental team to this effect.

(b) Mr Miller (Miller 1, [46], [48] **[C/T1/11-12]**), who did not realise that some of the LBHI2 Sub-Debt would continue to exist, and did not address the "*relative ranking*" of subordinated debt at all.

294. In this regard, on 18 April 2007[228], A&O circulated (i) a Procedures Memorandum; (ii) a Note Purchase Agreement; and (iii) draft Board Minutes for the Issuer.

295. Under the Note Purchase Agreement, the initial purchaser of the LBHI2 Sub-Notes was PLC (so that PLC held, albeit for a *scintilla temporis*, both the LBHI2 Sub-Debt and the LBHI2 Sub-Notes). The draft minutes noted that the issuance of the LBHI2 Sub-Notes was "*for the purpose of strengthening the regulatory capital base of the group and paying off existing loans of the Company.*"

296. The same day A&O circulated the draft opinion[229] confirming compliance with "*GENPRU requirements for LT2*". The opinion was finalised on 30 April 2007 and was addressed to LBHI2 for the attention of Ms Dolby. In relation to this:

(1) The opinion constituted the confirmatory opinion for the purposes of GENPRU 2.2.159(12);

227 "*There is no evidence to suggest that anyone in the Lehman Brothers group gave any consideration to how these provisions would operate in the event of an insolvency....and indeed the recollection of several witnesses in interviews which have been conducted suggests that it is highly unlikely that any such consideration was given*".

228 **[F/V4/2061-2076]**.

229 **[F/V4/2077-2080]**.

(2) It confirmed that the LBHI2 Sub-Notes complied with GENPRU 2.2.159(1)-(7).

(3) As to GENPRU 2.2.159(1), in particular, it set out the rule ("*the claims of the creditors must rank behind those of all unsubordinated creditors*") and stated "***A&O: confirmed. This is contained in Condition 3***" (emphasis added)[230].

297. In relation to Condition3, Mr Miller has confirmed, having been asked by the LBHI2 Joint Administrators' legal representatives in correspondence in in November 2016[231], that the drafting also reflected a preference within the regulatory team at the Lehman Group for flexibility (reiterated in Miller 1, [48] **[C/T1/12]**).[232] The drafting preserved the ability to issue a layer of subordinated debt sitting above the subordinated notes.

FSA Approvals

298. On 12 April 2007[233] Ms Hutcherson wrote to the FSA to explain the group's plans "*regarding changes to the route by which LBIE sources some of its regulatory capital*", and that the 2007 Restructuring was driven mainly by US tax efficiencies ("*the proposed changes are being driven largely by US tax efficiencies and we believe should have no adverse regulatory consequences*").[234] The letter also stated that "*$4.8 billion of the tier 3 capital in the UK consolidated group will be replaced with a corresponding $4.8 billion of tier 2 capital*".

Tax Advice/Clearance

299. Given the 2007 Restructuring was tax-driven, the Lehman Group received detailed tax advice from both PwC and A&O. In summary:

(1) On or around 17 May 2007, PwC emailed Jackie Dolby detailed UK and US tax opinions. The UK tax opinion (the "**PwC Memorandum**")[235] concluded that the LBHI2 Sub-Notes should be treated as debt and not equity for UK tax purposes.

(2) The PwC Memorandum also concluded that interest paid by LBHI2 to SLP3 would be considered tax deductible for UK corporation tax purposes.

230 **[F/V4/2078]**.

231 **[F/V9/5246-7]**. As to this exchange see Howell 2, [35] **[A/T2/18]**.

232 As set out above, this preference within the Lehman Group for flexibility forms part of the factual matrix, being knowledge reasonably available to both parties to the transaction, and which is relevant to the issue of interpretation.

233 **[F/V4/2044-8]**.

234 See also Hutcherson 1, [87] **[C/T6/87]**.

235 Dated 31 May 2007 **[F/V5/2391-2492]**.

(3) A&O's tax advice dealt with points of US law.

300. Ms Dolby also sought and obtained tax arbitrage clearance from HMRC in relation to the 2007 Restructuring[236]. In this context, she explained to HMRC that under the refinancing the amount of debt funding available to the Lehman Group would be the same, and the LBHI2 Sub-Notes would be under the same terms and conditions as the LBHI2 Sub-Debt. Ms Dolby wrote:

> "*As the proposed transaction does not displace or alter the existing amount of debt funding to the UK group it would seem that no comparison needs to be made here; the same loan amount is in place before and after the transaction and fulfils the same purpose – that of providing capital to support the general UK business activities.*
>
> *The loan was made for the same amount, and* ***under the same terms and conditions*** *prior to the insertion of the hybrid entity*" (emphasis added).[237]

301. In short, to achieve the tax objectives that were the core driver of the 2007 Restructuring, it was unnecessary for the Lehman Group to change the relative ranking of its dated subordinated debt, nor would that have been necessary to achieve the regulatory purpose of the transaction.

Transfer to SLP3

302. The LBHI2 Sub-Notes were initially issued by LBHI2 to PLC. They were then transferred up the group from PLC to LBUKH and then to LBLIS and finally to LBDI by way of *in specie* repayments of the subordinated debts that were being refinanced.[238] This was because the LBHI2 Sub-Notes were "*in effect replacing some of the core sub-debt that was coming down the chain*". [239] The LBHI2 Sub-Notes were then contributed by LBDI (as general partner) to SLP2 and then to SLP3, in return for hybrid notes issued by SLP2 and SLP3 respectively (Hutcherson 1, [88] **[C/T6/88]**).

303. As she had done with the 2006 Restructuring, at the conclusion of the process Ms Dolby sent an email thanking various individuals within the Lehman Group for the "*completion of the project to refinance the UK group subdebt. This brings to a close a 4 month project to create a tax efficient funding structure that will result in an ongoing tax benefit of c. $200m per annum*"[240].

LBHI2 Sub-Notes: Terms

304. The LBHI2 Sub-Notes were issued in the amount of $6.139 billion by way of an Offering Memorandum dated 26 April 2007.

305. As set out above, as the aim was partially to refinance existing subordinated debt, the LBHI2 Sub-Notes were initially issued to PLC, and subsequently transferred "up the chain" via a series of transfer agreements.

306. The LBHI2 Sub-Notes were not drawn up on FSA Standard Form 10:

(1) This was because of the regulatory change pursuant to which GENPRU had come into effect on 31 December 2006, which meant that standard forms were no longer required.

(2) Accordingly, the PLC Sub-Notes would not have been a natural precedent as they were based on an adapted version of FSA Standard Form 10: A&O used a precedent that complied with the requirements for LT2 capital under what was now GENPRU (Miller 1, [43] **[C/T1/10-11]**).

307. The intention to achieve a regulatory purpose is plain on the face of the LBHI2 Sub-Notes: see e.g. Condition 1 (definition of "FSA")[241]; page 1 of the Offering Circular[242]; and page 14 of the Offering Circular, which states that their aim is to "*strengthen the regulatory capital base of the group of companies in which it operates, to pay off existing loans and for general corporate purposes*"[243].

Payment Condition

308. The relevant subordination provisions of the LBHI2 Sub-Notes were structured in materially the same way to FSA Standard Form 10 and, consequently, to the LBHI2 Sub-

236 See Ms Dolby's letter to HMRC dated 30 March 2007 **[F/V4/1897-1909]**.
237 See Ms Dolby's letter to HMRC dated 30 March 2007 **[F/V4/1905]**. See also the email of 12 March 2007 from Huw Lees to Susan Her where he asked to see the agreements between LBIE and LBHI2 so that "*we can* ***mirror the terms*** *of the note agreements we are working on*" **[F/V4/1882]**.
238 See Dolby Interview, page 13, lines 12-18 **[C/T21/276]**.
239 See Dolby Interview, page 13, lines 12-13 **[C/T21/276]**.
240 See Ms Dolby's email to Lehman Group personnel dated 2 May 2007 **[F/V4/2278-9]**.
241 **[E/T4/53]**.
242 "*Under the existing terms of the [FSA], the Issuer may not redeem or purchase any Notes prior to their maturity date unless the FSA has given its prior consent*" **[E/T4/50]**.
243 **[E/T4/63]**.

Debt. Once the 'Senior Creditors' have been paid in full, SLP3 is entitled to prove in respect of the LBHI2 Sub-Notes.

309. Condition 3(a) provides:[244]

"[...] *The rights of the Noteholders against the Issuer in respect of the Notes are subordinated in right of payment to the Senior Creditors (as defined below) and* ***accordingly payment of principal in respect of the Notes is conditional*** *upon the Issuer being solvent at the time of, and immediately after, such payment, and* ***accordingly no such amount which would otherwise fall due for payment shall be payable*** *except to the extent that the Issuer could make such payment and still be solvent immediately thereafter"* (emphasis added).

Solvency Requirement

310. Whether or not an insolvency process has begun, the solvency condition referred to in Condition 3(a) must be satisfied. Condition 3(b) provides that LBHI2 is "*solvent*" if (i) it is able to pay its debts as they fall due and (ii) its 'Assets' exceed its "Liabilities" other than its "Liabilities" to persons who are not "Senior Creditors". In short, payment of any amount of the Notes is conditional on LBHI2's ability to pay its "Senior Creditors" in full.

"Liabilities", "Senior Liabilities", "Subordinated Liabilities", "Excluded Liabilities"

311. The relevant terms are defined as follows:

(1) "Liabilities" [245] are defined to mean "all present and future sums, liabilities and obligations payable or owing by the Issuer (whether actual or contingent, jointly or severally or otherwise howsoever".

(2) "Senior Creditors" are defined to mean "*creditors of [LBHI2] (i) who are unsubordinated creditors of [LBHI2] or (ii) who are subordinated creditors of [LBHI2] other than those with whose claims the claims of the Noteholders are expressed to rank pari passu and those whose claims rank, or are expressed to rank, pari passu with, or junior to, the claims of the Noteholders.*"

[244] **[E/T4/55]**.
[245] This is the same definition of "Liabilities" as is used in the LBHI2 Sub-Debt.

312. The "Senior Creditors" are therefore all unsubordinated and subordinated creditors *other than* several defined categories of subordinated creditors, including those who rank or are expressed to rank *pari passu*, or those who rank or are expressed to rank junior (and, as set out below, "Senior Creditors" include subordinated creditors that are not expressed to rank nor do rank either *pari passu* with or junior to the claims of the Noteholders).

LBHI2 Sub-Notes were neither publicly available nor intended to be traded

313. The LBHI2 Sub-Notes were listed on the CISX. The LBHI2 Sub-Notes needed to be in the form of a quoted Eurobond listed on a recognised stock exchange. This was specifically because interest payable on such instruments would not be subject to UK withholding tax and so would be paid gross (Dolby 1, [37] **[C/T3/37]**). As to the choice of the CISX itself, Ms Dolby explained that this was "*because it had a light touch on filings, etc.*"[246]

314. Ms Dolby confirmed in her interview that it was never the intention that the LBHI2 Sub-Notes should be transferred on the CISX.[247] That would have defeated the purpose of the 2007 Restructuring. Instead, the Eurobond was to be held and transferred within the Lehman Group rather than issued into the market (Miller 1, [37] **[C/T1/9]**). As Ms Dolby has confirmed "*This was an internal structure*".[248] That also appears to have been Ms McMorrow's understanding, when she wrote to A&O "*I'm assuming by* ***transferable*** *Jackie [Dolby] just means it can* ***be transferred between Lehman entities***"[249] (emphasis added).

315. Further, the LBHI2 Sub-Notes were registered in definitive form and not on a clearing system and so were not readily tradable.[250]

316. Moreover, despite being listed on the CISX, it was clear to the lawyers at A&O that at least the terms of the *amended* LBHI2 Sub-Notes would also not be publicly available:

(1) On 26 June 2008[251], Mr Grant of A&O emailed the partner engaged on the case, Anne-Claude Mozel, stating that the amended terms would need to be emailed to

[246] See Jackie Dolby Interview, page 12, lines 31-32 **[C/T21/275]**.
[247] Jackie Dolby Interview p. 13, lines 1-2 **[C/T21/275]**.
[248] Jackie Dolby Interview p. 13, line 6 **[C/T21/275]**.
[249] Ms McMorrow's email to Stephen Miller dated 30 March 2007 **[F/V4/1895]**.
[250] Mr Miller explained to Mr Barnett, of Dentons, in his email of 22 November 2016 that "*Definitive registered form as the FRNs will be held intragroup and thus Lehman would make a saving on custody fees which they would have had to incur if they held the FRNs in a clearing system*" **[F/V9/5247]**.
[251] **[F/V6/3100]**.

the CISX with a number of supporting documents. He added "*It should be made clear that this is not for public announcement*".

(2) On 3 September 2008[252], Mr Grant emailed the CISX, attaching the amended LBHI2 Sub-Notes and stating in his covering email: "*I was told that it would not be made public but stored in your internal records. Please ensure that this is the case.*"

<u>**Ranking Analysis**</u>

LBHI2 Sub-Debt: *pari passu* inter se

317. The LBHI2 Sub-Debt ranks *pari passu inter se* for the same reasons as set out above in relation to both the ranking of the different tranches of PLC Sub-Debt among themselves, and the PLC Sub-Notes among themselves. This is notwithstanding that none of the LBHI2 Sub-Debts refer to any other.

318. Significantly, PLC agree with this conclusion, albeit they do not state their reasoning/analysis: PLC PP, [38] **[A/T7/106]**.

319. A conclusion that the LBHI2 Sub-Debt did not rank *pari passu* would lead to a patent commercial absurdity: the three LBHI2 Sub-Debts were entered into on the same day between the same parties (LBHI2 and PLC).

320. However, to the extent that GP1's theory that debts drawn up on FSA Standard Form 10 cannot rank *pari passu* with other subordinated debt is correct, then it would of course follow that, in relation to the LBHI2 Ranking Issue, the LBHI2 Sub-Notes would rank *senior* to the LBHI2 Sub-Debt because the latter would be incapable of ranking *pari passu* with anything and thus fall to the "*bottom of the pile*".

LBHI2 Sub-Debt and LBHI2 Sub-Notes rank *pari passu*

321. SLP3's position is that the claims of SLP3 in respect of the LBHI2 Sub-Notes rank for distribution *pari passu* with the claims of PLC under the LBHI2 Sub-Debt: see Joint PP, [23]-[24] **[A/T5/69-70]**; and Reply PP, [40]-[42] **[A/T10/194-196]**. In summary:

[252] **[F/V6/3487]**

(1) The operative subordination provisions under the LBHI2 Sub-Debt and the LBHI2 Sub-Notes are structured in materially the same way.

(2) On a proper construction, the LBHI2 Sub-Debt and the LBHI2 Sub-Notes are subordinated behind the same "Senior Liabilities"/"Senior Creditors".

(3) SLP3 is entitled to prove for the full nominal amount of the LBHI2 Sub-Notes at the same time as PLC is entitled to prove in respect of the LBHI2 Sub-Debt.

(4) By operation of the 2016 Rules, SLP3's claims in respect of the LBHI2 Sub-Notes and PLC's claims in respect of the LBHI2 Sub-Debt rank *pari passu* and abate in equal proportions.

<u>SLP3: Ordinary Meaning</u>

322. The ordinary meaning of the language used in both instruments is only consistent with a *pari passu* construction.

323 SLP3 makes two preliminary points in relation to the wording of the LBHI2 Sub-Notes:

(1) *First*, it should be noted that the "carve-outs" or exceptions in item (ii) of the "Senior Creditors" definition are drafted in very broad terms. To the extent that the LBHI2 Sub-Notes envisage "subordinated creditors" that can rank senior, that is a neutral point: they also expressly refer to various categories of subordinated creditors that can rank either *pari passu* with or junior to the LBHI2 Sub-Notes so as to leave the reader in little doubt that the "subordinated creditors" ranking senior to the LBHI2 Sub-Notes are a potential category.

(2) *Second*, the definition of "Senior Creditors" is in materially[253] similar terms to the definition of "Senior Creditors" in FSA Standard Form 5: "*all such persons who are: (a) unsubordinated creditors of the Borrower; or (b) subordinated creditors of the Borrower other than those whose claims are expressed to rank and do rank pari passu with or junior to the claims of the Lender*". As to this:

(a) FSA Standard Form 5 and FSA Standard Form 10 (on which the LBHI2 Sub-Debts were drawn) were required to meet the same subordination

[253] The only difference is the use of "*expressed to rank and do rank pari passu*" (Form 5.1) and "*expressed to rank pari passu and those whose claims rank .... pari passu*" (LBHI2 Sub-Notes").

requirement under the EU Directives, where the senior claims were those of "*all other creditors*".

(b) FSA Standard Form 10 and FSA Standard Form 5 relied on slightly differing drafting techniques, but were intended to achieve (and did achieve) the same subordination result.

(c) The subordination of the LBHI2 Sub-Notes to "subordinated creditors" (subject to the broad "*other than*" exceptions) is similar to the language used under FSA Standard Form 5, and the Court should adopt a uniform approach when construing the relevant subordination provision[254].

324. The structure and substance of the operative subordination provisions under the LBHI2-Sub-Debt and the LBHI2 Sub-Notes are materially[255] the same:

(1) In order for the "solvency" condition under Paragraph 5(1)(b) of the LBHI2 Sub-Debt and Condition 3(b) of the LBHI2 Sub-Notes to be satisfied, LBHI2 must be able to pay its "Senior Liabilities"/"Senior Creditors" in full.

(2) For the purposes of the LBHI2 Sub-Debt, the following are *not* "Senior Liabilities" which must be capable of being paid in order for the solvency condition to be satisfied:

(a) Subordinated "Liabilities" which rank or are expressed to rank *pari passu* with the different tranches of LBHI2 Sub-Debt. This follows from the fact the different tranches of LBHI2 Sub-Debt must themselves rank *pari passu*, which is accepted in principle by PLC: see above, at [317] to [320].

(b) Subordinated "Liabilities" which are "*expressed to…rank junior to the Subordinated Liabilities*" under the definition of "Excluded Liabilities".

(3) For the purposes of the LBHI2 Sub-Notes, the following are *not* "Senior Creditors" who must be paid prior to the payment of the LBHI2 Sub-Notes in order for the solvency condition to be satisfied:

254 See the seventh principle of contractual construction referred to at [126] above.

255 In this regard, SLP3 includes and relies on a comparative table setting out to the operative provisions of the LBHI2 Sub-Debt alongside those of the LBHI2 Sub-Notes at Appendix B to this skeleton argument ("**Appendix B**"). The table set out in Appendix B also sets out the operative provisions of the PLC Sub-Debt alongside the PLC Sub-Notes.

(a) Subordinated creditors whose claims "*rank, or are expressed to rank, pari passu with…*" the holders of the LBHI2 Sub-Notes. That much is stated in item (ii) of the definition of "Senior Creditors".

(b) Subordinated creditors whose claims are "*expressed to rank…junior to*" the claims of the holders of the LBHI2 Sub-Notes. That much is stated in item (ii) of the definition of "Senior Creditors."

(4) For the purposes of the both the LBHI2 Sub-Debt and the LBHI2 Sub-Notes, the "Senior Liabilities" /"Senior Creditors" which *do* require payment in priority are:

(a) The unsubordinated creditors. This is stated expressly under item (i) of the definition of "Senior Creditors" in the LBHI2 Sub-Notes. As to the LBHI2 Sub-Debts, despite not being stated expressly, it is necessarily correct, it being a core purpose of the EU Directives that an institution's regulatory subordinated debt be subordinated to the claims of "*their customers and other stakeholders*" (David Richards J <u>Waterfall I</u> at [33]), or as IPRU(INV) put it "*liabilities and commitments to consumers and counterparties*".

(b) Statutory interest: <u>Waterfall I</u> (Supreme Court).

(c) Non-provable liabilities: <u>Waterfall I</u> (Supreme Court).

325. For the purposes of both the LBHI2 Sub-Debt and the LBHI2 Sub-Notes, the "Senior Liabilities"/"Senior Creditors" could also *potentially* include any subordinated senior liabilities/creditors which (i) did not rank pari passu or were not expressed to rank pari passu with the LBHI2 Sub-Debt/LBHI2 Sub-Notes and (ii) which were not expressed to rank junior to the LBHI2 Sub-Debt/LBHI2 Sub-Notes.

326. The LBHI2 Sub-Notes expressly acknowledge a potential category of subordinated senior debt in the definition of "Senior Creditors", subject to broad exceptions. In the LBHI2 Sub-Debt the definition of "Senior Liabilities[256]" is drawn in very broad terms on the basis of the 'exclusionary' mechanism so that the definition "Senior Liabilities" could similarly include a potential category of subordinated senior debt.

256 "Liabilities" is defined very broadly to include "*all present and future sums, liabilities and obligations payable or owing by the Borrower (whether actual or contingent, jointly or severally or otherwise howsoever*".

327. In both cases, this is a potential category which could have included, to the extent that they already existed or were created at some point in the future, non-regulatory subordinated debt such as commercial subordinated debt (see paragraph [44] above) and/or could have preserved the flexibility to issue subordinated senior debt in the future (see Miller 1, [45] **[C/T1/11]**); Mr Miller's email to the legal representatives of LBHI2's Joint Administrators in November 2016,[257] and the subsequent creation of "TLAC" subordinated senior debt).

328. Significantly, **PLC** appears to accept[258] that the subordinated "Senior Creditors" category could be directed at *future* subordinated debt as well as *existing* subordinated debt. This mirrors the position with e.g. the "Excluded Liabilities", which could refer to *future* subordinated debt where there was not *existing* subordinated debt in that category at the time of the debts creation (see David Richards J in Waterfall I, at [75]; LBLIS v LBUKH at [16]).

329. Accordingly, the structure and substance of the subordination provisions under the LBHI2 Sub-Notes and the LBHI2 Sub-Debt is materially the same. In particular:

(1) In the LBHI2 Sub-Debt, the "Senior Liabilities" are all unsubordinated and subordinated "Liabilities" (and "Senior Liabilities" include subordinated Liabilities that neither rank nor are expressed to rank pari passu with or junior to the claims of the "Subordinated Liabilities"). The "Senior Liabilities" are subject to carve-outs, including: (a) the "Subordinated Liabilities" (i.e. the LBHI2 Sub-Debt); (b) any other subordinated liabilities that either do rank or are expressed to rank *pari passu*; (c) the "Excluded Liabilities" (i.e. junior subordinated debt).

(2) In the LBHI2 Sub-Notes, the "Senior Creditors" are all unsubordinated and subordinated creditors (and "Senior Creditors" include subordinated creditors that neither rank nor are expressed to rank *pari passu* with or junior to the claims of the Noteholders). The "Senior Creditors" are subject to carve-outs, including: (a) the LBHI2 Sub-Notes; (b) any other subordinated liabilities that either do rank or are expressed to rank *pari passu*; and (c) junior subordinated debt.

[257] Stephen Miller's email to Nigel Barnett dated 22 November 2016 **[F/V9/5246-7]**: "***I do not recall any specific discussion on the layering point.*** *The regulatory capital team at Lehman with whom we worked extensively had a preference for flexibility and advised their clients similarly. I think entities like Halifax had similar layering allowed* ***even if they never actually used the option****. So it may be we had that prevailing atmosphere in mind when we prepared the conditions*" (emphasis added).

[258] See PLC PP [47.2] **[A/T7/108]**: "*Hence, the subordination provisions in the LBHI2 Sub-Notes were directed to the existing subordinated debt as well as to any future debts*".

330. In view of the symmetry and direct correspondence between the subordination categories envisaged under the LBHI2 Sub-Debt and the LBHI2 Sub-Notes, the reasonable reader would conclude that both the LBHI2 Sub-Debt and the LBHI2 Sub-Notes were subordinated at the same level, *not* that they were somehow subordinated to each other. Further, the reasonable reader would conclude that the subordinated "Senior Creditors" did not refer by necessity to *existing* debt (i.e. the LBHI2 Sub-Debt) but referred to potential *future* subordinated senior debt.

331. Thus:

(1) since they are both subordinated to the same "Senior Liabilities"/"Senior Creditors", PLC and SLP3 are precluded from proving until all "Senior Liabilities"/ "Senior Creditors" (including statutory interest on senior claims, and non-provable liabilities) have been paid in full: see Waterfall I at [70], per Lord Neuberger; Rule 14.40 of the 2016 Rules.

(2) PLC is entitled to prove in respect of the LBHI2 Sub-Debt at the same time as SLP3 in respect of the LBHI2 Sub-Notes, and

(3) by operation of the 2016 Rules, PLC's claims and SLP3's claims rank *pari passu* and abate in equal proportions: see Rule 14.12 of the 2016 Rules.

332. Finally, the LBHI2 Sub-Notes were drafted at a time when the LBHI2 Sub-Debt was known to exist (at least, by the Lehman Group decision-makers[259]). Despite this, the LBHI2 Sub-Notes and LBHI2 Sub-Debt do not cross-refer to each other in any way to suggest subordination of one to another. That is a further strong indicator that there was no intention to subordinate one to the other, and that they rank *pari passu*.

SLP3: Factual Matrix/Commercial Considerations

333. The Pari Passu Construction above is the only construction consistent with the objective purpose of the instruments and which makes sense against the relevant background that would have been reasonably available to their relevant audience.

[259] The evidence of Mr Miller is that the LBHI2 Sub-Notes were drafted in ignorance of the continued existence of the LBH2 Sub-Debt: Miller 1, [36] **[C/T1/9]**.

334. The Court is entitled to and should consider the full factual matrix available to Lehman Group entities: this is not a case where the Court should give either limited or no attention to the available background. In relation to this (Reply PP, [13] **[A/T10/179]**):

(1) The "*audience*" for the LBHI2 Sub-Notes and to whom the instrument was addressed was the Lehman Group[260], and only the Lehman Group. It was not entities operating in the outside world.

(2) This is consistent with the evidence of the key decision-makers that there was never any intention to transfer or assign the LBHI2 Sub-Notes outside of the Lehman Group. Ms Dolby confirmed in her interview that "*to my knowledge there was never an intention to transfer it out of the Lehman Group*" (page 13, line 1). That is unsurprising in view of the LBHI2 Sub-Notes' status as regulatory capital.

(3) The LBHI2 Sub-Notes were deliberately listed on the CISX[261] in order to be a quoted Eurobond. The documents clearly show that this was for withholding tax reasons only: and not because there was an intention to trade the Eurobond (Dolby 1, [37] **[C/T3/37]**).

(4) The terms of the LBHI2 Sub-Notes were not public. They were stored in the exchange's internal records: see above [313] to [316].

(5) This was not a case (c.f. Re Sigma Finance) of a multi-party agreement securing multiple creditors/stakeholders over a long duration.

(6) In the circumstances, the Re Sigma Finance cases are distinguishable and this is not a case where the factual matrix should be limited in the manner in which the other parties contest.

335. The factual matrix overwhelmingly supports a *pari passu* construction. SLP3 rely on the following:

[260] Indeed, the only other parties to the LBHI2 Sub-Notes before SLP3 were other Lehman Group entities, as the instrument was passed "up the chain" to pay down the pre-existing subordinated debt. It is no small irony that the first entity to hold the LBHI2 Sub-Notes, albeit for a *scintilla temporis*, was PLC. The necessary logic of PLC's position on the LBHI2 Application is that, during that *scintilla temporis*, it held two very substantial subordinated debt instruments, but that they did not rank *pari passu* in any insolvency of LBHI2.

[261] The disclosure shows that, prior to the eventual listing on the CISX, the original plan had been to list the LBHI2 Sub-Notes on a stock exchange in the Cayman Islands. To that extent, the listing was for synthetic purposes only: there was no intention to trade or transfer.

(1) The principal purpose of both issuances (which is clear on their face) was regulatory. In both regulatory phases (the 2006 Restructuring and the 2007 Restructuring) the core regulatory requirement applicable to subordinated loan capital was subordination behind the claims of "*all other creditors*" and not to other regulatory subordinated debt: see Waterfall I and LBLIS v LBUKH at [16]. Accordingly, it would play no meaningful regulatory purpose to subordinate one of the LBHI2 Sub-Debt/LBHI2 Sub-Notes to the other.

(2) The other key purpose of the LBHI2 Sub-Notes was to obtain a US tax benefit. It was no part of that purpose to affect the relative priorities of the subordinated debts. The mechanism by which the tax benefit was obtained was conversion of the subordinated debt into note form and the transfer of the subordinated debt out of the existing structure to an alternative structure (i.e. SLP3 and its associated sub-group): there was no need to address priorities in insolvency in order to obtain that tax benefit.

(3) To achieve these purposes, the issuance of the LBHI2 Sub-Notes partially refinanced the LBHI2 Sub-Debt on materially the same commercial terms, including the same interest rate/coupon (LIBOR plus 32 basis points). The refinancing purpose is clearly stated on the face of the LBHI2 Sub-Notes[262]. It is common ground with PLC that prior to the refinancing the LBHI2 Sub-Debts ranked *pari passu*. There is no indication in the language of the LBHI2 Sub-Notes that in partially refinancing the LBHI2 Sub-Debt on the same commercial terms it was *also* altering the status quo on ranking. That, however, is the case PLC must make out given its acceptance that the partially refinanced LBHI2 Sub-Debts ranked *pari passu*.

(4) The IPRU(INV) regime, specifically referenced on the face of the LBHI2 Sub-Debt, is relevant regulatory background to the LBHI2 Ranking Issue. Like the LBHI2 Sub-Notes, FSA Standard Form 5 under IPRU(INV) also employed a drafting technique by which the "Senior Creditors" were the "*unsubordinated creditors*" and "*subordinated creditors…other than*" certain exceptions. It would be surprising if an FSA prescribed form had the objective meaning of generally subordinating dated regulatory subordinated debt to other dated regulatory subordinated debts given its specific regulatory function. This in itself suggests

[262] See Offering Circular, page 14 stating the purpose as including "*to pay off existing loans*" **[E/T4/63]**.

that the other Respondents are seeking to attribute an import to the wording of the "Senior Creditors" which a reasonable reader would not ascribe to them against the regulatory background.

(5) The insolvency of the Lehman Group and the relative priorities of subordinated debts were not in the contemplation of the parties (see Dolby 1, [52]-[53] **[C/T3/39-40]** and David Richards J in <u>Waterfall I</u> at [48]), and there is no evidence that anyone within the Lehman Group wanted one to rank senior to the other. The strong inference is that there was no purpose to the transactions other than to ensure the ranking of subordinated creditors behind the firm's general creditors (consistent with the overriding regulatory objective of both IPRU(INV) and GENPRU).

(6) The materials show that it was standard market practice for Tier 3 and LT2 dated subordinated debts to rank *pari passu*: see above at [102] to [107]. In this context, PLC refer to and rely upon the Tier 3 status of the LBHI2 Sub-Debt (PLC PP, at [51.4] **[A/T7/113]**).

336. The subordination mechanism used in the LBHI2 Sub-Notes was reflected by other entities within the market place at the time (Miller 1, [45] **[C/T1/11]**). So much is clear from publicly available materials: see the dated subordinated notes instruments issued by, for example, Anglo Irish (2004) and Standard Bank Plc (2008).

337. There was no commercial rationale to subordinate the LBHI2 Sub-Debt to the LBHI2 Sub-Notes or *vice versa*: and a relevant decision-maker has confirmed that relative insolvency priorities formed no part of the commercial considerations underlying the 2007 Restructuring (Dolby 1, [52]-[53] **[C/T3/39-40]**).

<u>Other Respondents' Ordinary Meaning Arguments</u>

PLC

338. PLC addresses the ordinary meaning of the LBHI2 Sub-Notes at PLC PP, [40]-[48] **[A/T7/106-110]**. It relies on two points (at [41]): (a) the different wording of the instruments; (b) the timing of the issuance of the instruments.

339. As a threshold point, PLC's construction does not construe the LBHI2 Sub-Notes subordination provision as a whole, and omits key words (Reply PP, [38]-[39] **[A/T10/193-4]**):

(1) The definition of "Senior Creditors" under Condition 3(b) consists of: *"creditors of the Issuer (i) who are unsubordinated creditors of the Issuer or (ii) who are subordinated creditors of the Issuer other than those with whose claims the claims of Noteholders are expressed to rank pari passu* ***and those whose claims rank*** *or are expressed to rank,* ***pari passu with****, or junior to,* ***the claims of the Noteholders****"*.

(2) PLC repeatedly misdescribes the operative subordination provision. For example, PLC says that "*the LBHI2 Sub-Notes are subordinated to Senior Creditors, who comprise (a) all unsubordinated creditors and (b) subordinated creditors* ***save those expressed to rank pari passu or junior***" (at [43]), and that the LBHI2 Sub-Notes contain "*an expression of juniority to all subordinated debt subject only to the qualification or exception of subordinated debt which itself* ***is expressed to be pari passu*** *with or junior to the LBHI2 Sub-Notes*" (ibid).

(3) Creditors "*whose claims rank...pari passu with...the claims of Noteholders*" (without expressing themselves to be *pari passu*) are omitted because they are incompatible with PLC's approach to the priority issue, which requires a subordinated debt to "express" itself to rank *pari passu* in order to fall within the "*other than....*" language ("*the LBHI2 Sub-Debt does not carry the necessary* ***expression*** *required to satisfy the qualification in the LBHI2 Sub-Notes*": see PLC PP [46]).

(4) However, this fails to deal address the fact the two regulatory subordinated debts in this case simply rank *pari passu*, given that they are subordinated to all of the same "Senior Liabilities"/"Senior Creditors".

(5) PLC's approach is also inconsistent with PLC's acceptance that no one tranche of the LBHI2 Sub-Debt contains an express contractual expression that it ranks *pari passu* with another tranche of LBHI2 Sub-Debt: and yet the tranches do rank *pari passu* (even if not expressed to).

(6) PLC's case elides the distinction that is expressly drawn on the face of the LBHI2 Sub-Notes between debts expressing themselves to rank *pari passu* and debts ranking *pari passu* (without expressing themselves to be *pari passu*) and fails to accord meaning to the operative subordination language in the LBHI2 Sub-Notes.

340. Putting this to one side, the PLC analysis is also wrong in several other respects.

"Different Wording Argument"

341. First, contradicting its own conclusion that the LBHI2 Sub-Debts rank *pari passu* among themselves (PLC PP, [38] **[A/T7/106]**), PLC says (incorrectly) that the LBHI2 Sub-Debt does not allow for the possibility of ranking *pari passu* with other subordinated debt (PLC PP, [45] **[A/T7/107]**). This is wrong for the reasons already set out in relation to the PLC Ranking Issue: see above at [211]-[225].

342. Second, PLC says that the structure of the LBHI2 Sub-Debt and LBHI2 Sub-Notes is not materially the same, because the LBHI2 Sub-Debt does not provide for subordinated senior debt (PLC PP, [43] **[A/T7/106-7]**). This too is incorrect:

(1) As set out above, the subordination provisions in the two instruments are substantially the same and both subordinate to subordinated senior debt. Crucially, it is not possible to identify a category of "Liabilities" which is a Senior Liability/Creditor for the purposes of one instrument but not the other. It follows that the instruments are subject to the same "Senior Liabilities"/"Senior Creditors" and, therefore, there is no expression of 'juniority' in the LBHI2 Sub-Notes.

(2) The only difference between the language of the two subordination provisions is that the LBHI2 Sub-Notes define the "Senior Creditors" as all "unsubordinated" and "subordinated creditors…other than…", whereas the LBHI2 Sub-Debt defines the "Senior Liabilities" as all "Liabilities" subject to broad carve-outs. As to this:

(a) The difference in wording is immaterial: both adopt an "exclusionary" approach to defining "Senior Creditors"/ "Senior Liabilities", both of which are capable of including subordinated senior liabilities, and any difference does not convey an alteration of ranking.

(b) This is supported by the fact that FSA Standard Form 10 (on which the LBHI2 Sub-Debts are drawn) and FSA Standard Form 5 (whose definition of "Senior Creditors" is materially similar to the LBHI2 Sub-Notes) respectively employed the "differing" wording PLC seeks to rely on, but on any view their subordination effect was the same.

"Timing Argument"

343. As to the "timing" point (PLC PP, [47.2]-[47.3] **[A/T7/108]**) PLC argues that: by the time the LBHI2 Sub-Notes were issued, the LBHI2 Sub-Debt was already in existence; the subordination provisions in the LBHI2 Sub-Notes were directed to the *existing* subordinated debt as well as to any *future* debts; and in that context, the reasonable inference to draw is that the drafting of LBHI2 Sub-Notes reflected *"an acknowledgment of juniority to the existing LBHI2 Sub-Debt (LBHI2's only other subordinated debt)"*. This analysis is misconceived.

(1) PLC assumes wrongly that, for the LBHI2 Sub-Debt to be included in the qualification to the definition of "Senior Creditors" in the LBHI2 Sub-Notes, it had to be identified by name and date.

(2) PLC accepts that the subordination provisions in the LBHI2 Sub-Notes were also directed *"to any **future** debts"* (PLC PP, **[47.2]**). That is an important concession. PLC then goes on to draw the incorrect inference (at [47.3]) that the words *"subordinated creditors"* in the definition could *only* reflect an *"acknowledgment of juniority"* to PLC's existing *regulatory* subordinated creditors as opposed to permitting flexibility for the future. In this regard, the evidence before the Court is that the general preference of the Lehman Group was to look ahead to the possibility of creating further layers of subordinated senior debt in the *future*: see Miller 1, [45], [48] **[C/T1/11-12]**. Moreover, the definition had to have regard to the possibility of existing non-regulatory subordinated debt, such as commercial subordinated debt. There is no basis to conclude that "subordinated" in the "Senior Creditors" can *only* refer to existing, and not future debt (not least because it is inconsistent with PLC's initial concession).

(3) PLC assumes wrongly that if the draftsman of the LBHI2 Sub-Notes had wished to ensure that the LBHI2 Sub-Debt fell within the qualification to the definition of "Senior Creditors", they could easily have said so. This is misconceived:

(a) First, what the draftsperson might or might not have done to make the position clearer is irrelevant to the exercise of construction (Charrington v Wooder [1914] AC 71, 82).

(b) Second, this puts the point the wrong way around. The correct starting point is that the LBHI2 Sub-Notes were issued to refinance a substantial part of the LBHI2 Sub-Debt, which was drawn up on FSA Standard Form 10 at a time when it is common ground that all of LBHI2's subordinated liabilities ranked *pari passu*. If (as PLC maintains) the intended effect of the issuance of the LBHI2 Sub-Notes was to subordinate them to the un-refinanced balance of the LBHI2 Sub-Debt, it is more surprising that the LBHI2 Sub-Notes did not expressly refer to the LBHI2 Sub-Debt ranking senior.

344. Finally, PLC seeks to criticise the position outlined by SLP3 in the Joint PP (PLC PP, at [48] **[A/T7/109-110]**). In relation to their criticisms of the Joint PP at [24] **[A/T10/185]**:

(1) PLC argues that the wording in the two instruments is not materially the same: PLC says that the LBHI2 Sub-Notes contain an express juniority to "subordinated creditors", but the LBHI2 Sub-Debt does not. This point is easily answered. *First*, SLP3's position is that "*the operative subordination provisions .... are structured in materially the same way*" (Joint PP at [24] **[A/T5/71-2]**), not that the wording is identical. *Second*, the term "Liabilities", as used in the expression "Senior Liabilities" in the LBHI2 Sub-Debt necessarily includes subordinated senior "Liabilities" that are neither the "Subordinated Liabilities" nor "Excluded Liabilities": see above.

(2) PLC states that the premise that the LBHI2 Sub-Debt and the LBHI2 Sub-Notes are subordinated to the same "Senior Liabilities" and "Senior Creditors" assumes what it seeks to prove and does not engage with the priority issue. SLP3 does not understand this criticism. The premise that the instruments are structured in the same way forms the basis of the conclusion that they prove at the same time and rank *pari passu*.

(3) PLC states that the Statutory Scheme is no answer in circumstances where this is a case of contractual priority. SLP3 fundamentally disagrees. This is a case where the two instruments do not expressly refer to each other, the subordination

provisions are symmetrical, and where the ordinary Statutory Scheme applies to the two instruments once the Senior Creditors/Liabilities have been paid in full, such that they rank *pari passu*.

Deutsche Bank's Further Argument

345. Deutsche Bank adopts PLC's position in relation to Part 1 of the LBHI2 Ranking Issue (DB PP, at [16] **[A/T8/128]**). It also advances one free-standing construction argument (not identified at the time it sought to be joined) (DB PP, at [18] **[A/T8/128]**) based on the solvency condition in Condition 3 of the LBHI2 Sub-Notes, as well as its general "commercial incentive" argument, which is said to influence the LBHI2 Ranking Issue as well.

346. Deutsche Bank's construction argument runs as follows:

(1) Condition 3(a) states that payment of principal in respect of the Notes is conditional upon the Issuer being solvent at the time of and immediately after payment.

(2) Condition 3(b) states that the Issuer shall be "solvent" if (i) it is able to pay its debts as they fall due and (ii) its Assets exceed its Liabilities (each as defined below[263]) (other than its Liabilities to persons who are not Senior Creditors).

(3) The LBHI2 Sub-Debts are "debts" for the purposes of Condition 3(b).

(4) The LBHI2 Sub-Notes rank after the LBHI2 Sub-Debt because, unless and until the LBHI2 Sub-Debt is paid in full, then no sums are payable under the LBHI2 Sub-Notes.

347. Deutsche Bank's argument is misconceived:

(1) Once "Senior Creditors" have been paid in full, there are no other relevant "debts" that need to be paid in order to satisfy the elements of the solvency condition. Payment of any amount of the LBHI2 Sub-Notes is conditional on LBHI2's ability to pay its "Senior Creditors" in full.

263 "Assets" means the unconsolidated gross assets of the Issuer and "Liabilities" means the unconsolidated gross liabilities of the Issuer, all as shown by the latest published audited balance sheet of the Issuer, but adjusted for contingencies and for subsequent events, all in such a manner as two directors of the Issuer, its auditors or its liquidator (as the case may be) may determine.

(2) In that regard, the plain and obvious meaning of "debts" in Condition 3(b) is "Senior Creditors". Such a construction renders the cash-flow and balance-sheet requirement in Condition 3(b) consistent i.e. neither of them take into account debts/Liabilities that are not "Senior Creditors". If "debts" included *all* other debts (namely debts that ranked *pari passu* or junior to the LBHI2 Sub-Notes), then the solvency test would be obviously unworkable.

(3) To that extent, Deutsche Bank's construction is not only circular (since it assumes that the LBHI2 Sub-Debt is a "senior" debt); but also at odds with the solvency condition of the LBHI2 Sub-Debt (which provides that the LBHI2 Sub-Debt is not a debt that will fall "due" unless and until "Senior Liabilities" have been paid).

Other Respondents' Factual Matrix/Commercial Arguments

PLC

348. PLC contends that this is a case where the factual matrix is of limited or no application: PLC PP, [19] **[A/T7/99-100]**. SLP3 does not agree for all the reasons already stated: see at [333] to [337] above. By contrast, Deutsche Bank's case pulls in completely the opposite direction. It relies on broad and unsupported commercial incentives purportedly to explain the ranking alteration which the refinancing of *pari passu* debts is said to have effected (as to which, see below).

349. In turn, PLC seeks to criticise points advanced by SLP3 in relation to the factual matrix/commercial considerations (PLC PP, [48.6] **[A/T7/16-7]**). In relation to these:

(1) While PLC appears to accept that the LBHI2 Sub-Notes refinanced the LBHI2 Sub-Debt for tax reasons (PLC PP, [48.6(a)]), it contends that this refinancing or "straight swap" is irrelevant to the priority issue. SLP3 disagrees. It was no aim or object of the transaction to affect priorities. The context of the "straight swap" serves to highlight the improbability of PLC's case, which requires the LBHI2 Sub-Notes to have *altered* the existing *pari passu* ranking of the LBHI2 Sub-Debts it was partially refinancing.

(2) PLC contends it "*may or may not be factually correct*" that the Lehman Group did not consider priorities on insolvency, and that is it irrelevant in any event (PLC PP, [48.6(b)]). *First*, it is factually correct, because *PLC's* only witness (Ms

Dolby) states in terms that "*there was no reason for us to think about, or seek advice on, the relative priority of LBHI2's different subordinated debts in the event of an insolvency*" (Dolby 1, [53] **[C/T3/40]**). *Second*, it may not be probative as to the meaning of the subordination provisions themselves, but it does illustrate that the overall purpose of the transaction was not concerned with priorities on insolvency.

(3) PLC contends that the lack of regulatory need for one subordinated instrument to rank ahead of the other "*may or may not be correct*" but is again irrelevant (PLC PP, [48.6(c)]). SLP3 disagrees. *First*, generally speaking, LT2 and Tier 3 subordinated debt ranked *pari passu*: that is important and would have been reasonably known (and indeed was) known to the Lehman Group. *Second*, Ms Hutcherson's evidence is that she would have notified the FSA if the LBHI2 Sub-Notes were ranked differently to the LBHI2 Sub-Debt (Hutcherson 1, [91] **[C/T6/88-9]**).

(4) PLC states that admissible evidence that ordinary market practice was for dated subordinated bonds to rank *pari passu* is irrelevant, not least because the wording of the LBHI2 Sub-Notes expressly contemplated tiers of subordinated debt (PLC PP, [48.6(d)]). The materials before the Court show that this was indeed market practice: see above at [102] to [107] above. The materials before the Court also show that (a) the LBHI2 Sub-Notes were based on commercial bonds (which adopted a similar definition of "Senior Creditors" to that used in FSA Standard Form 5) (b) that the subordination structure used in Condition 3 was in use by the Lehman Group more generally and (c) that the subordination language used in Condition 5 was in use elsewhere in the financial markets during the relevant period i.e. 2006-2007.

(5) PLC contends that SLP3's interpretation is no more commercially rational than PLC's (PLC PP, [48.7]). SLP3 disagrees. The super-subordination of a $6.139 billion dated subordinated instrument to another dated subordinated instrument in the context of an intra-group refinancing transaction conducted for tax/regulatory purposes is, with respect, not commercially rational.

Deutsche Bank

350. Despite PLC criticising SLP3 for its reliance on a relatively narrow factual matrix, Deutsche Bank advances expansive arguments based on alleged commercial drivers which are nowhere reflected on the face of the LBHI2 Sub-Notes or the documents reviewed during the substantial disclosure exercise which covered thousands of documents. This overlaps strongly with Deutsche Bank's factual arguments in relation to the PLC Ranking Issue and is supported by lengthy evidence from Mr Katz (but no longer Mr Sutton, whose evidence has been withdrawn) which will need to be explored at trial.

351. Deutsche Bank cites "*important commercial and tax reasons*" why the LBHI2 Sub-Debt should rank in priority to the LBHI2 Sub-Notes (DB PP, [22] **[A/T8/130-2]**).

352. *First*, in relation to Deutsche Bank's alleged commercial reasons, in summary these are:

(1) LBHI was incentivised to ensure that scheduled distributions were paid under the ECAPS because it undertook not to pay any dividends or repurchase any common stock if payments were suspended under the ECAPS (i.e. the Dividend Stopper).

(2) If the ECAPS issuers were ever short of funds, this would have necessarily triggered the Dividend Stopper and had serious adverse consequences for LBHI.

(3) To ensure this did not happen, it was necessary to ensure that LBHI2 should be able to prioritise payments under the LBHI2 Sub-Debt.

(4) If the LBHI2 Sub-Notes rank *pari passu* with the LBHI2 Sub-Debt, then LBHI2 could not prioritise payments to PLC under the LBHI2 Sub-Debt over payments to SLP3.

353. There are serious evidential difficulties with this analysis, which bears the hallmarks of reverse engineering. For example:

(1) There is no documentary evidence in support of it at all.

(2) It is contrary to the evidence of the individual who was the CFO of LBHI at the time.

(3) No evidence in support of it is advanced by PLC.

(4) The only evidence in support – the witness statement of Mr Katz – is from an individual who had no involvement in the LBHI2 Sub-Debt, the LBHI2 Sub-Notes, the 2006 Restructuring or the 2007 Restructuring.

(5) The argument is obviously unsustainable. The LBHI2 Sub-Notes and the LBHI2 Sub-Debt were two levels removed from the ECAPS regime in the Lehman Group's capital structure. The contention amounts to saying that the Lehman Group's capital structure as a whole was specifically designed to ensure the payment of the ECAPS Holders.

(6) It also fundamentally misunderstands the way that payments within the Lehman Group (including interest payments) were made by book entry.

354. *Second*, in relation to Deutsche Bank's tax reasons, in summary, the premises of Deutsche Bank's argument are two-fold:

(1) First, that it was necessary for the LBHI2 Sub-Notes to be treated as equity for US tax purposes.

(2) Second, that in order to achieve this, and the Lehman Group's "tax planning objectives", the LBHI2 Sub-Notes had to be structured as debt instruments that were so deeply subordinated that they would be treated as equivalent to a form of equity under US tax rules.

355. Again, this simply is not made out on the evidence:

(1) It is mere assertion. Deutsche Bank has not sought to advance witness evidence (either from Mr Katz or Mr Sutton or otherwise) in support of this.

(2) It is not what the documentation says. Both the US tax advice from A&O dated 1 May 2007[264] and the memorandum drafted by Ms Dolby on 1 May 2007[265] state very clearly that the LBHI2 Sub-Notes were to be treated as debt (and not equity) for US tax purposes.

(3) Deutsche Bank misstates and misunderstands the entire premise of both the 2006 Restructuring and the 2007 Restructuring.

264 **[F/V4/2255-6]**.
265 **[F/V4/2096-8]**.

356. Deutsche Bank's argument should be given very short shrift indeed by the Court.

Conclusions

357. SLP3's construction is consistent with the ordinary meaning of the words used, and, to the extent that there is any ambiguity in the relevant subordination provisions, it is by far the commercially preferable interpretation.

L THE LBHI2 RANKING ISSUE – Part II

358. Part II of the LBHI2 Ranking Issue relates to amendments made to the LBHI2 Sub-Notes at the beginning of September 2008 (**"the 2008 Amendments"**).

359. The parties' respective positions in relation to Part II are set out as follows:

(1) SLP3: Joint PP, [25]-[31] **[A/T5/72-79]**; Reply PP, [43]-[58] **[A/T10/197-206]**.

(2) PLC: [49]-[80] **[A/T7/111-123]**.

(3) Deutsche Bank: [8]-[20] **[A/T8/126-9]**.

360. SLP3 advances three principal arguments in relation to the 2008 Amendments:

(1) The 2008 Amendments do not alter priorities.

(2) In any event, the 2008 Amendments are not engaged.

(3) If the 2008 Amendments do alter priorities and are engaged, they should be rectified on the basis of common mistake.

361. This skeleton argument deals with each of the three arguments referred to above in turn.

2008 Amendments: Background

362. The LBHI2 Sub-Notes were amended in 2008 by way of an extraordinary written resolution dated 3 September 2008. LBHI2 resolved to amend the LBHI2 Sub-Notes and SLP3, as the sole noteholder, assented to the modifications.

363. The 2008 Amendments permitted the deferral of LBHI2's obligation to settle interest on the LBHI2 Sub-Notes. They also made certain amendments to Condition 3(a) of the

LBHI2 Sub-Notes, which addressed tax concerns raised within A&O. PLC relies on the amendments to Condition 3(a) as "*confirming the existing position or by creating a new position by amendment*" (PLC PP, [50.2] **[A/T7/111]**). For all the reasons provided in Part I, the LBHI2 Sub-Notes ranked *pari passu* with the LBHI2 Sub-Debt when issued in May 2007. Accordingly, the other Respondents' cases in relation to Part II necessarily require them to demonstrate that the 2008 Amendments *altered* the status quo on *pari passu* ranking. This is wrong for all the reasons set out below but if (which is denied) the Court considers this to be the legal effect of the 2008 Amendments, then the 2008 Amendments fall to be rectified for common mistake.

364. Ms Dolby's evidence sets out the background to the 2008 Amendments. The amendments were proposed in order to obtain a discrete US tax benefit (Dolby 1, [55]-[57] **[C/T3/40]**):

(1) By LBHI2 paying greater amounts of interest than it received from LBIE, potentially useful tax losses could accrue in LBHI2.

(2) In high level terms, such losses were only useful for US tax purposes if the Lehman Group had sufficient current year tax profits in certain UK entities to be set off against those losses.

(3) There were insufficient UK tax profits available in the specific UK Group companies in summer 2008, and so the US tax advantage would be reduced. Therefore, it would be better for LBHI2 to delay the settlement of its interest liability to SLP3, and to make that settlement during a future period in which the specific UK entities had sufficient profit capacity to set off the LBHI2 tax loss.

365. Ms Dolby goes on to explain the process by which the 2008 Amendments were executed (Dolby 1, [60]-[68] **[C/T3/41-3]**):

(1) Ms McMorrow instructed A&O to draft the relevant documents. Ms Dolby and Ms McMorrow were aware of the need to ensure that the amendments would not prevent the LBHI2 Sub-Notes from keeping their status as LT2. Confirmation was provided by A&O that the LT2 status was not altered as a result of the amendments. The confirmation provided by A&O by a letter dated 17 June 2008[266] stated *"we confirm that the confirmations provided in the Original Letter*

266 **[F/V6/3006-3017]**.

will continue in full force and effect in relation to the Notes after the Amendment".

(2) Mr Grant of A&O provided amendments to Condition 3 ("Status and Subordination") to Ms Dolby and Ms McMorrow and stated by email that the "*Deferral provisions introduce tax sensitivities*"[267].

(3) Ms Dolby did not discuss the amendments to Condition 3 with anyone. She did not focus on this aspect of the amendments and did not consider the effect if any on the respective priorities of LBHI2's subordinated status.

(4) Ms Dolby did not think about what would happen in the event of an insolvency, or about what order the LBHI2 Sub-Notes and the LBHI2 Sub-Debt would be paid in any such insolvency.

(5) Ms Dolby would have discussed the position with her colleagues in the legal and regulatory teams in the event that Mr Grant had told her that the LBHI2 Sub-Debt would now take priority over the LBHI2 Sub-Notes in the event of insolvency.

366. Pursuant to Condition 12(a) of the LBHI2 Sub-Notes, a written resolution taking effect as an 'Extraordinary Resolution' was required in order for the amendments to take effect. The terms and conditions of the LBHI2 Sub-Notes (the "**Conditions**") as amended were annexed to a written resolution dated 3 September 2008[268], which was signed by duly authorised signatories of SLP3 and LBHI2 (the "**Written Resolution**").

367. As to the resolutions by LBHI2 and SLP3 in respect of the 2008 Amendments:

(1) The 2008 Amendments were approved in the minutes of a meeting of LBHI2's board held on 28 August 2008 (the "**LBHI2 Board Minutes**")[269]. The LBHI2 Board Minutes stated that "*the purpose of the amendment was to allow [LBHI2] to defer cash settlement of the interest on the Notes at its discretion*".

(2) The board of directors of LBDI (as the sole general partner of SLP2, which was in turn the sole general partner of SLP3) signed an electronic consent in respect of the 2008 Amendments (the "**Delaware Consent**") on 3 September 2008[270]. The

267 See Mr Grant's email to Ms Dolby and Ms McMorrow dated 12 June 2008 **[F/V5/2839]**.
268 **[E/T5/70-80]**
269 **[F/V6/3325-6]**.
270 **[F/V6/3503]**.

Delaware Consent provided that: "*The purpose of the amendment is to allow the Issuer to defer cash settlement of the interest on the Notes at its discretion. The holder of the Notes is SLP3*".

368. GENPRU 2.2.171 required the FSA's non-objection to any amendment of the subordinated instrument, as well as a confirmation that the legal opinions originally obtained under GENPRU 2.2.159(12) would "*continue in full force and effect in relation to the terms of the debt and documents*". Consistent with GENPRU, pursuant to Condition 12(b) of the LBHI2 Sub-Notes, the 2008 Amendments required the prior written consent of the FSA.

369. In obtaining that consent, the FSA were not referred to any change in the *subordination* of the LBHI2 Sub-Notes:

(1) On 11 July 2008[271], Ms Claire Edwards of the Lehman Group's central compliance team emailed the FSA providing details of the proposed amendments, stating: "*It is our intention to amend the terms of the notes to allow deferral of the cash payment for the interest on the notes*". That email also referred to A&O's confirmation letter of 17 June 2008, which was described as confirming "*that the additional provision to defer the payment of interest would not impact on the eligibility of the notes to be included in Lower Tier 2 capital*".

(2) On 16 July 2008[272], the FSA (Daniel Edgerley) provided its non-objection to the 2008 Amendments, having referred to the intention set out in Ms Edwards's email "*to amend the terms of the notes to allow deferral of the cash payment for the interest on the notes.*" The FSA confirmed that "*there is no reason for us to object to **this change** in the terms of a lower tier two instrument*" (emphasis added).

(3) Having been asked to provide further information to the FSA about the proposed "*rationale*" of the amendments, on 17 July 2008 Ms Edwards wrote to Mr Edgerley stating[273]: "*The change to the terms of the notes is to provide Lehman with flexibility around their US tax planning. For tax purposes any deferral of the cash payment of interest on the notes will result in a tax deduction for the interest being deferred until cash payment is actually made. This should have no net*

271 **[F/V6/3147]**.
272 **[F/V6/3153]**.
273 **[F/V6/3154]**.

impact on UK tax but is purely a US tax planning initiative." The FSA confirmed that this was "*very clear*" three minutes later.[274]

2008 Amendments: Terms

370. The main amendments were as follows.

371. Condition 4(a) and 4(f) were amended. These gave LBHI2 a discretion not to pay interest on any "Interest Payment Date"

372. Further amendments relating to the deferral of interest settlement were made to Conditions 5(a), 5(b), 5(c) and 8(b). These introduced the concept of "Arrears of Interest"[275]

373. Condition 3(a) was amended[276]. The amendments to the original wording are underlined below:

"Status and Subordination

The Notes constitute direct, unsecured and subordinated obligations of the Issuer and the rights and claims of the Noteholders against the Issuer rank *pari passu* without any preference among themselves. The rights of the Noteholders against the Issuer in respect of the Notes are subordinated in right of payment to the Senior Creditors (as defined below) and accordingly payment of principal and interest (including Arrears of Interest as defined below) in respect of the Notes is (subject as provided below) conditional upon the Issuer being solvent at the time of, and immediately after, such payment, and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that the Issuer could make such payment and still be solvent immediately thereafter. The conditionality referred to above shall not apply where an order is made by a competent court, or a resolution passed, for the winding-up or dissolution of the Issuer (except for the purposes of a reconstruction, amalgamation, reorganisation, merger or consolidation on terms previously approved in writing by an Extraordinary Resolution of the Noteholders).

If any time (sic) an order is made by a competent court, or a resolution passed, for the winding-up or dissolution of the Issuer (except for the purposes of a reconstruction, amalgamation, reorganisation, merger or consolidation on terms previously approved in writing by an Extraordinary Resolution of the Noteholders), there shall be payable by the Issuer in respect of each Note (in lieu of any other payment by the Issuer) such amount, if any, as would have been payable to the Noteholder, if, on the day prior to the commencement of the winding-up and thereafter, such Noteholder were the holder of one of a class of preference shares in the capital of the Issuer having a preferential right to a return of assets in the winding-up of the Issuer over:

(i) the holders of all other classes of issued shares in each case for the time being in the capital of the Issuer; and

(ii) the Notional Holders

on the assumption that such preference share was entitled to receive, on a return of assets in such winding-up, an amount equal to the principal amount of such Note together with Arrears of Interest (if any) and any accrued interest (other than Arrears of Interest).

For the purposes of the above provisions:

"**Notional Holder**" means any creditor of the Issuer whose claims against the Issuer on a winding-up are quantified as though they held a Notional Share.

"**Notional Share**" means any notional and unissued shares in the capital of the Issuer which have a preferential right to a return of assets in the winding-up of the Issuer over the holders of all other classes of issued shares for the time being in the capital of the Issuer but not further or otherwise.

The Notes are intended to have a right to a return of assets in the winding-up or dissolution of the Issuer in priority to the rights of the holders of any securities of the Issuer which qualify (or, save where their non qualification is due only to any applicable limitation on the amount of such capital, would qualify) as Upper Tier 2 Capital or Tier 1 Capital (within the respective meanings given to such terms in the General Prudential Sourcebook published by the Financial Services Authority, as amended, supplemented or replaced from time to time)."

374. Condition 3(b) (the definition of "solvency") was not amended.

274 {F/V6/3190}.
275 Grant 1, [18] {C/T2/19}.
276 {E/T5/73}.

375. Accordingly, the following subordination provisions remained unchanged: (i) the core subordination wording in Condition 3(a) that "[t]*he rights of the Noteholders against the Issuer in respect of the Notes are subordinated in right of payment to the Senior Creditors*" (ii) the definition of '*solvency*'; and (iii) the definition of "Senior Creditors".

376. The 2008 Amendments inserted a mechanism pursuant to which the solvency condition to payment was disapplied in the event of a winding-up and replaced with a mechanism whereby an amount became "*payable*" to the Noteholder in a winding-up ***as if*** it held a ***notional*** preference share which had a right to return over, *inter alia*, all of LBHI2's shareholders ***as well as*** "Notional Holders", which category expressly includes "***any creditor***" (emphasis added) whose claims are quantified according to the "Notional Share" mechanism.

2008 Amendments: do not alter priorities

SLP3: Ordinary Meaning

377. SLP3's position is that the amendments to Condition 3(a) do not have the effect of altering the relative ranking between the LBHI2 Sub-Debt and the LBHI2 Sub-Notes as a matter of construction.

378. SLP3's positive case in relation to this is set out at Joint PP, [27]-[29] **[A/T5/75-6]**. In summary:

(1) Before the 2008 Amendments, the LBHI2 Sub-Notes and the LBHI2 Sub-Debt ranked *pari passu* for all of the reasons set out above at [321] to [356].

(2) After the 2008 Amendments, the key subordination provisions remain unchanged. The 2008 Amendments did not amend the subordination provision pursuant to which the "*rights of the Noteholders against [LBHI2] in respect of the Notes are subordinated in right of payment to the Senior Creditors*". Nor did they amend the definition of "Senior Creditors" under Condition 3(b).

(3) The modification to Condition 3(a) only disapplies in a winding-up the "*conditionality*" by which payment is expressed as being conditional on LBHI2 being "*...solvent at the time of, and immediately after, such payment.*" Accordingly, the modification relates only to the manner in which the subordination is expressed as taking effect in a winding-up (i.e. not dependent on "*solvency*"), but with the LBHI2 Sub-Notes remaining subordinated to the **same** "Senior Creditors" as defined in Condition 3(b).

(4) Within a "*winding-up*", the amendment provides that the notional preference share has a right to return over (i) the holders of other classes of issued shares in each case for the time being the capital of the Issuer and (ii) the Notional Holders. Notional Holders are **creditors** whose claims on a winding-up are quantified as though they hold shares which have a preferential right of return in a winding-up over all other issued shares.

(5) In this regard, **creditors** whose claims are quantified as if they held a Notional Share are, in general, UT2 subordinated creditors[277], who rank just above the shareholders.

(6) This is clarified by the italicised language at the end of Condition 3(a) ("**the Confirmatory Note**") which states that the LBHI2 Sub-Notes were intended to have a right to a return of assets in a winding-up "*in priority*" to the rights of the holders of any securities of LBHI2 which qualify as "*Upper Tier 2 Capital or Tier 1 Capital*" within the meaning of GENPRU. The LBHI2 Sub-Notes retained their status as LT2 capital before and after the 2008 Amendments were made; and the Confirmatory Note confirmed that they ranked *above* UT2 subordinated creditors.

(7) The ranking of the LBHI2 Sub-Notes is described from the "bottom-up". The LBHI2 Sub-Notes rank *above* the Notional Holders (i.e. UT2 subordinated creditors), preference shares and the ordinary shares making up Tier 1 capital. They also continued to rank *below* the same "Senior Creditors" as they did prior to the amendments. They continued to occupy the same place in the waterfall.

379. Against this background, the reasonable reader would conclude that the same position pertained both inside and outside a winding-up, save that inside a winding-up the subordination is also described from the "bottom-up".

380. Significantly, just as the definition of "Senior Creditors" (which remained the same post-amendments) envisaged the LBHI2 Sub-Notes ranking *above* subordinated creditors "*whose claims rank or are expressed to rank junior*" to the LBHI2 Sub-Notes, so too the

277 See Grant 1, [42]-[43] **[C/T2/24]**.

definition of "Notional Holders" envisaged the LBHI2 Sub-Notes ranking *above* other subordinated *creditors* of the Issuer (i.e. UT2 and Tier 1).

381. Moreover, the retention of the words the "*rights of the Noteholders against [LBHI2] in respect of the Notes are subordinated in right of payment to the Senior Creditors*" in Condition 3(a), and the continuing application of GENPRU requirements, meant that the position from the "top-down" remained the same after the 2008 Amendments (i.e. ranking, on the facts of the case, behind only the unsubordinated creditors, statutory interest and non-provable liabilities).

382. Thus, following the 2008 Amendments, the LBHI2 Sub-Notes remained at the "second level" in the tiering waterfall below, with its position vis-à-vis the LBHI2 Sub-Debt unchanged:

(1) Unsubordinated Creditors;

(2) <u>Dated subordinated creditors (LT2/ Tier 3 Capital);</u>

(3) Undated subordinated creditors (UT2 Capital) (i.e. "Notional Holders"); and

(4) Ordinary Shares (Tier 1 Capital).

383. The notional preference share language inserted by the 2008 Amendments produces the same result in a "winding-up" as the solvency condition to payment produces outside of a winding-up, and the "amount" that is "payable" in accordance with the notional preference share is the same as the amount that could be paid once the solvency condition is satisfied.

<u>SLP3: Factual Matrix/Commercial Considerations</u>

384. The reasonable reader would not understand the amendments to Condition 3(a) as having effected an alteration to the ranking of the LBHI2 Sub-Notes in a "winding-up" against the relevant background reasonably available to the Lehman Group addressees:

(1) In all of the principal documents documenting the decision to approve or assent to the 2008 Amendments, the purpose behind the 2008 Amendments was unequivocally stated to be to allow LBHI2 to defer cash settlement of the interest on the LBHI2 Sub-Notes at its discretion.

(2) The LBHI2 Sub-Notes qualified as LT2 capital both before and after the 2008 Amendments. This is plain from the Confirmatory Note, A&O's confirmation letter and the correspondence with the FSA.

(3) A&O's confirmatory letter[278] confirmed that the amended LBHI2 Sub-Notes continued to comply with the requirements under GENPRU 2.2.159(1) - (7), including the requirement that "*the claims of the creditors must rank behind those of all unsubordinated creditors*".

<u>Other Respondents' Arguments</u>

PLC

385. PLC's position is set out at the PLC PP, [49]-[56] **[A/T7/111-115]**.

386. At the core of PLC's case on the 2008 Amendments is the contention that the new wording is a "*deeming provision*[279], *to the effect that the claims of Noteholders are to be treated, not at a priority level of debt claims, but at a priority level of claims by preference shareholders satisfying the definition given*". This is wrong for the reasons set out in Reply PP, [50] **[A/T10/200-1]**. These include:

(1) The express language used very clearly states that the LBHI2 Sub-Notes rank *above* (i) actual shareholders (in relation to all issued shares i.e. ordinary and preference) and (crucially) (ii) the "Notional Holders". The Notional Holders are defined as a particular class of "creditor" of LBHI2. Only a holder of debt (and not equity) could fall within the definition of "Notional Holder". Therefore the 2008 Amendments expressly provide that the LBHI2 Sub-Notes rank above other forms of *debt* as well as *equity*. It is wrong to state that they are "*not at a priority level of debt claims*".

(2) Further, PLC is incorrect to state that "*by deeming the Noteholder claims to be equivalent to those of preference shareholders, the amendment relegates Noteholder claims behind all other creditors*". The amendment explicitly ranks the LBHI2 Sub-Notes *above* the Notional Holders. Preference shares do not rank above creditors in an insolvency (<u>In re Nortel GmbH (in administration) [2013] UKSC 52</u>, at [39]; <u>Waterfall I</u> [60] per Lewison LJ in the Court of Appeal: "*the*

278 **[F/V6/3006-3017]**.
279 In relation to "deeming provisions", see <u>The Interpretation of Contracts</u> (Lewison, 6th edition), at 14.12.

liquidator must discharge the company's liabilities as defined by rule 13.12(4) [Rule 14.1(6) of the 2016 Rules] before making a distribution to members").

(3) PLC is also wrong to state that the effect of the Confirmatory Note is that the Noteholders only have a right to return of assets "*over (and so only over) shareholders*". The italicised language of the Confirmatory Note states that the Notes are intended to have a right of return in priority to "*any securities...which qualify as Upper Tier 2 Capital or Tier 1 Capital*". UT2 "*securities*" include undated subordinated debt i.e. creditors. The italicised wording is therefore consistent with the LBHI2 Sub-Notes ranking above the "Notional Holders" (being holders of debt).[280]

387. So much is consistent with the evidence of Mr Grant (a partner in the Capital Markets department of A&O and the draftsman of the 2008 Amendments), who explains that the notional preference share concept was a "*tried and tested*" mechanism he adopted from UT2 subordinated debt, which did not change the subordinated debt into equity, but merely stated that it ranked immediately *above* all issued equity (ordinary and preference shares) (Grant 1, [45] **[C/T2/24-5]**).

388. For these reasons, PLC is wrong to state that as a result of the 2008 Amendments the LBHI2 Sub-Notes are "*necessarily inferior to all other debt. The language is not capable of supporting any other meaning*" (PLC PP, [53] **[A/T7/114]**). On a proper construction, the amendment to Condition 3(a) leaves the LBHI2 Sub-Notes' insolvency ranking (and the quantum payable in an insolvency) unchanged.

Deutsche Bank

389. Deutsche Bank's position is set out at the DB PP, at [10]-[15] **[A/T8/127-8]**. There are in reality only two points, which do not materially advance the position taken by PLC (and which is wrong for the reasons above):

(1) Deutsche Bank contends that "*since the LBHI2 Sub-Debt ranks ahead of a holder of a preference share, it follows that the LBHI2 Sub-Debt must rank ahead of the LBHI2 Sub-Notes*". The LBHI2 Sub-Notes are not preference shares, and rank above a class of creditors i.e. the Notional Holders. The correct analysis is that the LBHI2 Sub-Notes and the LBHI2 Sub-Debt both rank ahead of preference shares and UT2 subordinated debt.

(2) Deutsche Bank maintains that the amount payable to SLP3 is zero unless and until LBHI2 has paid all its debt in full including the LBHI2 Sub-Debt. This is based on the same false premise and assumes what it seeks to prove. The LBHI2 Sub-Notes are not preference shares.

Conclusions

390. Even if the 2008 Amendments are engaged (which they are not, for the reasons set out at [391] to [405] below), then they do not alter priorities. PLC and Deutsche Bank have fundamentally misunderstood and/or mischaracterised the payment condition created and implemented in the 2008 Amendments; no argument they advance supports the submission that the priorities were altered as a result of the amendments.

2008 Amendments: not engaged

SLP3

391. SLP3's primary case is that the 2008 Amendments do not alter relative ranking (Joint PP, at [29]-[30] **[A/T5/75-6]**). If SLP3's primary construction case is wrong, its position is that LBHI2 is not in a "winding-up" in any event for the purposes of Condition 3 (Joint PP, at [27]-[28] **[A/T5/75]**).

392. The effect of the amendment to Condition 3(a) is that the default 'solvency' condition to payment is only disapplied – and the amending language is only effective – where an order is made or a resolution passed for the "*winding-up or dissolution of the Issuer*".

393. SLP3's position is that the amended wording in Condition 3(a) is only engaged where an order is made or a resolution passed putting LBHI2 into liquidation. This is consistent with the express words used.

394. Further, the effect of a "*winding-up*" or "*dissolution*" under Condition 3(a) is automatically to accelerate the LBHI2 Sub-Notes: an amount becomes immediately "*payable*" upon the winding-up order under the amended Condition 3(a) ("*there shall be*

[280] It should be noted that PLC makes a point (not for the first time) that if the draftsmen had intended the LBHI2 Sub-Notes to rank *pari passu* with the LBHI2 Sub-Debt, they could easily have done so and would have been clear in this paragraph. The evidence of Mr Grant – who was the relevant draftsperson – is that he did not know of the existence of the LBHI2 Sub-Debt (Grant 1, [16] **[C/T2/19]**).

payable by the Issuer") albeit the quantum payable is limited by reference to the notional preference share payment condition.

395. In order to qualify as Tier 2 capital resources (and PLC agrees with SLP3 that the LBHI2 Sub-Notes qualified as LT2 capital prior to and after the 2008 Amendments – PLC PP at [56.3] **[A/T7/115]**), the LBHI2 Sub-Notes had to comply with the requirements under GENPRU.

396. GENPRU permits acceleration *only in a winding-up*, and not in an administration. This is because *automatic acceleration* would defeat the stated purposes of administration by, among other things, terminating the ability of the company to continue as a going concern[281]. As to this:

(1) the "*only*" event of default must be non-payment of any amount falling due or "*the winding-up of the firm*" (GENPRU 2.2.159(2)R);

(2) the debt must not become due and payable prior to maturity except on an event of default under 2.2.159(2)R, and in certain other instances (GENPRU 2.2.159(5)R); and

(3) an express distinction is drawn between "*winding-up*", which *may* constitute an event of default, and "*administration*", which *may not* constitute an event of default but in which process a subordinated creditor is entitled to prove for its debt (GENPRU 2.2.159(3)R).

397. Condition 8(b) of the LBHI2 Sub-Notes reflects GENPRU, permitting acceleration only in a winding-up. Thus, it permits the Noteholder to declare the LBHI2 Sub-Notes to be due and payable "*If an order is made by any competent court or a resolution passed for the winding-up or dissolution of the Issuer*".

398. Condition 3(a) (as amended) reflects Condition 8(b), and the effect of the provision was to accelerate the LBHI2 Sub-Notes in a winding-up (but not in an administration). SLP3 agrees with PLC (at [62.2] **[A/T7/116]**) that Condition 8(b) uses "*the same wording as is used in the Clause 3(a) amendment*".

281 In this regard, the rescue of the company as a going concern is the first statutory objective of an administration: see paragraph 3(1)(a), Schedule B1 of the Insolvency Act 1986.

399. By virtue of being an event of default entitling the Noteholder to declare the Notes to be due and payable, the term "*winding up*" under Condition 8(b) must exclude administration[282], whether distributing or otherwise, if the LBHI2 Sub-Notes are to comply with GENPRU. It follows that the identical phrase deployed in Condition 3(a) (which also provides that the effect of a "*winding up*" is automatically to accelerate the LBHI2 Sub-Notes) should bear the same meaning as in Condition 8(b) and exclude administration.

400. In the circumstances, including the applicable regulatory context, Condition 3(a) can only apply in a winding-up (but not in an administration). LBHI2 is in administration and is not in a winding-up.

401. This conclusion is consistent with the broader distinction between, on the one hand, winding-up, and on the other hand, administration: see Joint PP, at [28] **[A/T5/75]**; and Reply PP, at [24] **[A/T10/185]**.

PLC

402. PLC addresses this at PLC PP, [57]-[67] **[A/T7/115-120]**.

403. *First*, PLC says (at [63]) that if SLP3 is right about Condition 3(a) not being engaged, then it would be without any remedy at all in a distributing administration, because Condition 8(c) states that "*no remedy...against the Issuer other than as specifically provided by Conditions 8(a) and 8(b) or submitting a claim in the winding-up of the Issuer will be available to the Noteholders*". However, under Condition 8(a), SLP3 is entitled to "***enforce payment** by instituting proceedings for the Insolvency of the Issuer*" in certain circumstances. By analogy with Lewison LJ's reasoning in relation to FSA Standard Form 10 in the Court of Appeal in <u>Waterfall I</u>, at [39], "*the only way of obtaining payment of a debt in an insolvency is by proving it in accordance with the rules, it must in my judgment have been envisaged that the subordinated creditor would be entitled to prove for its debt*". It follows that where Condition 8(c) provides that no remedy is available to SLP3 "*other than as specifically provided by Conditions 8(a) and 8(b)*", this includes the ability for SLP3 to prove for its debt in an administration under Condition 8(a). Alternatively, the expression "winding-up" under Condition 8(c) includes an administration in circumstances where GENPRU 2.2.159(3)R expressly permits a subordinated creditor "*proving for the debt in the liquidation or administration*".

282 This is confirmed by Mr Grant in his evidence: see Grant 1, [40] **[C/T2/23]**.

404. *Second*, PLC argues (at [64]) for what is described as the "*broader definition*" i.e. that "winding-up" must also include an Insolvency Act distributing administration. In relation to this:

(1) PLC refers to Article 2 of the Recast Insolvency Regulation. Against this, there are numerous instances in the European legislation where the distinction between winding-up and administration is made: see Article 4(3)(d) of Directive 89/299/EEC; Paragraph 3 of Annex V of Directive 93/6/EEC; Article 64(3)(d) of Directive 2006/48/EC; Article 13(3) of Directive 2006/49/EC; The Credit Institutions (Reorganisation and Winding Up) Regulations 2004. See also paragraph 3(1)(b), Schedule B1 of the Insolvency Act 1986 ("Purpose of Administration") which draws a clear distinction between winding-up, on the one hand, and administration, on the other.

(2) PLC contends that a distributing administration is functionally the same as a winding-up. This is incorrect: see Reply PP, [44] **[A/T10/197]**.

405. *Third*, PLC misstates and misunderstands the regulatory context: see Reply PP, [45.1] **[A/T10/197-8]**.

2008 Amendments: should be rectified

406. Finally, if SLP3 is incorrect and the 2008 Amendments were engaged and *did* alter the priorities as a matter of construction, SLP3's position is that the 2008 Amendments should be rectified to give effect to the parties' common intention which, by mistake, would not have been reflected in the 2008 Amendments.

407. SLP3's positive case is at Joint PP, [30] **[A/T5/76-7]**; and Reply PP, [52]-[58] **[A/T10/202-6]**.

408. If the effect of the 2008 Amendments was (unintentionally) to relegate or demote SLP3's subsisting rights under the LBHI2 Sub-Notes, then this is a paradigm case where the Court should rectify that unintended outcome.

Applicable Legal Principles

409. The law of rectification for common mistake was comprehensively reviewed by the Court of Appeal in FSHC Holdings Ltd v Glas Trust Corporation Ltd [2019] EWCA Civ 1361 ("**FSHC**") (after the exchange of position papers).

410. The court concluded (Leggatt LJ, [176]) that:

(1) Before a written contract may be rectified for common mistake, it is necessary to show either (1) that the document fails to give effect to a prior concluded contract or (2) that, when they executed the document, the parties had a common intention in respect of a particular matter which, by mistake, the document did not accurately record.

(2) In the latter case it is necessary to show that each party to the contract had the same actual intention with regard to the relevant matter and that, as a result of communication between them, they understood each other to share that intention.

411. As stated by the Court of Appeal in FSHC, the remedy of rectification is an equitable doctrine that a party will not be allowed to enforce the terms of a written contract, objectively ascertained, when to do so would be against conscience because it is inconsistent with what the parties in fact intended those terms to be when the document was executed. That basis for rectification is entirely concerned with the parties' subjective or actual states of mind (at [140]-[143], [146], [148]-[153]). There are also good reasons based on policy and fairness for maintaining the requirement to show that the wording of a contractual document is inconsistent with the parties' subjective or actual common intention before a document can be rectified (at [173]-[175]).

412. Accordingly, the Court of Appeal was unable to accept that the objective test of rectification for common mistake articulated *obiter* by Lord Hoffmann in Chartbrook v Persimmon Homes Ltd [2009] ACC 1101 correctly stated the law (thereby disapproving Daventry District Council v Daventry & District Housing Ltd [2011] EWCA Civ 1153).

413. In reaching these conclusions on the law, the Court of Appeal upheld the factual findings of Henry Carr J, where at first instance he had concluded that the absence of a positive intention suffices for the necessary common intention and that, on the facts, the absence of any relevant discussion about a fundamental change to the nature of the parties' obligations constituted "*convincing proof*" of an intention not to incur such additional and

onerous obligations (see FSHC Group Holdings Ltd v Barclays Bank Plc [2018] EWHC 1558 (Ch) at [158]).

414. The Court of Appeal agreed with the judge's findings that the parties understood and intended the relevant documentation "***to do no more** than provide the missing security*" (at [4], [42]) (emphasis added), and concluded[283] that:

> "…. *the judge was undoubtedly correct to characterise this mistake as a mistake about the legal effect of the contractual documents and not just about their commercial consequences. This is not a case in which the parties had merely a general intention about how it was to be achieved. Rather, on the judge's factual findings, their common intention was the legally specific one of binding the Parent to particular contract terms …..This is the classic case of rectification*".

415. For the reasons set out below, this too is a classic case of rectification, where the parties' *actual* understanding and intention was "*to do no more (or less)*" than to permit the deferral of interest[284].

416. Contrary to PLC's position[285], the principle that, where parties have not discussed a particular legal effect of their agreement, that may itself be compelling evidence that they did not intend it, is *not* limited to the pension context.

417. The principle is stated clearly in Konica Minolta Business Solutions UK Ltd v Applegate [2013] EWHC 2536 (Ch) at [31] per Mr Edward Bartley Jones, QC (sitting as a Deputy High Court Judge), and was cited to Henry Carr J at first instance in FSHC:

> "*…care needs to be taken when applying these basic principles [regarding common mistake rectification] to a set of circumstances where a written instrument was intended to produce Result A but has, in fact, produced Result X. The parties may never have addressed Result X because it may have come as a total shock to them.* ***But, on objective analysis, it can clearly be seen that there was no common intention to achieve Result X and that any outward expressions of accord between the parties are wholly inimicable to Result X.*** *If so, as I understand the position, there is no bar whatsoever to rectification occurring. None of this involves any enquiry into uncommunicated subjective intentions of the parties*" (emphasis added).

[283] The judge's findings are summarised by the Court of Appeal at [42]-[44]. In short: the judge found that the parties subjectively had a common intention at the time of execution of the accession deeds to execute a document which satisfied the Parent's obligation to grant security over a shareholder loan, and which did "***no more than this***". The judge also held that the objective observer would have concluded from the background facts and the communications between the parties that they had such an intention.

[284] In this context, Leggatt LJ also referred to and relied on an analogous set of facts in AMP (UK) Plc v Barker [2001] Pens LR 77, where Lawrence Collins J held that an amendment that had the effect of introducing substantial benefits for early leavers from a pension scheme was a mistake as to the legal effect of the amendment – and not merely to its commercial consequences (at [181]).

[285] PLC PP [73]] **[A/T7/121]**.

418. However, having considered the principle at [46] (i.e. that "*if it can be seen from the evidence that the change in question was never discussed at all, the absence of discussion may itself support the conclusion that the parties did not intend to make that change*"), Henry Carr J went on to conclude that "***I do not accept that the principle is confined to pension cases***" (at [47]) (emphasis added). He continued by stating that "*the authorities illustrate the proposition that, where an important change is made to an existing arrangement between the parties, the absence of any discussion of that change may itself be evidence that the parties did not intend it*".

419. The Court of Appeal did not overturn this finding (expressly approving these authorities at [76]-[79] of its judgment). There is therefore no basis for PLC's assertion (PLC PP, [73] **[A/T7/121]**) that "*the absence of a positive statement of intention*" is insufficient for rectification, or that this unacceptably lowers "*the bar for this highly restrictive remedy*". That is wholly at odds with the Court of Appeal's conclusions.

420. Finally, PLC wrongly states (at PLC PP, [75] **[A/T7/122]**) that the absence of any positive intention would "*have to be established objectively*" and that evidence of the actual intention of the relevant individuals is insufficient for rectification purposes. That incorrectly states the law in the light of the Court of Appeal's judgment in FSHC.

Attribution of Knowledge

421. In relation to attribution of knowledge, Mann J identified the following principles in Murray Holdings Ltd v Oscatello Investments Ltd [2018] EWHC 162 (Ch) (in turn derived from Hawksford Trustees Jersey Limited v Stella Global UK Ltd [2012] 2 All ER (Comm) 748):

(1) One is looking for the person who in reality is the decision-maker in the transaction in order to find intentions in relation to rectification.

(2) In the case of a company, that person will usually be the person with authority to bind that company.

(3) Someone who is not the person with power to bind can nonetheless be treated as the decision-maker if that is the reality of the facts.

(4) The intention of a mere negotiator may be relevant if it is shared with the actual decision-maker; but that is because the intention has become that of the actual decision-maker.

(5) Where the person who would normally be expected to be the decision-maker (such as the board of the company) leaves it to the negotiator to negotiate a deal and produce the contract by instructing solicitors, on the understanding that the decision-maker would do a deal on those terms, then the negotiator's intention is the relevant one, either because that person is the decision-maker or if that description is not an apt one, because the technical decision-maker has simply adopted the intentions of the negotiator.[286]

The Evidence

Background to the 2008 Amendments

422. SLP3 relies on the evidence of A&O in support of its rectification case.

423. It does so in the context of the following assertions made by PLC in the PLC PP:

(1) "*Had there been any intention to rank these claims pari passu with the sub-debt, this could easily have been done and would have been made clear in this [Confirmatory Note]*" (PLC PP at [51.4] **[A/T7/113]**).

(2) "*It is not presently known exactly what Allen & Overy LLP were and were not instructed to do. Nor is it known ... what the draftsman had in mind when he selected the words for the amendment*" (PLC PP at [56.2] **[A/T7/115]**).

(3) "*The assertion that the common intention of the parties was merely to enable LBHI2 to defer interest is an incorrect statement of the facts*" (PLC PP at [72] **[A/T7/121]**).

(4) "*The difficulty remains that the evidence ... is inconclusive as to the precise reason or reasons for the words chosen in the amendments to clause 3(a) ... the*

286 Hawksford at [43]; see Liberty Mercian Ltd v Cuddy Civil Engineering Ltd [2013] EWHC 2688 (TCC), at [130].

amendments were intended to affect the priority of the LBHI2 Sub-Notes ... and there is no clear evidence as to the specific intention behind the words chosen" (PLC PP at [76] **[A/T7/122]**).

424. The evidence now before the Court answers each of these contentions.

425. In relation to the role of A&O in the 2008 Amendments:

(1) A&O acted[287] on behalf of both parties to them - LBHI2 and SLP3 - and took instructions principally from Ms Dolby and/or Ms McMorrow in their capacity as the relevant decision-makers of both LBHI2 and SLP3.

(2) A&O were instructed to document the amendments devised and planned by Ms Dolby and/or Ms McMorrow, namely to permit the deferral of the payment of interest.

(3) A&O were not instructed to amend the LBHI2 Sub-Notes in any further way. Indeed, this has been confirmed by PLC's own witness, Ms Dolby who has stated that she does not recall anyone within the Lehman Group discussing or giving instructions to A&O to change the extent of subordination or quantum payable on the LBHI2 Sub-Notes.[288] Ms Dolby also states that save for enabling the deferral of interest "*I wasn't aware that anyone else was directing A&O to change anything else*".[289]

426. Within A&O, the matter was allocated internally to Mr Grant, who was at the time a senior associate in A&O's Capital Markets department. Mr Grant joined A&O as a trainee in 2001 and became a partner in the Capital Markets department in 2013. During 2007-2008, he worked in the same team as Mr Miller (Grant 1, [11]-[12] **[C/T2/18]**).[290]

427. Like Mr Miller (Miller 1, [36] **[C/T1/9]**), Mr Grant was not aware of the existence of the LBHI2 Sub-Debt. Like Mr Miller, the LBHI2 Sub-Notes were the only LBHI2 subordinated debt of which Mr Grant and A&O were aware (Grant 1, [16] **[C/T2/19]**).

287 A&O ultimately invoiced £3,500 plus VAT for the work done **[F/V6/3098]**.

288 Dolby Interview page 18, lines 21 to 28 **[C/T21/281]**.

289 Dolby Interview page 18, lines 31 to 32 **[C/T21/281]**.

290 For example, Mr Grant also assisted Mr Miller in drafting two series of ECAPS issued by LP IV and LP V in 2007 (but which are not the subject of these applications).

428. A&O took instructions principally from Ms Dolby, in her capacity as head of European corporate tax and planning within the Lehman Group, and Ms McMorrow, in her capacity as in-house legal counsel to the Lehman Group (Grant 1, [14]-[15] **[C/T2/18-9]**).

429. The evidence of Mr Grant is summarised in his "Executive Summary" (Grant 1, [10] **[C/T2/16-7]**):

(1) The instruction from the Lehman Group in June 2008 was to amend the LBHI2 Sub-Notes in order to permit the deferral of interest. The instruction did not include a request to change or address the degree of subordination of the LBHI2 Sub-Notes (Grant 1, [15] **[C/T2/19]**).

(2) Mr Grant amended the LBHI2 Sub-Notes to permit the deferral of interest and sent the draft to Ms McMorrow at the Lehman Group in an email dated 5 June 2008 (Grant 1, [17], [18], [20] **[C/T2/20-1]**).

(3) Mr Grant then discussed the LBHI2 Sub-Notes with his colleague, Mr Dehal, who was a Senior Associate in the A&O tax department. Mr Dehal raised a concern that, as the solvency condition to payment of the LBHI2 Sub-Notes applied within a winding-up as well as outside a winding-up, payments of interest on the LBHI2 Sub-Notes might not be tax deductible (Grant 1, [19], [36] **[C/T2/20;22]**).

(4) Mr Grant told Ms McMorrow in an email dated 6 June 2008 that "*I have a few refinements from Amrita [Dehal]. I will hold off on these and put them in when I receive any comments from you*" (Grant 1, [22], [55] **[C/T2/20;27]**).

(5) To address Mr Dehal's concerns Mr Grant amended Condition 3(a) such that the solvency condition to payment would not apply in a winding-up, but the status quo would be preserved with respect to the degree of subordination (Grant 1, [50] **[C/T2/26]**). Further, Mr Grant states that he was not asked to make the amendments by anyone in the Lehman Group (Grant 1, [57] **[C/T2/27]**); and he does not recall discussing the potential tax sensitivities with the Lehman Group or the resulting amendments to Condition 3.

(6) The amendments to Condition 3 would not have been made if the tax deductibility issue had not been raised (Grant 1, [57] **[C/T2/27]**).

(7) Mr Grant drafted the resolutions of LBHI2 and SLP3 to amend the LBHI2 Sub-Notes, and the memo addressing the corporate benefit for SLP3 in agreeing the amendments (Grant 1, [58]-[59] **[C/T2/28]**). He referred only to the deferral of interest and not to the amendments to the subordination clause, as the amendments to the subordination clause were introduced solely to clarify the tax position and not to make a substantive change to the parties' rights to payment.

430. The evidence of Mr Grant is entirely consistent with the evidence of Ms Dolby, who (with Ms McMorrow) instructed him to make the 2008 Amendments, and who was in reality the relevant decision-maker (applying the test set out by Mann J in <u>Murray Holdings Ltd v Oscatello Investments Ltd, see above</u>):

(1) Ms Dolby thinks it is likely that she would have reviewed and approved the amended Conditions but she does not recall having a conversation with anyone about the amendments to Condition 3(a), whether at A&O or internally (Dolby 1, [64] **[C/T3/42]**).

(2) Ms Dolby relied on A&O and Ms McMorrow to prepare the documentation. She had no reason to second-guess the drafting, so long as they were content that the amendments were necessary and appropriate and did not impact the LT2 status of the LBHI2 Sub-Notes (at [65] **[C/T3/42]**).

(3) Ms Dolby did not focus on the amendment to the "Status and Subordination" provision at Condition 3. She did not consider the effect if any of the amendment on the respective priorities of LBHI2's subordinated debts (at [66] **[C/T3/42]**).

<u>A&O's Tax Concerns</u>

431. In relation to the concerns upon which the amendment was based, the evidence of Mr Grant is as follows:

(1) The amendment resulted from concerns raised by Mr Dehal. Mr Dehal considered there was a potential argument that interest on the LBHI2 Sub-Notes would not be tax deductible[291]. This was because LBHI2's obligations were expressed to be conditional on "solvency" (even in winding-up), so that the Noteholders could

[291] SLP3 notes that no one at A&O appears to have been aware of the very detailed PwC Memorandum **[F/V5/2391-2492]** provided by PwC to the Lehman Group in relation to the tax treatment of the LBHI2 Sub-Notes in or around the time the LBHI2 Sub-Notes were issued.

lose their rights to payment of amounts otherwise expected to be paid in an insolvent liquidation (Grant 1, [28] **[C/T2/21]**).

(2) This meant that payments could be seen as being as dependent on the results of the business (Grant 1, [29] **[C/T2/21]**), which in turn created a potential risk[292] that the LBHI2 Sub-Notes might be regarded as equity rather than debt, which would affect the tax deductibility of interest.

(3) In an insolvent winding-up, the claim of the Noteholders would be limited to whatever remained after the payment of "Senior Creditors", which could be less than 100% of principal and interest. Mr Dehal wanted it to be made clear that the Noteholders would be able to claim for 100% of their entitlements (even if that claim was not paid in full) (Grant 1, [32] **[C/T2/22]**).

<u>The Amendment to Condition 3(a) ("Status and Subordination")</u>

432. In relation to the drafting of the amendment to Condition 3(a), Mr Grant's evidence is as follows:

(1) Mr Grant amended the subordination language so that it was no longer conditional on solvency in a winding-up. This was done solely to address the tax issue raised by Mr Dehal. It was intended to ensure that the Noteholders would always have a claim for the full amount due under the LBHI2 Sub-Notes in a winding-up, but on a subordinated basis (Grant 1, [39] **[C/T2/23]**).

(2) Mr Grant used the concept of the "notional preference share". This would permit an express reference to the claim being for the *full* amount, i.e. "*an amount equal to the principal amount of such Note together with Arrears of Interest (if any) and any accrued interest (other than Arrears of Interest)*" but subject to the amount actually paid on that claim being as if the claim were only submitted at the relevant level of the waterfall (Grant 1, [41] **[C/T2/23]**). This addressed the key issue from a tax perspective i.e. as the claim was now expressed to be for all amounts outstanding even if previously deferred, rather than limited by the amount which LBHI2 could pay whilst remaining "solvent".

292 Mr Grant has acknowledged in his evidence that the potential issue regarding the solvency condition operating in a winding-up would also have arisen on the unamended LBHI2 Sub-Notes (though the proposed interest deferral could potentially have exacerbated the problem) (Grant 1, [35] **[C/T2/22]**).

(3) Mr Grant adapted this concept from "the tried and trusted approach" typically used for UT2 subordinated bonds. Under this method, the junior creditor is only entitled to what they would have received had they been the holder of a notional preference share which ranked above all the other classes of issued shares (Grant 1, [42]-[43] **[C/T2/24]**). Mr Grant varied this formula and applied it to a LT2 security: it was not possible to use standard UT2 wording since the ranking needed to continue unaltered (Grant 1, [44] **[C/T2/24]**).

(4) The new drafting provided that the Noteholders ranked *above* the Notional Shares, rather than ranking as if the Noteholders held a Notional Share (Grant 1, [46]-[47]). The definition of Notional Holder expressly referred to any "creditor" of the Issuer, since UT2 securities could be undated subordinated bonds.

(5) By having a right to a return of assets in priority to Notional Holders, the Noteholders had a right to a return in the assets in priority to the holders of any UT2 securities and to any Innovative Tier 1 securities (Grant 1, [48] **[C/T2/25-6]**). Mr Grant then added the Confirmatory Note to make it explicit that the LBHI2 Sub-Notes would continue to rank above any UT2 securities (Grant 1, [50] **[C/T2/26]**).

433. Mr Grant summarises the effect as follows (Grant 1, [52] **[C/T2/26]**):

"*Following the amendments, in a winding-up, the Noteholders were still described as ranking below Senior Creditors, but in place of the solvency condition, they were also described as ranking above all classes of issued shares (including ordinary and preferential shares) and above the Notional Holders/Upper Tier 2 securities. Whereas before the amendments, the Conditions only described what ranked above the LBHI2 Sub-Notes, the amended Conditions describe what ranks above the LBHI2 Sub-Notes and also what ranks below them*".

The Rectification Claim

<u>Relevant Decision-Makers</u>

434. At all material times up to and including the time of the execution of the Written Resolution on 3 September 2008, it was the common intention of both LBHI2 and SLP3 that the 2008 Amendments would "*do no more (or less)*" (<u>FSHC</u>, at [183]) than permit LBHI2 to defer the payment of interest on the LBHI2 Sub-Notes.

435. For these purposes, rectification is entirely concerned with the parties' actual and subjective states of mind (and not what the hypothetical reasonable observer would have attributed to the words used).

436. In reality the relevant decision-makers (applying the test set out by Mann J in Murray Holdings Ltd v Oscatello Investments Ltd) were Ms Dolby and, to a lesser extent, Ms McMorrow, who shared the same actual and subjective intention.

437. As to SLP3's intention:

(1) SLP3's intention in relation to the 2008 Amendments was that of Ms Dolby and/or Ms McMorrow. They were the relevant decision-makers in reality and their knowledge and intentions are to be attributed to SLP3 for the purposes of the transaction (Murray Holdings Ltd v Oscatello Investments Ltd). Alternatively, they were negotiators whose intentions were ultimately adopted by the technical decision-maker, the board of directors of LBDI (in its capacity as the general partner of SLP2, which in turn was the general partner of SLP3), which approved and/or sanctioned amendments to the LBHI2 Sub-Notes which gave effect to the intentions of Ms Dolby and/or Ms McMorrow.

(2) In executing the Written Resolution, SLP3's intention was to assent to amendments to the LBHI2 Sub-Notes which did no more than to permit LBHI2 to defer the payment of interest on the LBHI2 Sub-Notes. It was not the intention of SLP3[293] to alter the ranking of the LBHI2 Sub-Notes.

438. As to LBHI2's intention:

(1) LBHI2's intention in relation to the 2008 Amendments was that of Ms Dolby and/or Ms McMorrow. Alternatively, the board of directors of LBHI2 was the technical decision-maker and approved and/or sanctioned amendments to the LBHI2 Sub-Notes which gave effect to the intentions of the negotiators Ms Dolby and/or Ms McMorrow (and thus adopted their intentions).

(2) In executing the Written Resolution approving the 2008 Amendments, LBHI2's intention was to propose amendments to the LBHI2 Sub-Notes which did no more than to permit it to defer the payment of interest on the LBHI2 Sub-Notes. It was not the intention of LBHI2 to alter the ranking of the LBHI2 Sub-Notes.

293 Insofar as it is relevant, in signing the Delaware Consent **[F/V6/3503]**, it was the intention of the board of LBDI to assent to amendments to the LBHI2 Sub-Notes which did no more than to permit LBHI2 to defer the payment of interest on the LBHI2 Sub-Notes. It was not the intention of LBDI's board to alter the ranking of the LBHI2 Sub-Notes.

Common Intention of SLP3 and LBHI2 and Outward Expression of Accord

439. The relevant decision-makers' actual intention must be considered based on the totality of the evidence, including the oral evidence at trial, the witness statements, the witness interviews and the contemporaneous documents.

440. The evidence shows that the actual intention of the decision-makers in this case, which (to the extent necessary) was communicated, was to do "*no more and no less*" (FSHC) than to enable LBHI2 to defer the payment of interest on the LBHI2 Sub-Notes.

441. At no stage before or at the time of execution of the Written Resolution was it the understanding or the intention of LBHI2, SLP3 and/or the relevant decision-makers or other personnel within the Lehman Group that the 2008 Amendments would subordinate the LBHI2 Sub-Notes to the LBHI2 Sub-Debt and/or alter the amount SLP3 could prove for in respect of the LBHI2 Sub-Notes. There is no evidence of any discussion of what would have been a fundamental change to the existing arrangements between the parties (FSHC, [47] (first instance); [191] (Court of Appeal)), which is compelling evidence that the parties did not intend it.

442. Moreover, Ms Dolby has confirmed that she did not think that the 2008 Amendments had effectively changed the existing ranking priorities,[294] as well as that to her knowledge there was no other reason for the 2008 Amendments than to permit the deferral of interest.[295]

443. That the decision-makers' subjective intentions in relation to the 2008 Amendments were as set out above is the *only* conclusion that can sensibly be reached in view of the following three matters.

444. *First*, it is inherently implausible that SLP3 would have consented to the subordination of over US$6 billion of debt without taking advice on the propriety of that course of action. This is particularly so when the Delaware Consent expressly noted: "*the Board of Directors consider that the Amendment is appropriate and in the best interests of the*

294 Dolby Interview, page 22, lines 30-33 **[C/T21/285]**, and re-questioned on her answer by Sidley at page 37, lines 1-7.

295 Dolby Interview, page 31, lines 15-20**[C/T21/294]**.

corporation"[296]. Indeed, this point gains force from the fact that it *was* thought necessary to obtain a corporate benefit opinion from A&O for SLP3 regarding the amendments enabling interest deferral. The fact that no such advice was obtained in connection with any proposed alterations to the ranking or quantum of SLP3's subordinated claims suggests that no such alterations were intended.

445. *Second*, there was a complete absence of discussion among Lehman Group personnel as to what would have been a fundamental legal change to the LBHI2 Sub-Notes. SLP3 is not aware of a single document in which Lehman Group personnel made reference to any alteration of ranking, let alone subordination of the LBHI2 Sub-Notes to the LBHI2 Sub-Debt. It is not possible to dismiss this lack of consideration on the basis that subordination is some tangential feature of the LBHI2 Sub-Notes: the subordination provision thereunder is the key provision enabling them to qualify as LT2 capital. Again, the absence of any discussion of alteration to ranking is *compelling* evidence that this was simply not intended (FSHC, [47] (first instance); [191] (Court of Appeal)).

446. *Third*, at the same time, the communications both internally at the Lehman Group and externally with A&O, the FSA and the CISX only ever referred to a discrete and limited legal purpose, namely, the inclusion of provisions enabling LBHI2 to defer the payment of interest – not to effect any form of alteration to the ranking or quantum of the LBHI2 Sub-Notes. This is particularly significant in circumstances where the individuals with the power to bind LBHI2/SLP3 were told that the *only* purpose of the 2008 Amendments was to enable the deferral of interest payments. In relation to this:

(1) On 2 June 2008 Ms Dolby emailed Ms McMorrow at 15:37 and stated that "*[w]e would like to continue to accrue the interest in 2008 but for the interest paydown (i.e. cash payment) not to be made until late 2009*", which was forwarded to A&O[297] (the "**Instructions Email**").

(2) On the same day, the Instructions Email was forwarded on to Daniel Fletcher at A&O at 15:56[298]. The Instructions Email acted at all times as A&O's principal instruction with regard to the 2008 Amendments. The email also asked Mr Fletcher whether SLP3 could sign a waiver letter without changing the Conditions. The Lehman Group would plainly have been satisfied to forego

296 [F/V6/3503].
297 [F/V5/2575].
298 [F/V5/2575].

amending the LBHI2 Sub-Notes at all, if it had been possible simply to waive the cash settlement of interest.

(3) On 3 June 2008, Jackie Dolby wrote to Gareth Bowen (in the regulatory team) in relation to the intention to "*defer payment of the interest due on the QEB*"[299]. She raised a query as to the requirement of FSA approval to the amendment. Mr Bowen replied on the same day[300]:

"*If we get the lawyers to provide an opinion that* ***the subdebt*** *still qualifies as Tier 2 capital and* ***operates in all other ways in the same way*** *then I don't think it would be a problem*" (emphasis added).

(4) On 5 June 2008[301], Mr Grant sent Ms McMorrow a draft of the amended conditions (the "**First Draft**") and a draft written resolution approving the amendments. The First Draft amended the provisions relating to the payment of interest and made various consequential amendments. Condition 3 was left completely untouched[302].

(5) On 10 June 2008[303] at 13:52, after the First Draft was reviewed by both Ms Dolby and Ms McMorrow, the latter replied to Mr Grant: "*We don't have any comments other than the holder of the resolution, so if you could send a revised version – could you send a cumulative blackline as well and separate off the annex on that one so that we can send the blacklined terms to the FSA*". From the Lehman Group's perspective, the First Draft was sufficient to achieve their limited purpose.

(6) On 11 June 2008[304], Ms Dolby emailed Parul Dave (an in-house lawyer within the Lehman Group) and Emily Upton (in the company secretarial team). She summarised the proposed amendments, stating "*The change will give flexibility to allow the deferral of the actual cash settlement of the interest though the interest will continue to accrue in both parties [sic.] accounting records and will ultimately be cash settled.*" It stated Ms Dolby's view that the board of LBHI2

299 [F/V5/2573].
300 [F/V5/2576].
301 [F/V5/2607-2619].
302 [F/V5/2611].
303 [F/V5/2676].
304 [F/V5/2682].

and the general partner of SLP3 should "*have a quick Board meeting to ratify this*" which, it appears, was considered little more than a formality.

(7) On 12 June 2008 at 10:29[305], Mr Grant emailed Ms Dolby and Ms Dave, attaching draft board minutes for LBHI2 ("**LBHI2 Draft Minutes**")[306], draft board minutes for the general partner of SLP3, and a note on corporate benefit for SLP3 (the "**A&O Corporate Benefit Note**")[307], all of which had been requested by Ms Dave. Each of the draft documents made no mention of any alteration to ranking.

(8) On the same day at 11:27[308], Mr Grant sent a further email to Ms Dolby and Ms Dave, attaching a second draft of the amended Conditions (the "**Second Draft**"). The email stated without further elaboration that: "*Deferral provisions introduce tax sensitivities. The amendments are designed to ensure these tax sensitivities are met*". The Second Draft contained the modifications to Condition 3(a), as set out above. They followed the internal discussions relating to Mr Dehal's tax concern, which were not relayed to the Lehman Group and who were not consulted or informed about the nature of A&O's tax concern save for the comment above.

(9) Between 11 and 16 July 2008[309], Ms Edwards, an employee within the Lehman Group's central compliance department, communicated with the FSA in relation to the proposed amendments. The FSA were not informed about any intention to alter the ranking of the LBHI2 Sub-Notes.

(10) On 28 August 2008, a meeting of LBHI2's board of directors took place with Mr Rush and Ian Jameson as directors of LBHI2. The LBHI2 Board Minutes[310] were in materially the same form as the LBHI2 Draft Minutes[311] drafted by Mr Grant and circulated on 12 June 2008 *before the Second Draft* was even produced. The LBHI2 Board Minutes recorded that it was reported to the meeting that "*the purpose of the amendment was to allow the Company to defer cash settlement of the interest on the Notes at its discretion*". Ms Dolby has confirmed that if the

305 **[F/V5/2819]**.
306 **[F/V5/2833-2]**.
307 **[F/V5/2837-8]**.
308 **[F/V5/2839]**.
309 See Claire Edwards' email to the FSA dated 11 July 2008 **[F/V6/3147]**; and Ms Edwards' email to the FSA dated 17 July 2008 **[F/V6/3154]**.
310 **[F/V6/3325-6]**.
311 **[F/V5/2833-2]**.

intention had been to alter the ranking of the LBHI2 Sub-Notes, she would have expected the Board Minutes to mention that.[312]

(11) On the same day[313], Ms Dave emailed Mr Aaron Guth of the Lehman Group with a draft of the Delaware Consent. Her email explained in relation to the proposed amendments that, "*The change will allow [LBHI2] to defer payment to SLP3 under [the LBHI2 Sub-Notes]. Interest will still accrue however.*" Ms Dave noted that "*The change has been approved by London tax and legal.*" On the same day[314], Mr Guth emailed Ms Dave informing her of the identity of the LBDI directors, adding "*Just email the resolution to the directors….and they will approve*". Again, approval was considered little more than a formality.

(12) On the same day at 18:29[315], Ms Dave emailed the consent to Mr Triolo, but did *not* attach the 2008 Amendments themselves. The email stated "*Jackie [Dolby] has been looking at amending the terms of [the LBHI2 Sub-Notes] issued by [LBHI2] to [SLP3]*" and explained that "*The Change will allow [LBHI2] to defer payment to SLP3 under the [LBHI2 Sub-Notes].*"

(13) On 3 September 2008, Jacqueline Marx, Mr Triolo's assistant, attached a signed pdf of the Delaware consent signed by Mr Triolo[316]. On the same day, the Written Resolution[317], which was in materially the same form as the one circulated by Mr Grant before he circulated the Second Draft, was signed by Emily Upton on behalf of SLP3 and Mr Rush as a duly authorised signatory of LBHI2.

447. For all the reasons set out above, the common subjective intention of SLP3 and LBHI2 was "*no more or less*" than to defer the payment of interest on the LBHI2 Sub-Notes ("**the Common Intention**"); and this common subjective intention was communicated (to the extent necessary) between SLP3 and LBHI2 (in circumstances where the relevant decision-makers were the same individuals).

448. Further or in the alternative, by analogy with the pensions cases (<u>AMP (UK) plc v Barker</u> [2001] Pens LR 77; <u>Gallaher v Gallaher Pensions Ltd</u> [2005] Pens LT 103; <u>IBM (UK) Pension Trusts Ltd v IBM Holdings Ltd</u> [2012] Pens LR 469) as approved Henry Carr J

312 Jackie Dolby Interview page 19 line 29 to page 20 line 5 **[C/T21/282-3]**.
313 **[F/V6/3338]**.
314 **[F/V6/3364]**.
315 **[F/V6/3342-3]**.
316 **[F/V6/3485-6]**.
317 **[E/T5/70-80]**.

and the Court of Appeal in FSHC, it is sufficient to rectify the 2008 Amendments on the basis that SLP3 and LBHI2 shared the same converging intention in respect of the 2008 Amendments without that actual intention being communicated.

Failure of the 2008 Amendments to reflect the Common Intention

449. If SLP3 is incorrect on its primary case on the construction of the 2008 Amendments, then the 2008 Amendments approved by the Written Resolution mistakenly effected a change to the LBHI2 Sub-Notes that went beyond and/or was contrary to SLP3's and LBHI2's Common Intention.

450. If so, the amendments made to Condition 3(a) under the Second Draft, which were ultimately retained in the 2008 Amendments, mistakenly had the legal effect that thereafter SLP3's claims under the LBHI2 Sub-Notes ranked for distribution after PLC's claims under the LBHI2 Sub-Debt (**"the Ranking Alteration"**).

451. The Ranking Alteration did not reflect the Common Intention of the parties:

(1) Ms Dolby did not intend the Ranking Alteration.

(2) A&O were not instructed to cause the Ranking Alteration.

452. There is no evidence that anyone else in the Lehman Group had any intention to bring about the Ranking Alteration, which was wholly inconsistent and/or contrary to the discrete Common Intention to amend the LBHI2 Sub-Notes only to permit the deferral of the settlement of interest:

(1) The Instructions Email[318], which was forwarded to A&O referred to the limited objective of deferring payment of interest until late 2009.

(2) In Ms Dolby's exchange with Gareth Bowen on 3 June 2008, Mr Bowen expressly told Ms Dolby that A&O should provide confirmation that post-amendment the LBHI2 Sub-Notes would "*operat[e] in all other ways in the same way*"[319].

(3) The initial draft amendments by A&O only addressed the interest point. After she had reviewed the draft, Sarah McMorrow's e-mail of 10 June 2008 stated that

[318] [F/V5/2575].
[319] [F/V5/2576].

there were no further comments in relation to this.[320] At this point, she was satisfied that the Notes achieved the Lehman Group's objective.

(4) Subsequently, Mr Grant drafted, on his own initiative, significant amendments to Condition 3(a) which he believed would address a tax concern A&O had identified, but which was never communicated to the Lehman Group. In her interview, Ms Dolby stated that the Lehman Group would have obtained a tax opinion prior to issuing the LBHI2 Sub-Notes to begin with which confirmed the tax deductibility point in respect of the LBHI2 Sub-Notes (i.e. the PwC Memorandum). As regards A&O's involvement with the tax point, she noted that "*it probably wasn't A&O's call*" and "*A&O weren't my tax advisors*".[321]

(5) The A&O Corporate Benefit Note was circulated in the Lehman Group prior to the circulation by A&O of the Second Draft.[322] There was no corporate benefit to any of SLP3, SLP2 or LBDI if the 2008 Amendments gave rise to the Ranking Alteration.

(6) In approving the Written Resolution by signing the Delaware Draft Consent, Mr Triolo, the sole director of LBDI, was provided with a copy of the Delaware Draft Consent but not the 2008 Amendments. The Delaware Draft Consent referred to the purpose of the amendments being the deferral of the cash settlement of interest; recorded that the LBDI directors considered that the amendments were appropriate and in the best interests of LBDI; but did not address any issue of subordination or ranking of the LBHI2 Sub-Notes arising out of the 2008 Amendments.

453. Accordingly, the Ranking Alteration would be wholly inconsistent and/or contrary to the limited Common Intention to amend the LBHI2 Sub-Notes only to permit the deferral of the settlement of interest

The 2008 Amendments should be Rectified

454. Accordingly, if the 2008 Amendments do not on their true construction reflect the Common Intention, that was the result of a mistake in the drafting of the 2008 Amendments and ought to be rectified.

[320] [F/V5/2676].
[321] Jackie Dolby interview transcript page 21 line 33 – 22 line 15 [C/T21/284-5].
[322] [F/V5/2837-8].

455. If Condition 3(a) were to be rectified by removing the language in Condition 3(a) beginning with (i) the underlined words "*subject as provided below*" and then (ii) the underlined words starting "*The conditionality referred to above…*" and ending with the italicised passage "*…from time to time*", then the LBHI2 Sub-Notes as amended would accurately reflect the parties' Common Intention.[323]

456. As Henry Carr J held at first instance in the FSHC case at [42]: "*if the parties shared a common intention, they do not need to have formulated the words by which the common intention is to be given effect in a subsequent rectification claim*".

457. Here, the Common Intention can be given effect by removing wording that A&O were never instructed to include and which addressed a tax concern that was not shared with the Lehman Group.

The Counter-Arguments are Wrong

458. PLC has various counter-arguments.

459. *First*, PLC says (PLC PP, [71] **[A/T7/121]**) that SLP3's case on rectification is implausible because it seeks to rectify large parts of Condition 3(a). PLC also appears to rely (PLC PP, [78] **[A/T7/123]**) on the "*magnitude of the mistake*" as militating against the rectification. This is misconceived if (as is the case) the 2008 Amendments mistakenly did not reflect the Common Intention: see, by extension, Chartbrook Ltd v Persimmon Homes Ltd [2009] 1 AC 1101 [25] in relation to there not being "*a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed*".

460. *Second*, PLC says (PLC PP, [73] **[A/T7/121]**) that "*it is doubtful whether (at least outside the pensions context) the absence of a positive statement of intention can demonstrate the necessary continuing contrary intention*". This is incorrect:

(1) As Henry Carr J said: "… ***the absence of any discussion about such a fundamental change is, in my view, convincing proof of an intention not to incur the Additional Obligations***" (see FSHC Group Holdings Ltd v Barclays Bank Plc [2018] EWHC 1558 (Ch) at [158]; upheld by FSHC Group Holdings Ltd v Glas Trust Corporation Ltd [2019] EWCA Civ 1361). The principle that the absence of a discussion can constitute evidence of the parties' intention is not one that is "*confined to pension cases*" (at [47]).

(2) There is no reason in principle why one approach should be applicable to pensions cases and one to non-pensions cases. In any event, the factual context here (where there are centralised decision-makers and the absence of adversarial negotiation: see PLC PP, [75]) is closely analogous to that in which the pensions rectification cases have tended to arise, involving the exercise of the power of amendment by a trustee of a pension scheme and the giving of consent to the amendment by an employer: see IBM (UK) Pension Trusts Ltd v IBM Holdings Ltd [2012] Pens LR 469 [23]-[24].

[323] The proposed rectification was set out at Joint PP, [30.4] **[A/T5/77]**.

461. *Third*, PLC variously says that the "*drafter of the amendment…plainly intended to do something rather than nothing*" (PLC PP, [71] **[A/T7/121]**), the evidence referred to is the "*weakest form of evidence*" (PLC PP at [74] **[A/T7/121]**), the "*evidence is inconclusive*" (PLC PP, [76]) **[A/T7/122]**, the rectification case is "*so inherently unlikely that it would require clear and cogent evidence*" (PLC PP at [77] **[A/T7/122]**) and there is "*no convincing proof*" (PLC PP, [79] **[A/T7/123]**). These are all premature and misconceived assessments of evidence which PLC had not yet seen at the time they were made. SLP3 will prove its case at trial on the basis of evidence from the relevant lawyers at A&O, among other things.

462. PLC and Deutsche Bank both contend that even if grounds for rectification are made out the Court should not exercise its discretion to rectify the LBHI2 Sub-Notes.

463. Rectification is a discretionary remedy, but equity does not normally refuse rectification where the requirements are made out (Barden v Commodities Research Unit International (Holdings) Ltd [2013] EWHC 1633 (Ch) at [61], per Vos J): it is only in "*exceptional cases*" that relief is refused on discretionary grounds[324]. Accordingly, once the requirements for a claim of rectification have been met the Court will be slow not to order rectification.

464. The first reason given is common to PLC and Deutsche Bank. It is said that rectification would be inappropriate having regard to the nature of the LBHI2 Sub-Notes as freely transferable debt securities listed on a stock exchange: PLC PP, [80] **[A/T7/123]** and Deutsche Bank PP, [20] **[A/T8/129]**.

[324] Spry, The Principles of Equitable Remedies (9th ed.), page 640.

465. PLC and Deutsche Bank's reasoning is misconceived. The rectification in question goes to the rectification of amendments that were sanctioned by a sole Noteholder, SLP3, who has at all times since then remained the sole Noteholder. There is no question of prejudicing any other party with an interest in the LBHI2 Sub-Notes.

466. The Court has jurisdiction to rectify a transferable security and neither PLC nor Deutsche Bank have provided any authority suggesting or explaining why it would decline to do so as a matter of discretion. The case and paragraph Deutsche Bank relies on at DB PP, [20] **[A/T8/129]** (BNY Mellon Corporate Trustee Services v LBG Capital No 1 plc [2016] UKSC 29 at [31]) is a construction case which merely refers to the principles set out in Re Sigma Finance, another contract case. In relation to this:

(1) There is no reason in principle why an amendment to a transferable or tradeable security should not be capable of being rectified. There is "*almost no limit*" to the range of documents which may be rectified in an appropriate case, and this includes "*bonds*": Rectification (2nd ed, Hodge, at 9.01).

(2) That is the approach taken in the authorities. In The Law Debenture Trust Corporation PLC v Elektrim S.A., Concord Trust [2009] EWHC 1801 (Ch) at [19]-[20], [48] Sales J said that he would have rectified the terms of the bond issuance in question had he not agreed with the claimant's primary case on construction. In the Australian case of RHG Mortgage Securities Pty Limited & Ors v Elektra Purchase No. 19 Limited [2009] NSWSC 258, the court (Einstein J) held that a subscription agreement in respect of an issuance of notes in the sum of $750 million could in principle be rectified, notwithstanding that the party claiming rectification was an assignee of the notes in question.

(3) There is no principled reason and no case law which ought to preclude the Court from rectifying the 2008 Amendments if the necessary requirements are made out. The position here is *a fortiori* to that in RHG Mortgage Securities, given that the party claiming rectification here assented to the amendments to begin with and continues to be the sole Noteholder.

467. The second reason given by PLC (PLC PP, [80] **[A/T7/123]**) is the complexity of the tax and regulatory issues in this case, and that the Court should decline to rectify the 2008 Amendments "*merely for the purpose of determining a priority dispute between Lehman entities*".

468. This does not amount to a cogent or recognisable ground for refusing rectification of a document.

Conclusions on Rectification

469. The jurisdictional requirements for rectification are plainly made out on the materials before the Court; and no sufficient reason has been identified (nor is there one) why, in those circumstances, the Court should not exercise its discretion in SLP3's favour.

470. Rectification is an equitable jurisdiction. It exists to prevent injustice, and, in particular, to prevent a party who receives a benefit as a result of mutual mistake from resisting "*the claims of justice*" (Commentaries of Equity Jurisprudence, 4th ed, 1846, cited by the Court of Appeal in FSHC at [53]).

471. To the extent that there was a Ranking Alteration, that was very obviously not the common intention of the parties. This is a classic case of rectification where the equity should be exercised in favour of SLP3 to prevent the injustice of an unintended benefit accruing to PLC through the accidental relegation/demotion of the LBHI2 Sub-Notes as a result of the 2008 Amendments.

Conclusions on LBHI2 Ranking Issue – Part II

472. Accordingly, for the reasons set out above:

(1) The 2008 Amendments do not alter priorities.

(2) In any event, the 2008 Amendments are not engaged.

(3) To the extent they do alter priorities and are engaged, the 2008 Amendments should be rectified.

SECTION II: THE OTHER PLC ISSUES

J. THE RELEASE ISSUE

473. The Release Issue is:

"*Within the administration of [PLC] whether the claims of [LBHI] under the [PLC Sub-Debt] have been released pursuant to a settlement agreement entered into as of 24 October 2011 between, amongst others, [PLC] and LBHI*".

474. LBHI's[325] position is that its claims under the PLC Sub-Debt – which it acquired in April 2017 and which aggregate to approximately US$1.9 billion – have *not* been released pursuant to the Settlement Agreement[326]. This is explained in the following:

(1) Joint PP, at [32]-[40] **[A/T5/79-84]**.

(2) Geraghty 2 (the factual background) **[C/T7/90-106]**.

(3) Gropper 1 (the New York legal position).

475. At the outset, LBHI notes that the first time it was ever asserted that the PLC Sub-Debt (or any other such after-acquired claims) had been released was when, very shortly before the issue of the PLC Application in March 2018, LBHI received a letter on 12 February 2018 from Sidley on behalf of Deutsche Bank (Geraghty 2, [59] **[C/T7/101]**) alleging that the PLC Sub-Debt had in fact been released by the Settlement Agreement in October 2011 i.e. some 6.5 years previously.

476. Deutsche Bank's arguments are misconceived. LBHI's position is as follows:

(1) As a matter of ordinary language, and as is clear on the face of its Recitals, the Settlement Agreement is obviously concerned with the compromise of "*outstanding*" inter-company claims owned by the relevant parties – the US Debtors and the UK Affiliates – at the time of its execution; and there is no provision for the release on a future date by LBHI of after-acquired claims.

(2) It would be commercially perverse for LBHI to have released all after-acquired claims in exchange for no consideration; nor has Deutsche Bank identified any other commercial rationale for why it would have released after-acquired claims on that basis, which would effectively amount to a waiver for no economic value.

(3) To the extent that the evidence of the parties' subsequent conduct is admissible – either because it may be considered in determining the original contemplation of the parties, alternatively because Section 8.02 is ambiguous (to the extent that it is reasonably susceptible of more than one meaning) – the evidence overwhelmingly militates against the construction advanced by Deutsche Bank and is consistent with the PLC Sub-Debt *not* having been released by the Settlement Agreement.

325 At the time the Settlement Agreement was entered into and became effective the PLC Sub-Debt was held by LBUKH.

326 **[E/T16/457-595]**.

477. On the final point i.e. subsequent conduct, LBHI notes that on 3 October 2019 Deutsche Bank formally withdrew Sutton 2, so that it no longer relies on any witness evidence *at all* in support of its case that the subsequent conduct of the parties points to the release of the PLC Sub-Debt.

478. Despite the wealth of materials before the Court, the Release Issue, in truth, involves a straightforward point of construction.

Settlement Agreement: Background

479. The Settlement Agreement was one of a number of Bilateral Settlements entered into between the Lehman Group's (US) "Debtors" on the one hand, and "Foreign Affiliates" on the other hand, prior to the filing of the Third Amended Joint Chapter 11 Plan of LBHI and its Affiliated Debtors (**"the Plan"**) (Geraghty 2, [15] **[C/T7/93]**). The Bilateral Settlements were contingent on the Plan becoming effective (which it did on 6 March 2012).

480. The purpose of the Settlement Agreement is stated in the Declaration of Daniel Ehrmann, a Managing Director at Alvarez & Marsal (**"A&M"**), LBHI's main restructuring advisors, dated 29 November 2011, at [40][327]. It was designed to resolve and settle certain inter-company balances and claims that were in dispute between the US Debtors and the UK Affiliates at the time (Geraghty 2, [16] **[C/T7/93]**). The claims in dispute did *not* relate to claims held by one UK Affiliate against another UK Affiliate; they were "trans-Atlantic" only and concerned only US-UK disputes (ibid). Therefore, none of the issues concerned allowing or releasing claims held by one UK Affiliate against another UK Affiliate.

481. The "Debtors" comprised LBHI and 22 of its affiliates that had filed for bankruptcy in the United States. The "UK Affiliates" comprised the (20) "UK Administration Companies" (including PLC and LBUKH), the (10) "UK Liquidation Companies" and the (27) "Other UK Affiliates" (Geraghty 2, [27]-[35] **[C/T7/95-96]**).

482. The steps leading up to the Settlement Agreement included the following:

(1) "Global Close". Under this process LBHI and its affiliates around the world achieved a final reconciliation of inter-company balances as at 14 September 2008. The UK Affiliates did not participate but used a similar process that was

327 **[F/V7/3779]**

consistent with "Global Close". This produced inter-company accounts which created the core of the process of negotiating the Settlement Agreement (Geraghty 2, [17]-[20] **[C/T7/93-4]**).

(2) Proofs of Claim. The UK Affiliates filed proofs of claim against the Debtors in the sum of $166 billion. These divided into direct intercompany claims ("**Direct Claims**") and claims where LBHI had issued a guarantee ("**Guarantee Claims**"). As a result of Global Close, it became clear that the Debtors also had very substantial claims against the UK Affiliates (ibid, [25]-[26] **[C/T7/95]**). The Direct Claims were based on intercompany balances between the Debtors and the UK Affiliates, including general balances, but also derivative transactions and repurchase agreements (ibid., [36]-[37] **[C/T7/97]**). The Guarantee Claims were based on a number of guarantees issued by LBHI, and there were complex legal issues which went to their enforceability (ibid, [38]-[39] **[C/T7/97]**).

483. By September 2011, the parties had made significant progress in the negotiations, and a series of meetings took place in London (ibid., [40]-[48] **[C/T7/97-9]**). The Debtors were represented by Mr Geraghty and Mr Ehrmann. The UK Affiliates were represented by Mr Antony Lomas and Mr Howell[328] of PwC.

484. There was a meeting on 13 September 2011 ("**the 13 September Meeting**") the purpose of which was to agree the final intercompany claims and how to resolve any outstanding issues. By this point, the vast majority of Direct Claims were agreed.

485. The parties agreed a carve-out for "Excluded Items"[329], being claims which were too complicated to be addressed; and where the parties wished to preserve the right to investigate them further. These claims were expressly carved-out of the releases, as they related to known issues that continued to subsist between the parties and which would otherwise have been released (ibid, at [50] **[C/T7/99]**).

486. The commercial objective underpinning the Settlement Agreement was that once the bankruptcy date balances and net intercompany claims between the Debtors and the UK Affiliates as at the commencement of the bankruptcy had been agreed, that debate could not be reopened (ibid, [51] **[C/T7/99]**).

328 Mr Howell is one of the administrators of LBHI2. However, LBHI2 are neutral on the Release Issue, and Mr Howell has not given evidence in relation to the Settlement Agreement.

329 A list of these "Excluded Items" is set out in the Agenda to the 13 September Meeting **[F/V7/3713]**.

487. There was no intention on the part of the Debtors nor any request by the UK Affiliates for there to be a prohibition on acquiring claims against UK Affiliates, nor any intention that such after-acquired claims be released (ibid, [47] **[C/T7/99]**).

Settlement Agreement: Terms

488. The Settlement Agreement is an agreement between the (US) Debtors, the UK Affiliates and the LBLIS Group Entities[330].

489. The terms of the agreement are preceded by important Recitals that record the commercial purpose of the Settlement Agreement (emphasis added)[331]:

(1) "*…**the UK Affiliates filed the proofs of claim** listed on Schedule 1……. ("Proofs of Claim") against certain Debtors….*"

(2) "*…. **certain of the Debtors have asserted that they have claims** against certain of the UK Affiliates…….*"

(3) "*…the Debtors and the UK Affiliates desire to resolve **all disputes and all other outstanding issues among them (except as expressly excluded herein)** and to avoid extensive and expensive litigation*".

(4) "*…in consideration of the recitals stated……the Parties agree as follows*".

490. As set out below, the crucial phrase is "***all disputes and all other <u>outstanding</u> issues***" (emphasis added). The express aim of the agreement is to address issues that have or could have been raised by the parties through the proofs/inter-company claims process that precede the agreement.

491. There is no reference in the Recitals to a resolution of claims between or among UK Affiliates and no provision therefore in the Settlement Agreement.

492. The release given by LBHI and the Debtors to PLC and its affiliates, including LBUKH ("**the Debtor Released Parties**") is at Section 8.02[332] ("**the Release Clause**") and provides as follows:

"***Debtors' Release. Upon the occurrence of the Effective Date**, except with respect to (1)*

330 These are various Lehman Group entities described at footnote 2, page 1 of the Settlement Agreement.

331 **[E/T16/458-9]**.

332 **[E/T16/498-9]**.

the Allowed Claims and the Admitted Claims and any rights and distribution entitlements in respect thereof, (2) the agreements, promise, settlements, representations and warranties set forth in this Agreement, (3) the performance of the obligations set forth herein and (4) the Excluded Items, and in consideration of the foregoing and each Party's execution of this Agreement, ***each Debtor [....], hereby fully and forever releases, discharges and acquits each Debtor Released Party, from all Causes of Action*** *(including in respect of any derivative claim by any third party or representative of any Debtors' estate, including the official committee of unsecured creditors appointed in the Chapter 11 Cases),* ***whether at law or in equity, whether based on contract (including quasi-contract, guarantee, indemnity or estoppel), statute, regulation, tort or otherwise*** *(excluding fraud in connection with the negotiation of (A) this Agreement or (B) the amounts of the Allowed Claims and the Admitted Claims), accrued or unaccrued, foreseen or unforeseen, foreseeable or unforeseeable, known or unknown, matured or unmatured, fixed or contingent, liquidated or unliquidated, certain or contingent, in each case, that arise from, are based on, connected with, alleged in or related to any facts or circumstances in existence prior to the date hereof, including (i) any Funding Claims, (ii) any Causes of Action under chapter 5 of the Bankruptcy Code or similar actions under applicable state law, (iii) except as explicitly set forth in Section 2.04, any claims based upon an asserted right of subrogation, indemnification (whether express or implied), contribution or reimbursement, including any such claims in connection with distributions to any of the UK Affiliates or any of their creditors based upon a guarantee or similar document by LBHI or any Lehman Entity and (iv) all Causes of Action against any Debtor Released Party, arising from, in connection with, or relating to any Causes of Action against any other entity (whether or not a Party) existing as of the date hereof. For the avoidance of doubt, this Section 8.02 is without prejudice to any of the Debtors' rights or Causes of Actions against any entity that is not a Debtor Released Party"* (emphasis added).

493. There is an analogous (and materially similar) release at Section 8.01[333] pursuant to which the UK Affiliates release their claims against the Debtors.

494. In each case, there are express-carve outs from the relevant release:

333 **[E/T16/497-8]**.

(1) The Admitted Claims and the Allowed Claims i.e. the subsisting compromised claims between the Debtors and the UK Affiliates as a result of the Settlement Agreement.

(2) The Excluded Items i.e. the continuing issues and claims that were not addressed at all in the Settlement Agreement and left over to be determined at a later date.

495. The Settlement Agreement also includes several other provisions upon which LBHI will rely at trial:

(1) Section 4.04(b)[334] ("Title: No Prior Transfer of Claims") provides that:

"*no UK Affiliate may...assign...any of the claims...that are released hereunder...provided that after the Effective Date the UK Affiliates may...assign...any of the Allowed Claims*".

(2) Section 5.04(a)[335] ("Title: No Transfer of Claims") provides that:

"*Each Debtor (i) owns all claims it may have against any UK Affiliate, including all claims released hereunder, free and clear of any and all liens, claims, setoff rights, security interests, participations or encumbrances created or incurred by such Debtor....*".

496. LBHI's position is that both of these provisions were breached or false if and to the extent that LBUKH's subsequent transfer of its claim against PLC to LBHI resulted in a retrospective release.

The Expert Evidence

497. Article 12 provides that the Settlement Agreement is governed by the laws of New York and the Bankruptcy Code.

498. Pursuant to the order of Mann J dated 24 July 2018, LBHI and Deutsche Bank were given permission to adduce expert evidence of US law. Pursuant to the Order of Hildyard J

334 **[E/T16/493-4]**.
335 **[E/T16/495]**.

dated 31 July 2019, the Court circumscribed the questions for consideration by the US law experts as being ("**the Expert Issues**")[336]:

(1) What are the rules of contractual interpretation under New York law and the Bankruptcy Code, insofar as relevant and applicable to the interpretation of Section 8.02 of the Settlement Agreement?

(2) As a matter of New York law and the US Bankruptcy Code, is extrinsic evidence admissible for the purpose of interpreting the scope of the Settlement Agreement, and in particular Section 8.02? If so, on what basis?

499. LBHI and Deutsche Bank have both produced expert reports on the Expert Issues. These are:

(1) For LBHI: the report of Allan L. Gropper dated 5 June 2019 ("**the Gropper Report**") **[D/V1/1]**. Judge Gropper is a member of the bar of the State of New York and a retired judge of the Bankruptcy Court of the Southern District of New York. In his capacity as a judge of the Bankruptcy Court, Judge Gropper authored several opinions to determine cases arising out of the scope of releases under New York law, including: Chapter 7 Trustee v Greenwich Insurance Co (In re Actrade Financial Technologies) **[D/V2/74]** (in which he did *not* enforce a general release); and T-Bone Restaurant LLC v General Electric Capital Corp (In re Glazier Group Inc) **[D/V2/79]** (in which he held that the release covered claims arising *prior to but not after* the date of the release).

(2) For Deutsche Bank: the report of Robert S. Smith dated 6 June 2019 ("**the Smith Report**") **[D/V1//2]**. Judge Smith is a member of the bar of the State of New York and a former Associate Judge of the New York Court of Appeals.

500. The Experts met on 24 June 2019 to discuss their reports. As a result of their meeting and subsequent correspondence, they have agreed and produced a "Joint Report of Experts" dated 25 July 2019 ("**the Joint Report**") **[D/V1/4]**. This contains, as per paragraph 18 of the Mann Order, a list of areas where the Experts agree, and a list of areas where they do not agree (including a brief summary of the reasons for their disagreement).

336 **[A/T12/227-8]**.

Areas of Agreement

501. Joint Report, [4]-[11] **[D/V1/4]** sets out the agreed general principles of contract law under New York law, including:[337]

(1) A contract must be construed as a whole, giving effect to all its provisions.

(2) A contract should be interpreted to avoid unfair or anomalous consequences. Parties to an agreement are presumed to act sensibly in regard to it, and an interpretation that produces an absurdly harsh result or a forfeiture is to be avoided.

502. Joint Report, [12]-[17] **[D/V1/4]** sets out the agreed principles governing the interpretation of releases. These include the following:

(1) In determining what claims are covered by a release, New York courts will consider the *purpose* for which the release is executed and the intention of the parties, in each case as expressed by the language of the release and the contract within which the release is found.

(2) Where appropriate, New York courts will, based on the intent of the parties as inferred from the context of the release, limit the effect of general releases containing broad language. A general release will be limited to the claims that were within the contemplation of the parties at the time the release was executed.

(3) A broad release will be given effect, regardless of the parties' unexpressed intentions, but in certain cases may be read not to cover matters which the parties did not desire or intend to dispose of. In such cases a general release will be limited to the claims that were within the contemplation of the parties at the time the release was executed.

503. Joint Report, [18]-[20] **[D/V1/4]** sets out the agreed principles governing the admission of extrinsic evidence.

(1) Where a contract is ambiguous, parol evidence of prior or contemporaneous conversations, negotiations and agreements are admissible to clear up the ambiguity.

337 These will be familiar to an English judge, as Mann J explained in Citibank v Oceanwood [2018] EWHC 448 (Ch) at [42].

(2) Post-transaction conduct used to interpret what the parties understood the agreement to mean is referred to as the parties' "practical construction" of an agreement. Isolated, inconsistent or equivocal conduct does not qualify as practical construction

Areas of Disagreement

504. Joint Report, [21]-[26] **[D/V1/4]** sets out the areas of disagreement in relation to the interpretation of releases.

505. The first issue relates to carve-outs from general releases. In summary:

(1) Judge Gropper's opinion (Gropper Report, [47]) **[D/V1/1]** is that the words of a general release will be limited by a Recital where there is nothing on the face of the agreement which otherwise indicates that matters other than those in the Recitals are intended to be discharged.

(2) Judge Smith's opinion (Smith Report, [38]) **[D/V1/2]** is that the Recital of particular released claims in a general release will not be read to imply the exclusion of other claims not recited from the scope of the release.

506. Though this is a matter for oral evidence, Judge Gropper's evidence is as follows:

(1) A release may not be read to cover matters to which the parties did not desire or intend to dispose of (Consolidated Edison Inc v Northeast Utilities 332F Supp 2d SDNY 2004) **[D/V1/58]**. The meaning and coverage of a general release depends on the controversy being settled and upon the purpose for which the release was actually given (In re Mercer 141 AD 3d 594 2nd Dept 2016) **[D/V2/88]**.

(2) It was the duty of any party who desired to expand the Release beyond the claims which were "outstanding" among the Debtors and the UK Affiliates at the time of the execution of the Release to have so specified in the Release itself (Haskell v Miller 221 App Div 48 1st Dept 1927) **[D/V1/9]**.

507. The second issue relates to the unliquidated and unmatured claims.

(1) Judge Gropper's view (Gropper Report, [42], [44]-[49]) **[D/V1/1]** is that unliquidated and unmatured claims (for example, as in the Release Clause, claims that are "accrued or unaccrued, matured or unmatured, fixed or contingent,

liquidated, certain or contingent") do not encompass claims held by a third party at the time of the release (but which are acquired later by the releasor).

(2) Judge Smith's view is that such claims may include claims not accrued at the time of the release, and that it would not be accurate to say that such claims were limited to "*claims that a releasor held at the time the release was granted*".

508. Again, this is a matter for cross-examination. Judge Gropper's position is that the purpose and context of the Settlement Agreement was the release of "outstanding claims" between the Debtors and the UK Affiliates (other than the extant "Excluded Items", which the parties chose to defer to be addressed later in time). It is clear from the Settlement Agreement that the compromise of after-acquired claims was not within the contemplation of the parties at the time the release was executed.

509. Further, Joint Report, [27]-[36] **[D/V1/4]** sets out areas of disagreement in relation to the admission of extrinsic evidence, the nature of subrogation and the California case of In re Professional Satellite and Communications LLC, 2017 WL 4286995 SD Cal Sept 27 2017 **[D/V2/89]**.

510. The areas of disagreement in relation to extrinsic evidence relate to the parol evidence rule are, in summary, as follows:

(1) Judge Gropper's opinion (Gropper Report, [39], [42]-[46]) **[D/V1/1]** is that the rule has frequently been modified by the New York courts, and does not bar evidence as to what was within the contemplation of the parties as to the scope of the release. Further, whether or not the contract is ambiguous, the rule does not bar evidence of the parties' "practical construction" of the agreement, which has been held to be "*compelling evidence*" of the parties' intent. The parties subsequent conduct has frequently been held to be good evidence of their original contemplation as to the scope of the release (Gropper Report, [25]-[26], [39]) **[D/V1/1]**.

(2) Judge Smith's opinion (Smith Report, [33]) **[D/V1/2]** is that the parol evidence rule applies as much to releases as it does to other contracts. Further, the parol evidence rule is a bar to evidence of post-transaction events. The parties' practical construction is only considered where an agreement is found to be ambiguous.

511. As set out below, and given the volume of evidence, this is not an issue which the Court needs to consider or determine. Either Section 8.02 is clear and unambiguous – in which case, evidence of subsequent conduct is irrelevant any way – or is it unclear and ambiguous – in which case evidence of subsequent conduct will be of possible relevance and assistance to the Court. A debate about whether extrinsic evidence is admissible where a provision is clear and unequivocal is ultimately an arid one that is of academic interest only.

512. In relation to subrogation, in summary.

(1) In Judge Gropper's view (Gropper Report, [49]-[50]) **[D/V1/1]**, claims based on rights of subrogation are not under New York law similar to after-acquired claims because they are contingent and unliquidated but held by the releasor at the date of the release.

(2) Judge Smith's view (Smith Report, [51]) **[D/V1/2]** is that rights of subrogation are comparable to after-acquired claims because they have not matured or accrued at the date of the release.

513. In relation to <u>In re Professional Satellite</u>, which is the only case at all cited by Deutsche Bank for the proposition that a release can be extended to include after-acquired claims:

(1) In Judge Gropper's opinion (Gropper Report, [55]) **[D/V1/1]**, the facts of the case demonstrate that the commercial purpose of the relevant settlement could have been fulfilled only by a finding that an after-acquired claim had been released. The case (which is California decision that has never been cited in New York) was very obviously decided on special facts that are of no application in the current case.

(2) In Judge Smith's view (Smith Report, [43]-[45]) **[D/V1/2]**, while not binding on the New York courts, the decision is well reasoned and would be accepted by a court applying New York law.

514. These further issues will be matters for cross-examination at trial.

Ordinary meaning: the PLC Sub-Debt has not been released

<u>LBHI Position</u>

515. LBHI's position is clearly stated at Joint PP, [35]-[40] **[A/T5/81-85]** and Reply PP, [59]-[64] **[A/T10/206-211]**.

516. In relation to the ordinary meaning of the agreement:

(1) The Recitals to the Settlement Agreement very clearly delineate the scope of the compromise contemplated by it. The parties intended to compromise "*all disputes and all other outstanding issues*" based on the proofs of debt and other correspondence exchanged between the Debtors and the UK Affiliates. The Recitals do not contemplate the release of after-acquired claims.

(2) The release of the PLC Sub-Debt was (very clearly) not in the contemplation of the parties at the time of the Settlement Agreement (<u>Mangini v McClurg</u> 24 NY 2d 556) ; <u>Consolidated Edison Inc v Northeast Utilities</u>, 332F Supp 2d 639). The meaning and the coverage of a general release depend upon the controversy being settled and the purpose of the release (<u>In re Mercer</u>, supra). The Court of Appeals of New York has cautioned that a release should not be read to cover the claims which the parties clearly did not intend to waive (<u>Lucent Technologies</u>, supra). The purpose of the Settlement Agreement was to deal with extant and "outstanding claims",[338] not after-acquired claims, and the parties to it clearly did not intend to waive after-acquired claims acquired many years later from third parties.

(3) At the Effective Date of 6 March 2012, the PLC Sub-Debt was held by the original lender, LBUKH. Both LBUKH and PLC are UK Affiliates for the purposes of the Settlement Agreement. The Recitals do not contemplate the release by one UK Affiliate of claims against another UK Affiliate i.e. they do not contemplate the release of the PLC Sub-Debt.

(4) The Settlement Agreement does not refer to the release of after-acquired claims. Indeed, key provisions suggest the reverse. Section 4.04(b) ("*no Affiliate*

[338] Similarly, in <u>In re Mercer</u>, the Court relied on express language in the release that it purported to "*resolve any and all claims and disputes raised or which could have been raised by the parties*" (Gropper Report, [30]): however, that referred to extant claims, not after-acquired claims.

may...assign......any of the claims..... that are released hereunder") envisages that claims being released are ones held by the parties at the Effective Date; and Section 5.04(a) ("*Each Debtor (i) owns all claims it may have against any UK Affiliate, including all claims released hereunder*") also envisages that the only claims being released are ones that are held at the Effective Date. Both clauses offer very strong support for LBHI's construction. As Judge Gropper states, these representations would have essentially been false if LBUKH's transfer of the claim against PLC resulted in a retroactive release (Gropper Report, [43]).

517. In relation to the commercial purpose of the releases in the Settlement Agreement, their purpose was for the Debtors to release the UK Affiliates; and for the UK Affiliates to release the Debtors. The objective aim of the Settlement Agreement was not for the UK Affiliates to release other UK Affiliates.

<u>Deutsche Bank Position</u>

518. Deutsche Bank's position is set out at DB PP, [26]-[32].

519. Remarkably, Deutsche Bank raised its release argument for the first time approximately 1 month before the issue of the PLC Application. The construction advanced is plainly at odds with the intention and purpose of the Settlement Agreement, and is obviously absurd. It should be dismissed in short order.

520. Deutsche Bank is arguing in substance that a circa US$2 billion claim was forfeited merely because it was assigned to another party. Such a release would effectively amount to a waiver for no economic value, which would be very unusual (Geraghty 2, [52]). Under New York law a contract should be interpreted to avoid unfair or anomalous consequences (Joint Report, [11]; Gropper Report, [40], [54]); and New York law abhors a forfeiture (Gropper Report, [40]). It is inconceivable that sophisticated parties advised by lawyers would have bargained away a US$2 billion claim without any monetary consideration (<u>Consolidated Edison</u>, supra).

521. Deutsche Bank's textual argument is largely based on two points.

522. *First*, Deutsche Bank relies on the apparent breadth of the expression "*all Causes of action.... whether.... accrued or unaccrued, foreseen or unforeseen, foreseeable or unforeseeable, known or unknown, matured or unmatured, fixed or contingent.....* ***in each case, that arise from, are based on, connected with, alleged in or related to any facts or circumstances in existence prior to the date hereof***" (emphasis added).

523. It argues that "*any claim in respect of the PLC Sub-Debt arises from, is based on, connected with, alleged in or related to facts or circumstances in existence prior to the date of the Settlement Agreement because* ***such claims arise from sums advanced to PLC prior to the Settlement Agreement under facility agreements entered into prior to the Settlement Agreement***" (DB PP, [31.2]) (emphasis added).

524. This is misconceived:

(1) The Recitals state at most that the settlement was designed to "*resolve all disputes and all other outstanding issues*" among the Debtors and the UK Affiliates (Gropper Report, [31]).

(2) Unknown, unforeseen and unforeseeable claims are claims that the releasor possesses at the time the release is executed but of which he is unaware. These are not the same as after-acquired claims, which are not even held by the releasor at the time of the release (Gropper Report, [31]).

(3) A party can only release claims that it has the power to release, and even the broadest release does not release a claim belonging to another person (Gropper Report, [42]).

525. *Second*, Deutsche Bank contends that (a) where particular claims are not explicitly carved out of a general release, they will be deemed to be included in it (DB PP, [27.3]; Smith Report, [38]); and (b) the PLC Sub-Debts are not expressly carved out of the release in the words "*except with respect to (1) the Allowed Claims and the Admitted Claims and any rights and distribution entitlements in respect thereof, (2) the agreements, promise, settlements, representations and warranties set for in the Agreement, (3) the performance of the obligations set forth herein and (4) the Excluded Items*".

526. Again, this is misconceived:

(1) This is an overly broad statement of the law (Gropper Report, [32]-[33]). In fact, none of the cases relied upon by Deutsche Bank support this as an invariable rule; and none of them concern after-acquired claims.

(2) The main decision relied upon (Hack v United Capital Corp 247 AD 2d 300) did observe that generally releases can be construed broadly to cover "all" claims: critically, though, the decision cited Mangini v McClurg (see above) for the proposition that a release can be avoided if it "*does not represent the intent of the parties*"; and, even more significantly, the Court noted that a release ordinarily covers claims or causes of action "***arising prior to its execution***" (emphasis added).

(3) Accordingly, very limited weight is to be attributed to the fact that after-acquired claims are not expressly carved out in Section 8.02. The absence of a carve-out in relation to after-acquired claims does not mean they were implicitly included in the release; rather that they formed no part of its purpose whatsoever, fell outside its scope, and did not need to be carved out.

527. Deutsche Bank makes several other textual points, which are again wrong: see Reply PP, [62].

(1) Deutsche Bank says that the "*occurrence of the Effective Date took place on 6 March 2012*" and that this was a condition precedent to the release which has been satisfied DB PP, [31.1]. The wording militates against Deutsche Bank's position. It indicates that the release took effect "*Upon*" the Effective Date and extended only to Causes of Action held by the Debtors on the Effective Date (Deutsche Bank omits the word "*Upon*"). The wording is not a condition precedent.

(2) Deutsche Bank says that the PLC Sub-Debt arises from "*facts or circumstances in existence*" prior to the date of the Settlement Agreement i.e. the sums advanced under the PLC Sub-Debt were first advanced in 2004. This misconstrues the phrase "*facts or circumstances in existence*". There was no factual or legal nexus between LBHI and PLC with respect to the PLC Sub-Debt before the Settlement Agreement, and therefore no Cause of Action between them with respect to the PLC Sub-Debt that could be the subject matter of the Settlement Agreement.

(3) Deutsche Bank says that there is no temporal restriction in Section 8.02. This puts the cart before the horse. The issue is not whether after-acquired claims are excluded from the scope of Section 8.02; but whether the ambit of the Section

8.02 release extends to claims acquired by the Debtor more than 5 years after the Effective Date.

(4) Deutsche Bank says that by Section 8.02(iii) LBHI agreed that the Causes of Action released included "*claims based on an asserted right of subrogation..... based upon any guarantee or similar document by LHBI*"; that this refers to Causes of Action that LBHI could acquire by subrogation only after the date of the Settlement Agreement; and that this shows that Section 8.02 is concerned with after-acquired claims. This is factually and legally wrong. These claims were not acquired by LBHI after the Effective Date, they were the legal incidents of guarantees issued, or allegedly issued, by LBHI prior to the Effective Date of the Settlement Agreement ("**the LBHI Guarantees**"). Under US bankruptcy law, Guarantee Rights and Obligations are not considered to be future-acquired claims (Gropper Report, [50]). They exist at the time the release is given.

528. Finally, Deutsche Bank relies upon Re Professional Satellite, the California case which held that a release had the effect of releasing a claim subsequently assigned to the releasing party.

529. In that case, there were two claims against the company ("Claim 41" and "Claim 50"). Both were covered by the relevant Settlement Agreement. The Settlement Agreement provided that to the extent one debtor, Schiff, made a payment on Claim 50 it would result in a credit in relation to Claim 41. Separately, Claim 41 was assigned to Schiff. Thus, if Claim 41 had not been released, Schiff would be entitled to claim the credit resulting from Schiff's payment on Claim 50. It was held that the release included Claim 41 in Schiff's hands. Otherwise Schiff would have recovered the benefit of payments it made under the Settlement Agreement.

530. LBHI's position is as follows (Gropper Report, [55]):

(1) The Bankruptcy Court found (page 4) that the creditor's "*attempt to back door claim against [the debtor] by subsequently acquiring from [a co-obligor] its proof of claim [] against [the debtor] (for no monetary consideration) is, in the Court's view, a violation of the spirit of the SA [Settlement Agreement]. As the parties agreed in the SA, the only possible avenue for the [creditor] to retain a claim against [the debtor] was for [the creditor] to have paid [its co-obligor's]*

claim and then make a claim against [the debtor] for the aliquot portion". It did not do so and was deemed to have released the claim.

(2) The case was decided on its own, very special facts.

(3) The case is of no application in the current context (which does not involve evidence of duplicitous conduct in relation to the assignment of claims) and does not assist.

531. Deutsche Bank does not seriously address the issue of the commercial absurdity of the construction it advances. Its only argument appears to be that the non-release of the PLC Sub-Debt would undermine the fundamental commercial purpose of the Settlement Agreement by leaving in place a substantial inter-company liability between LBHI and PLC (DB PP, [32.2] **[A/T8/138-9]**). That is simply wrong. The Recitals to the Settlement Agreement (and Geraghty 2) show that the purpose of the agreement was to compromise claims between the Debtors and the UK Affiliates that were "*outstanding*" at the date of the agreement; not to release after-acquired claims of LBHI obtained from the UK Affiliates some 5 years later through a series of assignments (Geraghty 2, [53]-[58] **[C/T7/100-1]**). Further, a number of LBHI's claims were not released, as set out in Schedule 10, including a claim by LBHI against PLC for $63,893,551 (Joint PP, at [39.4]).

<u>Conclusions</u>

532. LBHI's interpretation is plainly preferable as a matter of the ordinary meaning of the words (taking account also of commercial considerations).

533. Further and in any event, Article 25 of the Settlement Agreement contains a "no third-party beneficiary clause" excluding any third-party rights under the Settlement Agreement. Deutsche Bank's arguments as a matter of New York law amount to a third party seeking to enforce a release under the Settlement Agreement for its own benefit: and are therefore in contravention of Article 25.

Settlement Agreement: Subsequent Conduct

534. Both LBHI and Deutsche Bank seek to rely upon the subsequent conduct of the parties in connection with the Release Issue.

535. However, Deutsche Bank seeks to do so having now withdrawn the only witness evidence in support of its case i.e. Sutton 2. Having done so, it is unclear how Deutsche Bank can continue to advance this argument *at all*.

536. The PLC Sub-Debt was assigned to LBHI in 2017, over 5 years after the Settlement Agreement became effective. It was transferred initially from LBUKH to LBLIS; then from LBLIS to LBDI; and from LBDI to LBHI (Geraghty 2, [53]-[58]). The Notice of Assignment was signed by Ms Bruce on behalf of the PLC Joint Administrators. She acknowledged the assignment and agreed that all dividends and/or payments due to LBDI in respect of the PLC Sub-Debt would be paid directly to LBHI.

537. In any event, Deutsche Bank's new "Release Argument" runs directly contrary to the actual treatment of after-acquired claims as between LBHI and the UK Affiliates.

538. LBHI relies on a Claims Schedule which shows that claims against the UK Affiliates with a nominal value of £4.2 billion and €180 million have been assigned to LBHI since the Settlement Agreement. By paying distributions of approximately £955 million and €72 million on the claims post-transfer, the UK Affiliates have demonstrated by their conduct that the claims were not released upon the transfer to LBHI (Geraghty 2, [61] **[C/T7/101]**).

539. The evidence from the Claims Schedule – a few examples of which are set out below – points overwhelmingly to the conclusion that the Settlement Agreement does not release after-acquired claims.

<u>After-Acquired LBIE Claims</u>

540. LBHI has acquired claims against LBIE after the date of the Settlement Agreement with a total notional value of £568 million (**"the After-Acquired LBIE Claims"**) (Geraghty 2, [63]-[66] **[C/T7/102-3]**). The original owners of these claims were third party creditors and UK Affiliates. The LBIE Scheme was sanctioned in June 2018. LBHI was permitted by the LBIE administrators to vote in relation to the After-Acquired LBIE Claims, and they were ultimately paid out and compromised under the LBIE Scheme, with LBHI receiving distributions in respect of statutory interest of approximately £249 million.

541. Deutsche Bank raised certain objections to the LBIE Scheme but did not argue that LBHI's claims had been released under the Settlement Agreement nor that such a release should prevent LBHI from Voting in favour of the scheme. Further, none of the parties to

the Settlement Agreement argued that the After-Acquired LBIE Claims had been released and the claims have now all been paid in full.

LBHI2 Loan

542. On 16 September 2016 LBHI as borrower entered into a term loan facility agreement with LBHI2 Financing Limited (a wholly owned subsidiary of LBHI2) as lender (**"the LBHI2 Loan"**) (Geraghty 2, [67]-[69] **[C/T7/103-4]**). LBHI assigned a number of the After-Acquired LBIE Claims to LBHI2 Financing Limited by way of security, with admitted total notional value of approximately £250 million. If LBHI2 Financing Limited or the LBHI2 administrators had considered them to be released, they would have had no value as security. Further, the LBIE Joint Administrators acknowledged the assignment and reassignment of these claims. This shows that they did not consider them to have been released when originally transferred to LBHI.

LBL Claims

543. LBHI has acquired claims held by the third parties against LBL (another UK Affiliate) after the date of the Settlement Agreement: for example, in 2017 LBHI acquired certain claims held by a third party against LBL (**"the LBL Claims"**) (Geraghty 2, [70] **[C/T7/104]**).

544. In February 2017, Mike Jervis, on behalf of the joint administrators of LBL (**"the LBL Joint Administrators"**) acknowledged the assignment to LBHI and agreed to admit the claims against LBL (Geraghty 2, [71]-[73] **[C/T7/104]**). The LBL Joint Administrators have not suggested that these claims have been released on assignment to LBHI. On 6 August 2018 Sidley (for Deutsche Bank) wrote to Dechert (for the LBL Joint Administrators) stating that the LBL Claims must have been released under the Settlement Agreement. Dechert responded on 6 September: "*our clients have admitted and paid distributions…in full knowledge of the Settlement Agreement,…it is evident from that conduct that the LBL Joint Administrators did not consider the Settlement Agreement to have released such claims*".

545. LBHI has received distributions of approximately £100 million in respect of the LBL Claims (Geraghty 2, [74] **[C/T7/105]**).

Subsequent conduct: the PLC Sub-Debt has not been released

546. There is a dispute between the experts about whether evidence of subsequent conduct is admissible in all circumstances (i.e. irrespective of ambiguity). However, as explained above, this is an academic debate the Court does not need to resolve. This is because:

(1) If the clause is clear and unequivocal, the Court does not need to refer to evidence of subsequent conduct in any event.

(2) If the clause is unclear and equivocal, is it common ground that the Court can consider extrinsic evidence as part of its "practical construction".

547. The subsequent conduct of the parties is clear and unequivocal and overwhelmingly favours the LBHI construction i.e. that Section 8.02 does not release after-acquired claims.

548. Deutsche Bank advances two further arguments (DB PP, [32.3] **[A/T8/139]**).

549 The first of these is a settlement agreement between, amongst others, LBIE and LBHI dated 10 October 2014 (**"the STG Agreement"**)[339]. Clause 5.1 provides that each "Agreed Proof Creditor's Admitted Claim is assigned to LBHI" subject to the proviso that "any releases in the 2011 Settlement Agreement shall not apply to the Agreed Proof Creditors' Admitted Claims"[340]. The point advanced is that this is consistent with LBHI practically construing Section 8.02 as applying to after-acquired claims. This is incorrect:

(1) John Keen (who negotiated the STG Agreement for LBHI) does not recall any of the parties to the agreement asserting that, in the absence of the words in Clause 5.1, the claims would be released (Geraghty 2, [77] **[C/T7/105]**).

(2) These words were "belt and braces" rather than reflective of a practical construction by LBHI.

(3) The STG Agreement did not form part of the same transaction and is therefore inadmissible and/or irrelevant as a matter of New York law (Gropper Report, [57]).

339 **[F/V9/4886-4949]**.
340 **[F/V9/4900]**.

550. The second of these is the settlement agreement between, amongst others, LBHI, the same "Debtors" under the Settlement Agreement and Deutsche Bundesbank dated 11 October 2011 (**"the DBB Agreement"**)[341]. The DBB Agreement expressly excluded "*future assigned*" claims from the scope of the release. The point advanced is this exclusion must show that, where LBHI intended that a release did not apply to future assigned claims, that intention was expressly recorded in an agreement. This analysis suffers from several obvious deficiencies (not least that the DBB Agreement *pre-dates* the Settlement Agreement, and so is not evidence of *subsequent* conduct at all):

(1) The DBB Agreement was negotiated between different parties, in a different situation, and is therefore inadmissible. It did not form part of the same transaction, and therefore a New York court would conclude that the DBB Agreement is inadmissible/irrelevant as a matter of New York law (Gropper Report, [57]).

(2) The exclusion of Acquired Other Creditor Claims from the release in Clause 7.2 of the DBB Agreement merely reflects that the acquisition of future claims by Deutsche Bundesbank was a matter the parties to that particular agreement chose to address expressly (Geraghty 2, [79] **[C/T7/106]**).

551. The two points advanced by Deutsche Bank are, at best, "*isolated, inconsistent and equivocal*", and therefore do not qualify as practical construction (see Joint Report, [20]).

Conclusions

552. This is a straightforward point, and the ordinary meaning of Section 8.02 and commercial considerations militate in favour of LBHI's construction. However, to the extent the Court wishes to consider the further issue of subsequent conduct, the evidence of the subsequent conduct of the parties to the Settlement Agreement clearly and unequivocally shows that there was no intention to release after-acquired claims under the Settlement Agreement.

Deutsche Bank's Alternative Argument

553. If (as LBHI contends is self-evident) Deutsche Bank is wrong about the Settlement Agreement, Deutsche Bank advances a further, alternative argument, that LBHI's claims

[341] **[F/V7/3714-3739]**.

under the PLC Sub-Debt have in any event been released in-part (if not in full) as a result of the LBHI Guarantees: see DB PP, [33] **[A/T8/140-1]** (**"the Alternative Release Argument"**).

554. The Alternative Release Argument from Deutsche Bank appears to run as follows:

(1) Under Section 2.04 of the Settlement Agreement, LBHI allowed a claim under the LBHI Guarantees by LBUKH, as original lender of the PLC Sub-Debt (**"the LBUKH Allowed Claim"**).

(2) LBHI has made distributions under the LBUKH Allowed Claim in the sum of over $216 million.

(3) The effect of such payment was to release or otherwise diminish the amount of any claim that LBHI can assert as the assignee of LBUKH under the PLC Sub-Debt (purporting to draw support from Re Blakeley (1892) 9 Morr 173; Re Amalgamated Investment and Property Co Ltd [1985] Ch 349).

(4) Any secondary claim that LBHI may otherwise have against PLC by way of subrogation is released by Section 8.02(iii) of the Settlement Agreement.

Applicable Legal Principles

555. The starting point is the well-established principle that a creditor is entitled to prove for the full amount of its debt in the insolvency of the debtor, notwithstanding that payments have been made by a surety in respect of such claim (unless and until the creditor has been paid in full).

556. This principle is derived from the case of Re Sass [1896] 2 QB 12. In Re Sass:

(1) A surety guaranteed a bank the payment of *all* sums of money owed by the bank's customer ("S") – being £755 – albeit the recoveries were not to exceed £300. S became bankrupt. The surety paid the bank £300 under the guarantee. The bank claimed to prove in the bankruptcy for the entire £755. The trustee rejected the proof of debt (on the basis that it should be reduced by the amount received from the surety).

(2) The Court (Vaughan Williams J) concluded that the trustee was wrong to do so. In doing so, it reasoned that: on the construction of the guarantee, the surety was

surety for the whole of the debt; the right of subrogation only arises where the surety has paid the whole the debt; as the surety had only paid part of the debt, he had no right to prove in priority to the bank; and the debtor's liability remained unaffected by the arrangement between the bank and the surety, so that the bank could prove against the debtor for the whole amount.

557. This principle has been restated and followed many times. For example:

(1) In Ulster Bank v Lambe [1966] NI 161, Lowry J said that:

"The true principle is that where the entire debt is guaranteed, with or without limit, the creditor can sue the principal debtor, or claim in his bankruptcy, for the full amount of the debt, despite any payments on foot of a guarantee, whether they are made before or after the principal debtor's bankruptcy, provided these payments in the aggregate fall short of the full amount of the debt".

(2) In Sugar Hut Brentwood Ltd v Norcross [2008] EWHC 2634 (Ch) Kitchin J said that:

"Finally, where a guarantor guarantees the whole of the principal debt as opposed to part, but his liability is limited to a maximum amount and he pays that maximum amount, then the creditor is entitled to prove for the full amount of the debt in the principal's insolvency and the guarantor may not prove in the insolvency for the amount he has paid until the creditor has been paid the entirety of the debt: In re Sass [1896] 2 QB 12. This principle is expressly reflected in the terms of the guarantees to which I have referred".

558. See also The Law of Guarantees (Millett & Andrews, 7th edition, 13-007):

"...where the principal is insolvent and the surety makes a part payment to the creditor before the creditor has been paid a dividend, the rule is that the surety has no right to prove and the creditor does not have to give credit by reducing his proof by the amount received from the surety, so long as the creditor does not receive more than 100 pence in the pound....... The basis of the rule is that the surety has undertaken to be responsible for the full sum guaranteed, including whatever may remain due to the creditor after receipt of dividends in the principal's insolvency and cannot prove (or more correctly, receive a dividend) in

competition with the creditor for a right of indemnity. Since the creditor is himself entitled to prove for the whole amount without giving credit for sums received from the surety, the rule against double proof will, upon the creditor proving for the full amount of the debt, preclude the surety from providing....in relation to the part paid".

559. The case has also been cited without criticism in (amongst others): Barclays Bank Ltd v TOSG Trust Fund Ltd [1984] AC 626 (HL); In re MF Global UK Ltd (in special administration) (No 4) v Attestor Value Master Fund LP [2013] EWHC 2256 (Ch).

560. The principle remains good law.

Application of Re Sass

561. The correct analysis, applying the principle is Re Sass, is therefore as follows:

(1) The LBHI Guarantees were for the full amount of the PLC Sub-Debt.

(2) Prior to the assignment, LBUKH would still have had the right to prove against PLC for the full amount of the PLC Sub-Debt.

(3) After the assignment, LBHI has the right to prove against PLC for the full amount of the PLC Sub-Debt.

(4) However, the rule against double proof prevents LBHI from submitting a proof for the full amount of the PLC Sub-Debt and for the amount paid to LBUKH under the LBHI Guarantees.

Deutsche Bank Position

562. Deutsche Bank argues that the effect of the payment of $216 million to LBUKH was to release or otherwise diminish the amount of any primary claim that may be asserted by LBHI as assignee of LBUKH under the PLC Sub-Debt. It does not cite the decision in Re Sass (or seek to argue that it does not apply): instead, it relies on two further cases: Re Blakeley (1892) 9 Morr 173; and Re Amalgamated and Property Co Ltd [1985] Ch 349.

563. These cases are authority for the proposition that (a) a creditor has a right to prove against both a surety and the principal debtor and (b) a proof in the surety's estate is reduced by any receipts or dividends from the principal's estate prior to but not after proof.

564. In Re Blakeley (1892) 9 Morr 173 (decided 4 years before Re Sass, by a panel including Vaughan Williams J), the Court considered the effects of the bankruptcy of a **surety** (rather than the principal debtor). It found that:

(1) Where a creditor proved against a bankrupt **surety**, if *prior* to proof the creditor has received part payment, the creditor will have to deduct the amount paid.

(2) Where a creditor proved against a bankrupt **surety**, if *after* proof the creditor has received part payment, the creditor will not have to deduct the amount paid.

565. The principle in Re Blakeley was upheld in Re Amalgamated and Property Co Ltd [1985] Ch 349, 385G (Vinelott J): "*grave injustices might therefore result in this and possibly other cases by the alteration in the practice of deducting only sums received and dividends declared before a proof is submitted*".

566. The position in the current case is plainly distinguishable. LBHI is seeking to prove in respect of a debt claim against the principal debtor (rather than the surety), in circumstances where the assignor (LBUKH) has previously received certain payments from LBHI in its capacity as guarantor. In this regard, the cases relied upon by Deutsche Bank do not assist, insofar as they concern claims against sureties (rather than principal debtors) so that the question of *when* the holder of the PLC Sub-Debt submitted its proof of debt is irrelevant.

567. Further, Deutsche Bank contends that any secondary claim LBHI may have against PLC by subrogation by reason of its payments under the LBHI Guarantees has been expressly released by Section 8.02(iii) of the Settlement Agreement. That is correct: but LBHI's claim against PLC is based on the PLC Sub-Debt (the primary claims) and not any right arising in connection with the LBHI Guarantees. This point is therefore misconceived.

Deutsche Bank's Further Alternative Argument

568. Finally, Deutsche Bank contends in the further alternative (DB PP, [33.6] **[A/T8/140-1]**) that pursuant to Paragraph 7(f) of the PLC Sub-Debt[342], the proceeds of the enforcement of any guarantee of the PLC Sub-Debt are held on trust for PLC such that "*LBHI's claims under the PLC Sub-Debt therefore fall to be reduced by the amounts that are or should be held on trust for PLC*".

569. The position is highly unsatisfactory:

(1) The argument is wholly unparticularised and unsupported by authority.

(2) This undermines the very purpose of the position paper procedure i.e. that the parties identify and describe (in outline at least) the arguments that they will advance at trial and provide the other parties with proper notice thereof.

(3) LBHI (which already has to reply to numerous arguments advanced by three parties in the litigation) will be seriously prejudiced by having to address this further argument (of which it has not had sufficient notice) at trial.

570. LBHI will make further submissions in relation to this further alternative argument once it has had sight of Deutsche Bank's skeleton argument.

571. However, if and to the extent that Deutsche Bank chooses not to advance the point in its skeleton argument, LBHI reserves the right to argue that Deutsche Bank is estopped from advancing this point in any subsequent proceedings on the grounds that to do so would be an abuse of process (as per the rule in Henderson v Henderson (1843) 3 Hare 100).

K. THE DISCOUNTING ISSUE

572. The Discounting Issue is as follows:

"*Within the administration of PLC, whether or not the quantum of PLC's liability under the PLC Sub-Notes for distribution purposes falls to be discounted under Rule 14.44 of the Insolvency (England and Wales) Rules 2016, or by reference to some other method and if so which method*".

342 This provides that from the Effective Date the Lender shall not "*take or enforce security, guarantee or indemnity from any person for all or any part of the Subordinated Liabilities, and the Lender shall, upon obtaining or enforcing any security, guarantee or indemnity notwithstanding this undertaking, hold the same (and the proceeds thereof) on trust for the Borrower*".

573. LBHI's position (Joint PP, [45] **[A/T5/87]**) is that the quantum of PLC's liability under the PLC Sub-Notes for distribution purposes falls to be discounted under Rule 14.44 of the 2016 Rules.

574. Deutsche Bank's primary position (DB PP, [54] **[A/T8/147]**) is that the quantum of PLC's liability under the PLC Sub-Notes for distribution purposes does not fall to be discounted under Rule 14.44 of the 2016 Rules, or otherwise, because PLC's liability is not, or should not be treated as, a future debt.

575. Alternatively, Deutsche Bank's position (DB PP, [55] **[A/T8/147]**) is that:

(1) In any event, PLC's liability under the PLC Sub-Notes, even if a future debt, is a non-provable debt, and therefore Rule 14.44 of the Rules is of no application;

(2) To the extent that PLC's liability under the PLC Sub-Notes is non-provable, it is either incapable of being subjected to a discount, alternatively can only be discounted at an appropriate commercial rate (being the Fixed/Floating 15-year Swap Rate, currently 1.0016% per annum); and

(3) If PLC's liability under the PLC Sub-Notes is treated as a future debt or liability for distribution purposes and subject to discounting (whether as a provable or non-provable debt or liability), PLC's liability for future interest in respect of the PLC Sub-Notes should also be admitted or accepted for distribution purposes, and subject to discounting in the same way (whether as a provable or non-provable debt or liability).

Rule 14.44 of the 2016 Rules

576. Rule 14.44 of the 2016 Rules ("Debt payable at future time") provides as follows:

14.44(1): *Where a creditor has proved for a debt of which payment is not due at the date of the declaration of a dividend, the creditor is entitled to the dividend equally with other creditors, but subject as follows.*

14.44(2): *For the purpose of dividend (and no other purpose) the amount of the creditor's admitted proof must be discounted by applying the following formula - $X/1.05^n$*

where– (a) "X" is the value of the admitted proof; and (b) "n" is the period beginning with the relevant date and ending with the date on which the payment of the creditor's debt would otherwise be due, expressed in years (part of the year being expressed as a decimal fraction of a year)."

577. The rationale for the discounting of future debts was described by David Richards J in <u>Waterfall I</u> at [77]:

"*......the contractual right of a creditor with a future debt is to payment on that due date, but not before it. In order to bring administrations and liquidations to a conclusion as quickly as practicable, future debts are discounted. The creditor receives the full present value of the debt, calculated as provided by the Insolvency Rules. The contractual rights of [contingent and] future creditors are clearly compromised by the insolvency process but their claims are, for the reasons I have given, properly regarded as paid in full.*"

Mandatory Application of Rule 14.44

578. The starting point is Lord Sumption's statement in <u>Waterfall I</u> (at [194]) that "*it is axiomatic that where the Insolvency Rules deal expressly with some matter in one way, it is not open to the courts to deal with it in a different and inconsistent way*".

579. The PLC Sub-Notes are provable future debts and fall within Rule 14.44 of the 2016 Rules (Joint PP, [44]-[46] **[A/T5/87-90]**).

580. First, to fall within Rule 14.44 the debt must be a debt for which payment is not due at the date of the declaration of a dividend. In relation to this:

(1) In the present case, payment on the PLC Sub-Notes will fall due on their "*Maturity Date*" and not be due until 2035 and 2036, respectively.

(2) The PLC Sub-Notes are provable debts (as to which, see below).

(3) On any view therefore, the PLC Sub-Notes fall within Rule 14.44.

581. Second, debts payable at a future time "***must be discounted***" by applying the formula in Rule 14.44. In relation to this:

(1) The discounting rule is mandatory.

(2) Where the 2016 Rules expressly deal with some matter in one way, it is not open to the courts to deal with that matter in a different and inconsistent way.

Application of Rule 14.44: the PLC Sub-Notes are Provable Debts

582. GP1's claims under the PLC Sub-Notes are provable debts under Rules 14.1 and 14.2 of the 2016 Rules.

583. Rule 14.1(3) provides that a "*debt*" in relation to an administration means, amongst other things, "*any debt or liability to which the company may become subject after the relevant date by reason of any obligation incurred before that date*". Rule 14.1(5) provides that for the purposes of references to "*debt or liability*" it is immaterial whether the debt or liability is present or future.

584. Rule 14.2(1) of the 2016 Rules provides that "*all claims by creditors except as provided in this rule, are provable as debts against the company... whether they are present or future, certain or contingent, ascertained or sounding only in damages*".

585. PLC was subject to a debt or liability in respect of the PLC Sub-Notes when it entered administration.

586. When each series of the PLC Sub-Notes was issued between March 2005 and 20 February 2006, PLC became subject to contractual obligations to redeem them at their principal amounts on the relevant maturity date, subject to Condition 3 and Condition 7: Condition 6(a) of the PLC Sub-Notes. The due dates of the PLC Sub-Notes are 30 March 2035, 21 September 2035 and 22 February 2036.

587. There can be no question that an obligation under a contract is an obligation for the purposes of Rule 14.1 of the 2016 Rules.

588. In Re Nortel GmbH [2014] AC 209 it was held that the statutory obligation arising from a contribution notice to make good a pension deficit arose by reason of an obligation incurred before the date on which the company went into administration. Lord Neuberger (with whom Lords Mance, Clarke and Toulson agreed) said that (at [75]):

"*Where a liability arises after the insolvency event as a result of a contract entered into by a company, there is no real problem. The contract, in so far as it imposes any actual*

or contingent liabilities on the company, can fairly be said to impose the incurred obligation".

589. The same is true of a future obligation arising as a result of a contract entered into by a company. Lord Sumption (with whom Lords Mance and Clarke also agreed) described an obligation arising in contract as the paradigm case (at [131]):

"*The paradigm case of an 'obligation'... is a contract which was already in existence before the company went into liquidation. It is implicit in the argument of those who contend on this appeal that there is no provable debt in this case that contract is not just the paradigm case but the only one*".

590. Subordinated debts drawn up on or based on FSA Standard Form 10 are provable debts.

591. Statutory interest is (in the event of a surplus) payable on subordinated debts issued on the same FSA Standard Form 10 in issue in this case (Waterfall I per Lord Neuberger at [70]). Statutory interest was and is only payable in respect of proved debts: Rule 2.88(7) of the Insolvency Rules 1986 (in issue in Waterfall I), and now Rule 14.23(7) of the 2016 Rules.

592. Further, as noted above at [46], in Waterfall I at [72] Lord Neuberger also restored paragraph (i) of David Richards J's Order at first instance to the effect that it was open to LBHI2 to prove for the subordinated debt after all 'Senior Liabilities' had been paid in full.

593. Accordingly, the PLC Sub-Notes (like all of the subordinated instruments in this case) are provable debts.

Deutsche Bank's Contention that the PLC Sub-Notes are "Presently Due"

594. Deutsche Bank contends (DB PP, [56] **[A/T8/147-8]**) that, as a matter of construction, the PLC Sub-Notes are current debts that should be admitted for their full, face amount and should not be discounted.

595. In the present case, it is plain that the Lehman Group specifically selected distant maturity dates 30 years in the future for the PLC Sub-Notes, as part of the structure that saw it issue *perpetual* securities in the form of the ECAPS.[343]

596. Contrary to the plain and obvious meaning of the instruments, Deutsche Bank advances at DB PP [56(1)-(6)] **[A/T8/147-9]** at least five arguments in support of its contention that the PLC Sub-Notes are somehow "presently due" (DB PP, [59] **[A/T8/150]**).

597. *First*, it is said that the Conditions of the PLC Sub-Notes anticipate either redemption at term (Condition 6(a): "Scheduled redemption") or immediate redemption at the full face amount (Condition 6(c), "Redemption at the option of the Issuer"); and if and to the extent that there is to be a payment in a distributing insolvency other than at term, such payment amounts, on its true construction, to redemption at the option of the Issuer for the purpose of Condition 6(c).

598. This is self-evidently wrong. The payment of a dividend by PLC's joint administrators is in no sense "*at the option of the issuer*" nor a "*redemption*" of the PLC Sub-Notes. Payment of a dividend under the Statutory Scheme is mandatory once the proof has been admitted, such that it is not at the issuer's "*option*" at all. Moreover, payments of dividends would be made in respect of GP1's *proved* claims under the PLC Sub-Notes and not in respect of its underlying claims, such that it could not sensibly be described as a "*redemption*" of the PLC Sub-Notes: see David Richards J in Waterfall IIA at [206]; and the Court of Appeal in Waterfall IIA at [57].

599. *Second*, it is said that a distributing insolvency process was neither intended nor contemplated in the drafting of Condition 6; and that it is clear from the terms of the PLC Sub-Notes, on their true construction, that they could only be treated as currently payable.

600. The parties deliberately selected distant maturity dates for the PLC Sub-Notes as part of putting in place a compliant regulatory capital structure for the Lehman Group. Further, it is plainly the case that the PLC Sub-Notes *did* address an 'Insolvency': see Conditions 3(a)(i) and (ii).

343 See the Lehman Group Presentation dated 25 February 2005 at page 3 **[F/V1/194]**: "*30-year **subordinated debt** is issued out of UK SPV...This sub-debt is purchased by a limited partnership that issues **perpetual** preferred securities to fund the purchase*" (emphasis added).

601. *Third*, it is argued that there is an obvious implied term in the PLC Sub-Notes that the amounts payable become immediately due and payable in their full, face value where PLC has entered into a distributing administration.

602. This is unsustainable. It runs contrary to the expressly stated maturity date of the PLC Sub-Notes. In this regard, it is a "*cardinal rule that no term can be implied into a contract if it contradicts an express term*": see Marks and Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2016] AC 742 at [28]. Moreover, any such implied term would have derogated from the limited 'permitted differences' granted by the FSA under the Waiver Directions.

603. *Fourth*, it is said that any attempt to redeem or pay the PLC Sub-Notes other than in accordance with Conditions (a)-(c) is a repudiatory breach of Condition 6(d), such that the Holder is entitled to accept the repudiation and prove for damages in an amount equivalent to the full, face value. In relation to this:

(1) This analysis is legally incoherent.

(2) Condition 6(d) provides that: "*No other redemption: The Issuer shall not be entitled to redeem the Notes otherwise than as provided in paragraphs (a)...to (c)..... above*".

(3) The rules relating to proof in a distributing administration are wholly unconnected to the contractual redemption obligations of the Issuer.

(4) There is no repudiatory breach to speak of, and it is not open to Deutsche Bank to accelerate their future debt claim by (incorrectly) seeking to convert it into a claim for present damages.

(5) Alternatively, to the extent that GP1 submits a proof in respect of the PLC Sub-Notes (as it must, in order to be entitled to be paid a dividend) then it will have triggered the very repudiatory breach of which Deutsche Bank complains, so as to amount to a waiver of that breach in any event.

604. *Fifth*, it is contended that the proposed constructions are all consistent with the regulatory regime i.e. IPRU(INV). This is simply incorrect. IPRU(INV) did not allow for acceleration. In this regard, IPRU(INV) 10-63(6)R states that "*a firm must not (except in accordance with the terms of the loan): (a) repay, prepay or terminate a long term*

subordinated loan before the agreed repayment date unless it has provided the FSA with at least five years' written notice".

Deutsche Bank's Contention that the PLC Sub-Notes should be made to be "Presently Due"

605. In addition, Deutsche Bank says (at DB PP [60] **[A/T8/150]**) that in order to avoid unfair harm and unfairness generally to the holders of PLC Sub-Notes, the Joint Administrators of PLC should act (and be directed to act) so as to make the PLC Sub-Notes currently due in their face amount.

606. There is no basis for the PLC Joint Administrators to adopt the course suggested by Deutsche Bank:

(1) The reliance Deutsche Bank places on paragraph 74 of Schedule B1 of the Insolvency Act 1986 is misconceived: see now Heis v Financial Services Compensation Scheme Ltd [2018] EWHC 1372 (Ch) at [143] per Hildyard J (overturned by the Court of Appeal on different grounds); and Lehman Brothers Australia Ltd (In Liquidation) v Lomas [2018] EWHC 2783 (Ch) at [61] per Hildyard J.

(2) Applying those two recent decisions, neither paragraph 74 nor the rule in *Ex parte James* is engaged in the present circumstances.

(3) The terms of the PLC Sub-Notes were freely accepted by the relevant Partnership/GP1 and PLC. There is no unfairness in the discounting of a future debt for the purpose of dividend. That is precisely what the Statutory Scheme envisages and was confirmed at all levels in Waterfall I: per David Richards J at [77]; per Lewison LJ at [94]; per Lord Neuberger at [105]. The sole effect of the PLC Joint Administrators making the PLC Sub-Notes currently due would be to increase the dividend payable on the PLC Sub-Notes, thus decreasing the dividend payable on the PLC Sub-Debt. This despite the fact that the PLC Sub-Debt has already matured and, subject to the subordination provisions, would otherwise be due.

(4) Deutsche Bank's contentions would be applicable in all cases where office-holders declined to exercise a contractual redemption clause on the grounds that there is an inherent unfairness under the Statutory Scheme applicable to future debts.

Conclusions on "Presently Due"

607. The PLC Sub-Notes are provable future debts. They should be discounted as is required under the 2016 Rules. This is the mandatory effect of the Rule 14.44. Deutsche Bank's contractual arguments are misconceived; and it cannot seek to improve the contractual/statutory position by citing notions of fairness and natural justice.

Deutsche Bank: arguments about "non-provable liabilities"

608. Deutsche Bank contends that the PLC Sub-Notes must necessarily be classified as non-provable liabilities (DB PP, [61]-[62] **[A/T8/150-1]**).

609. This is plainly wrong for the reasons stated above. It should be noted that no other Respondent to these proceedings contends that the subordinated debts in issue are non-provable liabilities.

610. *First*, Deutsche Bank states that the subordination provisions in Condition 3 provide for the payment of the PLC Sub-Notes after all "Senior Liabilities", being all "Liabilities" other than "Subordinated Liabilities" and "Excluded Liabilities"; and that "*Other Liabilities will therefore include any Statutory Interest, postponed debts, and other non-provable liabilities*".

611. This incorrectly suggests that e.g. postponed debts are not provable debts. That is not the case.

(1) Rule 14.2(4) provides for certain claims that "*are not provable until after all other claims of creditors have been in full with interest*".

(2) Rule 14.2(4)(b) provides for "postponed debts", which include "*in administration and winding up, a claim which by virtue of the Act or any other enactment is a claim the payment of which in a bankruptcy, an administration or a winding up is to be postponed*".

(3) One example of a postponed debt is a debt falling within Section 74(2)(f) of the Insolvency Act 1986 as a "*sum due to any member of the company (in his character of a member) by way of dividends, profits or otherwise*": see Soden v British & Commonwealth Holdings plc (in administration) [1998] AC 298.

612. *Second*, Deutsche Bank says said that Conditions 3 and 9 operate to preclude any claim being made in respect of the PLC Sub-Notes until all statutory interest and non-provable liabilities have been paid in full: Waterfall I (Supreme Court), at [69]. LBHI agree: it is evident from this that Lord Neuberger concluded that subordinated debts ranked after non-provable liabilities.

613. *Third*, Deutsche Bank refers to Lord Neuberger's observation in Waterfall I at [71] that "*On the face of it at any rate, it seems a little strange that a proof can be, or has to be, lodged for a debt which ranks after statutory interest (which can only be paid out of a "surplus") and non-provable liabilities. It may be that the proper analysis is that the subordinated debt is a non-provable debt which ranks after all other non-provable liabilities*". However, in relation to this:

(1) It was an *obiter dictum* upon which little weight should be placed ("*[i]t is unnecessary to decide that point, and, as it was not argued, I say no more about it*").

(2) The observation is at odds with the *ratio* of his Lordship's judgment that the subordinated debts in question were provable debts.

(3) Contrary to Lord Neuberger's observation, there is nothing strange about multiple rounds of proof. As set out above at [36] to [37], the Statutory Scheme allows for more than one round of proof (Rules 14.39, 14.40 and 14.45 of the 2016 Rules, formerly Rule 4.182 of the Insolvency Rules 1986), and expressly provides for the deferral of the right to prove in relation to postponed debts (Rule 14.2(4) of the 2016 Rules). Where a proof is lodged after the declaration of a dividend, the creditor is not entitled to disturb the payment of any dividend or the making of any distribution (Rule 14.40(1)(b) of the 2016 Rules) but is entitled nevertheless to be paid a dividend in the future.

614. *Fourth*, Deutsche Bank says that statutory interest can only be calculated and paid after payment of all provable debts, such that PLC's liability under the PLC Sub-Notes is necessarily classified as a non-provable debt. This is wrong:

(1) It is not the case that statutory interest must all be paid out at a single point in time.

(2) Statutory interest is payable on postponed debts which are provable debts, and which may not be proved until provable non-postponed debts have been paid in full with interest: see Rule 14.2(4); and Pearson v Primeo (Grand Court of the Cayman Islands, Kawaley J, 27 August 2018, [77]-[78]).

(3) Statutory interest is also payable on subordinated debts drawn up on FSA Standard Form 10: see Waterfall I, per Lord Neuberger at [70].

(4) There is therefore no conceptual problem in relation to statutory interest being calculated and paid/provided for in stages in respect of different classes of debt which become entitled to prove at different stages of the process.

615. The PLC Sub-Notes are provable debts. Rule 14.44, which is mandatory, applies.

Deutsche Bank: arguments about "interest"

616. Deutsche Bank contends (DB PP, at [65] **[A/T8/152]**) that a claim for future interest on the PLC Sub-Notes should be admitted or accepted for distribution purposes to reflect the contractual right to interest payable prior to the date at which the interest would otherwise have fallen due.

617. LBHI's position is that interest should be calculated according to Rule 14.23. Any other contention is contrary to the plain wording of the statute.

618. Deutsche Bank is wrong for at least the following reasons:

(1) Its contention is contrary to the plain wording of the statute and binding authority.

(2) Interest is only provable on a debt bearing interest up to the date of administration: see Rule 14.23(1) of the 2016 Rules. Irrespective of whether or not the debt is a future or present debt, in the event of a surplus, statutory interest will be payable on the debt in respect of the period commencing with the date of administration: see Rule 14.23(7) of the 2016 Rules.

(3) In Waterfall IIA, David Richards J held that statutory interest runs on future debts from the commencement of administration: [209] and [225]. David Richards J's decision on future debts was not appealed to the Court of Appeal, while his decision on contingent debts was appealed. The Court of Appeal rejected the

argument that statutory interest was not payable on a contingent debt from the date of administration because the rules provide:

"the same regime for statutory interest for all provable debts, whether due at the date of administration, due then only in the future, or subject then to a contingency which may, in fact, never occur" (at [53]).

(4) The effect of Deutsche Bank's argument is that GP1 would have a provable claim for future interest as well as a claim to statutory interest on that future interest in the event of a surplus. That is a non-sensical outcome, and the wrong conclusion.

(5) Deutsche Bank's reliance (DB PP, [65] **[A/T8/152]**) on Re Browne and Wingrove Ex Parte Ador [1891] 2 QB 574 (and associated authorities is misconceived. In relation to this:

(a) In Browne and Wingrove Lindley LJ said that *"[t]he rule which prevents proof for future interest **is not a positive enactment, it is rather a rule of convenience**"* (page 581, emphasis added), referring to the judge-made rule.

(b) That position plainly no longer applies. Rule 14.23(1) of the 2016 Rules is now a positive enactment which expressly prohibits a creditor from proving for future interest on an interest-bearing debt in respect of any period after the date of administration.

(c) In those circumstances, *"it is axiomatic that where the Insolvency Rules deal expressly with some matter in one way, it is not open to the courts to deal with it in a different and inconsistent way"* (Waterfall I at [194] per Lord Sumption).

619. Accordingly, interest should be calculated according to Rule 14.23. Any other contention is contrary to the plain wording of the statute.

L. THE GUARANTEE ISSUE

620. The Guarantee Issue is as follows:

"Within the administration of [PLC], whether any liability of [PLC] which might be established under guarantees given by [PLC] by Deeds of Guarantee in favour of

*"Holders" (as defined in each Deed of Guarantee)[the "**PLC Guarantees**"] of certain preferred securities issued by each of [the Partnerships] in the context of the transaction referenced in paragraph 2 above (the "**[PLC] Guarantee Liabilities**") rank for distribution before, after or pari passu with each of the [PLC] Sub-Debt and the [PLC] Sub-Notes"*.

621. LBHI's position is that the PLC Guarantee Liabilities rank after the PLC Sub-Debt and after the PLC Sub-Notes.

Declaration

622. All the respondents to the PLC Application are agreed that the PLC Guarantee ranks after each of the PLC Sub-Debt and the PLC Sub-Notes: see at **[21]** above.

623. LBHI seeks a declaration from the Court that the PLC Guarantees rank below each of the PLC Sub-Debt and the PLC Sub-Notes, which has been agreed with the other parties.

Analysis

624. LBHI sets out its full reasoning on this issue in its Joint PP at [43(2)-(7)] **[A/T5/85]**, with which GP1 has stated that it largely agrees.[344]

625. It is clear from the plain words of the PLC Guarantees that they rank below each of the PLC Sub-Debt and the PLC Sub-Notes:

(1) Pursuant to Clause 2.9 of the PLC Guarantees[345], the PLC Guarantee Liabilities are expressed to be subordinated in right of payment to Senior Creditors and at all times rank:

"junior to all liabilities of the Guarantor including subordinated liabilities (in each case other than any liability of the Guarantor which constitutes or would, but for any applicable limitation on the amount of such capital, constitute Tier 1 Capital or which is referred to in (b) or (c) below and any other liability expressed to rank pari passu with or junior to this Subordinated Guarantee) (the "Senior Creditors");

344 See GP1 PP, [6.3] **[A/T9/156]**.
345 See **[E/T10/176]**.

(b) pari passu with Parity Securities, if any, issued by the Guarantor and any guarantee or support agreement of the Guarantor ranking pari passu with the Subordinated Guarantee and issued in respect of Parity Securities issued by the Issuer or any Subsidiary; and

(c) senior to the Junior Share Capital of the Guarantor."

(2) 'Parity Securities' are defined to mean[346] "*any non-cumulative preference shares, non-cumulative preferred securities (other than the Preferred Securities) or other securities either (a) issued directly by the Guarantor and ranking pari passu with the Guarantor's obligations under this Subordinated Guarantee including the sterling and US dollar non-cumulative preference shares of the Guarantor outstanding or (b) issued by the Issuer or any Subsidiary or other entity and entitled to the benefit of this Subordinated Guarantee or benefitting from any other guarantee or support agreement from the Guarantor ranking pari passu with this Subordinated Guarantee*".

(3) The PLC Guarantee Liabilities express themselves to rank *pari passu* with the 'Parity Securities' issued by PLC, which include "*any non-cumulative preference shares, non-cumulative preferred securities or other securities*". The "*other securities*" expressly include "*the sterling US dollar non-cumulative preference shares of the Guarantor outstanding*".

(4) Accordingly, the PLC Guarantee Liabilities express themselves to rank *pari passu* with PLC's non-cumulative preference shares outstanding at the time the PLC Guarantees were entered into and "*any*" non-cumulative preference shares issued in the future.

(5) It is well established that in an administration and in liquidation, the statutory waterfall provides that the shareholders rank last in the order of priority for payment out of the company's assets: see In re Nortel GmbH (in administration) [2013] UKSC 52 at [39].

(6) The PLC Sub-Notes and the PLC Sub-Debt are subordinated debts, not shares.

[346] See **[E/T10/174]**.

(7) The PLC Guarantees specify that they rank *pari passu* with an actual and existing class of instrument (i.e. PLC's non-cumulative preference shares) which rank junior to the PLC Sub-Debt and the PLC Sub-Notes.

(8) It follows that each of the PLC Sub-Notes and the PLC Sub-Debt rank prior to the PLC Guarantee Liabilities.

626. Moreover, it is plain from the background materials that the PLC Guarantee Liabilities were intended to rank below all other subordinated debts. In this regard:

(1) A Lehman Group presentation in respect of the ECAPS dated 25 February 2005 provided at page 4:

"*The Subordinated Guarantee is a "Tier 1 Guarantee and ranks junior to all debt of PLC (senior or subordinated). The Subordinated Guarantee will only rank senior to the Ordinary Shares of PLC.*"[347]

(2) This came to be reflected in the ECAPS Offering Circular itself:

"*The Subordinated Guarantee will rank pari passu with the non-cumulative perpetual preferred securities or preference shares of the Guarantor [PLC] (whether or not in issue)*".[348]

627. Against the backdrop of substantial agreement on the Guarantee Issue between all parties to the PLC Application, the clear meaning of the PLC Guarantees themselves and the unequivocal intention of the parties as to the ranking of the PLC Guarantees, the Court is requested to make a declaration in the following form:

"*Within the administration of PLC, any liability of PLC which might be established under guarantees given by PLC by Deeds of Guarantee in favour of "Holders" (as defined in each Deed of Guarantee) of certain preferred securities issued by each of Lehman Brothers UK Capital Funding LP, Lehman Brothers UK Capital Funding II LP and Lehman Brothers UK Capital Funding III LP in the context of transactions referenced in paragraph 2 of the application dated 16 March 2018 rank for distribution after each of the PLC Sub-Debt and the PLC Sub-Notes*".

628. In this case:

[347] See **[F/V1/195]**.
[348] At page 8 **[E/T10/154]**.

(1) It is clear that the answer to the Guarantee Issue as a matter of construction is that the PLC Guarantee Liabilities rank below each of the PLC Sub-Debt and the PLC Sub-Notes for the reasons above.

(2) Every person or a representative of each class of person with an economic interest in the Guarantee Issue is joined to the PLC Application and has had the opportunity to consider the relative ranking of the PLC Guarantees.[349] This includes Deutsche Bank, which, as an ECAPS Holder, is a party with a direct economic interest in the Guarantee Issue.

(3) The declaration sought serves a useful purpose. It provides finality and certainty to the parties to the PLC Application and to the other stakeholders of PLC in the context of its long-running administration.

(4) The intention to ask the Court to make a declaration in relation to the Guarantee Issue has been foreshadowed: see Reply PP, [66] **[A/T10/211]**.

<u>Conclusion</u>

629. In the above circumstances, the Court is asked to grant the declaration sought.

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31 October 2019

349 Namely: (a) PLC (by its JAs), as the party which entered into the PLC Guarantees in favour of the ECAPS Holders; (b) Deutsche Bank, as a significant ECAPS Holder, has a direct economic interest in respect of the PLC Guarantee; (c) GP1, which is the General Partner of the Partnerships. The Partnership issued the ECAPS to the ECAPS Holders, which are guaranteed by the PLC Guarantees. Further, the PLC Sub-Notes were issued and are held by the Partnerships; and (d) LBHI, which is the holder of the PLC Sub-Debt.