Monday, 11 November 2019

(10.30 am)

MR BELTRAMI: My Lord good morning. I appear for the administrators of Lehman Brothers PLC. There are two applications. Can I ask you first of all to go to the timetable --

MR JUSTICE SMITH: Yes, indeed.

MR BELTRAMI: -- so you can understand where we are going today. It is bundle B tab 8. Now, as I should indicate in a minute, this timetable certainly for the first week is nearly agreed, there may be a little bit of tweaking to it, but for present purposes as your Lordship is aware there are two applications: my application, the estate of Lehman Brothers Holdings PLC which we have all called "PLC", and there is also Mr Arden's application and the estate of LBHI2.

The plan is, as you will see in the timetable, that Mr Arden and I have 15 minutes just to give you very broad summary of what the applications are about, and then we go into the issues and first of all it's Mr Phillips after that. So this is my 15 minutes to explain what is on my application.

MR JUSTICE SMITH: 15 minutes of fame, Mr Beltrami.

Application by MR BELTRAMI

MR BELTRAMI: Well we have to get it when we can.

My Lord, it's an application for directions in the PLC estate to determine certain issues arising in respect of a prospective surplus in that estate. As your Lordship will have seen, PLC was an intermediate holding company within the Lehman Group and was placed in administration on 15 September 2008, became a distributing administration on 2 May 2014. Now it has paid 100 per cent of its unsecured creditors and some statutory interest but there is still significant liability for statutory interest to pay.

It has a substantial subordinated creditor claim against LBHI2, which is Mr Arden's application, and on which I am a combatant if you like. That is subject to a priority dispute with Mr Phillips for SLP3. If I prevail in that dispute then it is likely there will be a surplus for the distribution in my estate to the subordinated creditors. If it is pari passu in the LBHI2 estate, on present estimates it seems unlikely there will anything for unsubordinated creditors per subordinated creditors, albeit that it is terribly complicated and no-one quite knows what the answer is going to be at the end of it.

So that is the context for the PLC application.

There are two subordinated creditors in the PLC estate who have competing claims to the surplus. LBHI

represented by Mr Phillips has claims of $1.9 billion as assignees of three sub-debt loan agreements. Your Lordship may have seen these, I won't take you to them for the moment, bundles E6, 7 and 8. Each of those agreements was between PLC, my client, and Lehman Brothers UK Holdings Limited which was another intermediate holding company at the time.

That company was also placed in administration in 2008. It has made claims against LBHI, which is the US parent, under a guarantee of PLC's obligations and received $185 million in distributions from LBHI.

The sub-debt claims have been assigned ultimately to LBHI, so the claimant's assignee of those agreements.

On the other side of the battle is LBGP1, which we call GP1, which is a claim of 790 million euros, as the general partner of three partnerships each of whom is the holder of an issue of PLC subordinated notes. So it is sub-debt versus sub-notes. Those partnerships, as your Lordship will have seen, were funded in the market through ECAPS which were preferred securities. The holders of the ECAPS obtained perpetual preferred securities in the partnership and a subordinated guarantee from PLC.

So PLC in fact has a third potential subordinated creditor group, which are the ECAPS holders themselves

represented by Ms Tolaney.

So the issues on my application are fourfold: first, and in no particular order but maybe in order of logic, I do not know, first whether the claims under the PLC sub-debts -- that is Mr Phillips's claims -- have been released pursuant to a settlement agreement dated 24 October 2011. That was a settlement agreement in broad terms between several US Lehman parties and several UK Lehman parties, which contained releases of claims between the US parties and the UK parties.

Your Lordship will have seen the principal question on that issue is whether the release applies to after acquired claims. So they were held by a UK company at the time of the release but they were subsequently assigned to the US company after the release. And there is also a sub-question on that issue: if there is a claim under the sub-debts whether the quantum of that claim is reduced by the guarantee payment. So those are the issues on that first question.

There is one piece of factual evidence on that issue which is Mr Geraghty, who has been called by LBHI, and there are issues of New York law and therefore two judges giving some evidence about that.

So that is the first issue on my application.

The second issue -- and everything is subject to the

first issue -- the second issue is a dispute as to the priority of the two sets of subordinated claims. In very broad terms, those claiming under the notes which are Ms Tolaney for Deutsche Bank and GP1 claim priority over the sub-debts and those claiming under the sub-debts, which Mr Phillips claims that they are pari passu.

So that is a matter of contractual interpretation but there is some factual evidence which your Lordship will hear being put forward on those issues particularly as to the commercial background to the agreement.

And the factual witnesses, there are three at the moment for LBHI, Mr O'Grady, Ms Hutcherson and Mr O'Meara; one for Deutsche Bank is Mr Katz. But I have told by Mr Phillips this morning I think he doesn't propose to call Mr O'Meara any more.

MR PHILLIPS: My Lord, just very briefly, your Lordship may or may not have seen that on Friday a third witness statement was served by Mr Katz and on that he said he accepted that he had erroneously identified a Miss Cullen as the CFO whereas in fact it had been Mr O'Meara, and that was the first Mr O'Meara was dealing with. The other point related to the operation of the dividend stopper in an insolvent context and that has now been conceded in Deutsche Bank's skeleton.

They've run it on the basis that the dividend stopper was relevant in a solvent situation. That was the other point dealt with by Mr O'Meara. In the light of those two facts, we no longer need to call Mr O'Meara and that frees up 45 minutes.

MR JUSTICE SMITH: I understand.

MR BELTRAMI: If we go back to the timetable, it does free up 45 minutes and there will not be a fight about that, so there we are.

So that is the second question, priority dispute, essentially contractual debate subject to those factual issues.

The third question on my application is as to the priority of the claims on the ECAPS guarantees. My understanding is that is not an issue for your Lordship in circumstances in which both sides agree that the ECAPS guarantee claims are more deeply subordinated than the other subordinated claims.

MR JUSTICE SMITH: So what you want there is a declaration that that is common ground between the parties, a declaration along the lines I think set out in Mr Phillips's skeleton.

MR BELTRAMI: Yes, my understanding is both sides are happy with that declaration, so it is not a live issue.

The fourth issue on my application is as to the

quantum for proving purposes of the claims on the sub-notes in circumstances in which they were not due for payment until 2035 and 2036 and therefore the question arises as to whether the claims on the notes fall to be discounted under Rule 14.44 or otherwise of the Insolvency Rules.

That is purely an issue of law, there is no evidence about it. There are a number of different permutations. In very short order, LBHI claim that the claims on the notes must be discounted as a matter of compulsory application of the rule. Deutsche Bank have various alternatives. They say it's not a future debt but a debt which has been redeemed and therefore it doesn't qualify for discounting or it should be redeemed by the administrators. If it is a future debt, it's not provable and therefore 14.44 doesn't apply, and if it is a future provable debt then there is a contractual liability to pay interest which also is a provable debt. So they raise permutations of insolvency rule argument for your Lordship on that.

The only point I wish to make, the last point in fact on that bit of the application, and as I just mentioned, on one version of Deutsche Bank's arguments they say that if they are wrong on discounting, the administrators should be ordered to redeem the notes

under paragraph 74 of schedule B1 on under the rule in ex parte James, because any decision not to do so -- there is power to redeem under the terms of the notes -- any decision not to do so would cause unfair harm to the holders of the notes or would be unfair generally or contrary to natural justice.

On that one, we are entirely neutral on our application and therefore to that extent on that bit of the application, and obviously my Lord we will abide by whatever order the court makes, but just to put a marker down, we certainly do not accept that decisions already made not to redeem the notes have been decisions made unfairly contrary to natural justice and all the rest of it. So we'll abide by the order of the court but the premise is not something we can accept as administrators.

My Lord so those are the issues on my application and that is my 15 minutes up.

MR JUSTICE SMITH: I am very grateful. Thank you very much.

Application by MR ARDEN

MR ARDEN: My Lord can I hand up one further piece of paper. It is a diagram which I hope will be of some assistance to your Lordship. My Lord this has been circulated but I have to say it is not an agreed document, although it's based on a document that is before you.

MR JUSTICE SMITH: Yes, of course (Handed). Yes.
MR ARDEN: My Lord, the derivation of the diagram is -- the flow of funds diagram is an agreed document, your Lordship has seen that.
MR JUSTICE SMITH: That appears to the agreed statement of facts, doesn't it? Yes.
MR ARDEN: What we've tried to do, the original document just sort of showed the way in which the funds flowed down or might flow down depending on the outcome of these applications. We thought it might be helpful if we just expanded on that and just added figures and references so that your Lordship can sort of see the financial position and possible financial outcomes.
MR JUSTICE SMITH: Yes.
MR ARDEN: If I start at the top, "LBIE" is at the top so that is the main European trade -- UK and European trading company. There is then a reference to the Wentworth JV, my Lord that is just a joint venture vehicle which is entered into by a number of parties, including LBHI2, under which realisations were pooled and then there is obviously a distribution mechanism.
But it is out of the Wentworth JV that LBHI2 should now receive substantial additional funds and you will see us just immediately below the Wentworth JV box.
MR JUSTICE SMITH: Yes.

MR ARDEN: You'll see the blue is new and that just indicates -- the blue in our box indicates what we estimate the future returns may be, so in the range of 300 to 900 million. Then there is just a reference to the most recent LBHI2 progress report; that is the source of that.

If I can then just take you over immediately left, you will see the box "Unsecured unsubordinated creditors" and you will see from that that we have paid slightly -- 1.1 billion or so, and nothing further is due. So we've paid our unsecured unsubordinated creditors all of their principal plus statutory interest. And what we expect to receive therefore is the surplus available for the payment of our subordinated creditors.

My Lord they then appear as they did in the original chart. You have got on the left, diagonally left and down, that is the LBHI2 sub-debt which is held by PLC. Those are the -- that is the November, the sub-debt arising under the 3 November 2006 agreements. And you will see that two figures are given there, US$2.2 billion or US$3.1 billion. And my Lord you may have seen certainly in the skeletons a reference to why there is an uncertainty about the precise amount due. It was originally -- it was thought that it was

2.2 billion, but further work has been done on that and there is a doubt as to whether or not that is the right figure or it should be a higher figure.

That work is still proceeding and it doesn't matter for the purposes of these applications which it is. Just so your Lordship knows that there are two possible figures for that.

MR JUSTICE SMITH: Yes.

MR ARDEN: On the right-hand side then are the LBHI2 sub-notes which are held by SLP3. And you will see the total amount there, US$6.139 billion.

In terms of what has been paid in respect of the subordinated debt, our subordinated debt, going back to the sub-debt you will see immediately below it PLC's box and then green, we have paid with the agreement of SLP3, £204.7 million in respect of the sub-debt. That was with the consent of SLP3, who would be entitled to -- they receive nothing. That is clear from their box. But if something is due to SLP3 as a result of these applications, then there will be a catch-up.

So that is where the sub-debt is in the LBHI2 estate.

Then if your Lordship looks at the sort of orange gold box between the two subordinated -- two sets of subordinated debt.

MR JUSTICE SMITH: Yes.

MR ARDEN: You will see we've estimated possible outcomes which reflect the estimated future returns and so if they rank pari passu then PLC would be entitled to somewhere between 78 and 301 million and SLP3 will be 199.5 to 666 million. By contrast, if the sub-debt ranks ahead, then PLC will get all of it. Even at the maximum SLP will receive nothing.

Then what follows below that box or those boxes, I should say, is then the position in PLC. If one just follows it down, I do not think I need to do this for the purposes of my application, you will see immediately below the "PLC" box the three bits of subordinated debts: the PLC sub-debts, sub-notes and the subordinated guarantees.

MR JUSTICE SMITH: Yes.

MR ARDEN: Your Lordship can avoid -- I think ignore the subordinated guarantees because it is common ground that they are discounted to the bottom of this.

So one is left with the sub-debt and the sub-notes and then again we have sought to estimate in the gold box here, yellow box, what the outcome will be. And we have sought in doing that to give various outcomes according to different exchange rates.

So my Lord there will probably come a point in this

hearing, if it hasn't already been reached, when your Lordship won't really need this but we thought certainly at the outset it's -- because everybody in their skeleton has said something about outcomes --

MR JUSTICE SMITH: Thank you, I have found the diagram very helpful.

MR ARDEN: -- it might be helpful to have this as a sort of form of anchor.

So far as the LBHI2 application is concerned, my Lord, there are in a sense fewer issues than those in the PLC issue.

The contest is between PLC, which holds the sub-debt which was as I said advanced under three subordinated debt agreements all made in November 2006; and SLP3, whose claim arises under floating rate notes issued in April 2007 which were then amended in early September 2008.

My Lord, in terms of issues, the first issue is essentially one of construction. What is the relative ranking between the subordinated debt on the one hand and the notes on the other hand?

But there then arises a further issue and that arises in this way. On one analysis it is possible, one possible outcome is that SLP3's claims under the notes are subordinated but subordinated only because of the

amendments that were made in September 2008. My Lord, if that is the case, if that is the reason for any -- if that is the reason for subordination, then SLP3 has a claim to -- a rectification claim and for that purpose, your Lordship will hear evidence and that evidence will consist of two partners or two now partners from Allen & Overy which was responsible for -- which was responsible for the drafting of those amendments, together with Ms Jacqueline Dolby from Lehman, who was similarly involved in the process by which the amendments came to be made.

So, my Lord, the issues are less in number, but clearly are clearly both substantial.

My Lord, as your Lordship knows, the LBHI2 administrators are obviously interested in the sense they want to pay the right person. And they are interested, directly interested in an economic sense because as we set out in our skeleton, we are in fact an unsubordinated creditor of another Lehman company which is an unsubordinated creditor of PLC. So there is a benefit to us in PLC's estate being swollen.

And we are also interested because some of the issues in the PLC application, and in particular the one which revolves around the attempt at the settlement agreement, has repercussions or potential repercussions

which extend beyond this application because the settlement agreement, as your Lordship knows, was a momentous agreement which substantially affected or settled the position as between many Lehman companies, as well as between Lehmans US and Lehmans UK.

So, my Lord, that is our position, that we are interested but neutral. We are here to assist if we can do and obviously to protect our interests if they need to be, but it is unlikely or not anticipated at the moment that we will be taking a very active part in the applications.

My Lord, that is my opening fairly quickly. Unless I can assist your Lordship further, I think Mr Phillips will be next.

MR JUSTICE SMITH: No, I am very grateful Mr Arden, thank you very much.

Mr Phillips can we have five minutes before we have a two-minute silence.

Submissions by MR PHILLIPS

MR PHILLIPS: Yes, of course my Lord. And my Lord, please do interrupt my flow if I lose track of time.

MR JUSTICE SMITH: I think the tannoy will actually do that for us.

MR PHILLIPS: Excellent.

MR JUSTICE SMITH: But I will keep an eye on the clock.

MR PHILLIPS: My Lord just a quick point in relation to the numbers, just in case your Lordship is left with the impression that this is all a question of internally moving money around. One thing that your Lordship should just have in mind is of course my clients LBHI, the New York end of Lehmans, of course went into Chapter 11 and had something like 220 to 230 billion of external creditors who have received various dividends but certainly in the order of, and I do not need the detailed numbers, but about 36 cents in the dollar so that ultimately there are a number of very interested external creditors.

My Lord, in relation to what we have called the PLC ranking issue, LBHI's position is that PLC sub-debt and PLC sub-notes rank pari passu in relation to what we have called the LBHI2 ranking issue. SLP3's position is that the LBHI2 sub-notes and the LBHI2 sub-debt rank pari passu. The LBHI2 ranking issue breaks down into two phases or stages, before and after the 2008 amendment.

And before the 2008 amendment we say the instruments ranked pari passu, after the 2008 amendment we say the LBHI2 sub-notes as amended ranked pari passu with the sub-debt and, secondly, there is a sub-issue which is whether or not it is engaged in a winding-up and,

thirdly, that if the LBHI2 sub-notes as amended do not rank pari passu with the LBHI2 sub-debt that is only because of a common mistake which should be remedied through equitable rectification.

Your Lordship has seen what the outcomes look like. GP1 and Deutsche Bank submit that the PLC sub-debt ranks junior to the PLC sub-notes. And PLC and Deutsche Bank -- sorry, did I say PLC? No, I got that right.

PLC and Deutsche Bank submit that the LBHI2 sub-notes ranked junior to the LBHI2 sub-debt. And my Lord, we are going to call this the juniority construction, which I know is inelegant but it at least helps make it clear.

In relation to both ranking issues, the economic out-turn of the juniority construction is that LBHI and SLP3 received no return at all from respectively the PLC and LBHI2.

In that context, my Lord, we note that at the start of its skeleton, Deutsche Bank criticises our clients for being "entirely motivated by its own financial interest" which is in paragraph 11. We do not think that any of the parties are advancing arguments against their financial interests and your Lordship will note, in relation to this, that we do not advance the case

that either the sub-note or the sub-debts that we are interested in rank senior to the other, notwithstanding the fact that that would advance our client's, the estate's financial interest.

Now, there are compelling reasons why the correct answer to both of the ranking issues is that the different tranches of sub-debt and sub-notes in both PLC and LBHI2 rank pari passu and your Lordship will have seen that we address those in the executive summary of our skeleton argument, for your Lordship's note pages 7 to 12, and I am going to name a couple at the outset.

First, each of the relevant instruments was based on or related to an existing standard form or precedent. The PLC sub-debt and the LBHI2 sub-debt were both based on the Financial Services Authority prescribed form 10. FSA Standard Form 10.

The PLC sub-notes largely incorporated the same subordination language as FSA Standard Form 10. The LBHI2 sub-notes definition of senior creditors was materially similar to FSA prescribed form 5 which we will call FSA standard form 5. This was in use in the market at the same time as Standard Form 10 and was created to implement the same subordination requirements that flowed out of the relevant EU directives. All of the existing precedents were intended to achieve the

same subordination outcome; this provides a very strong indication that the instruments were subordinated at the same point in the Waterfall at both PLC and LBHI2 level and that they rank behind the same senior liabilities and senior creditors.

The next point that flows directly out of the first, and I am looking nervously at the clock, is that the two sets of instruments were designed to replicate each other's terms and what I mean by that is the PLC sub-notes were required as closely as possible to replicate the subordination provisions of the PLC sub-debt and the LBHI2 sub-notes were required to refinance the majority of the LBHI2 sub-debt, and PLC has -- I wonder if that is a point at which I should stop.

(Pause for two minutes silence)

My Lord, the point that I was just dealing with which flows directly from the point I just made was that the two sets of instruments were designed to replicate each other's terms, and I just made the point that the sub-notes were required as closely as possible to replicate the subordination provisions of the PLC sub-debt, and the next point is that the LBHI2 sub-notes were required to refinance the majority of the LBHI2 sub-debt.

PLC has expressly accepted that the three different tranches of the LBHI2 sub-debt ranked pari passu. So make good the juniority construction, the other respondents need to establish that the purpose of the LBHI2 sub-notes included altering the pre-existing pari passu ranking within the three tranches of the LBHI2 sub-debt.

And finally, it is common ground that all the relevant instruments were either lower tier 2 or tier 3 instruments for regulatory capital purposes. And the materials show that as a general rule lower tier 2 and tier 3 regulatory capital ranked pari passu with each other.

The reasonable reader when armed with the relevant factual and legal background would conclude that in relation to both the PLC ranking issue and the LBHI2 ranking issue, the relevant subordinated debt, the PLC sub-debt, the PLC sub-notes on the one hand, the LBHI2 sub-debt and the LBHI2 sub-notes on the other, would rank behind the same senior liabilities and senior creditors, and applying the test set out by Lord Neuberger in the Supreme Court in Waterfall I, the consequence of that is that they rank pari passu.

My Lord may I just say something about the statutory scheme?

MR JUSTICE SMITH: Yes.

MR PHILLIPS: To understand the legal context of the ranking issues in this case, it is necessary to start with the statutory scheme. The subordination of debt hinges on the interplay between personal contractual rights, which can be altered by agreement, between the company and the creditor, and the statutory scheme which is prescriptive and can only be altered by Parliament.

The creditor has a personal contractual right to enforce his debt through proof in the insolvency. And that is a right that he can agree by contract to defer.

An error in my learned friend Mr Beltrami's skeleton is to suggest that it is possible to have a contractual free-for-all when it comes to ranking and proof of debt. My Lord, in paragraph 71 of his skeleton, which again my Lord will note as being at tab 2 at 21, Mr Beltrami says two things. One is he says there is no law for example that all subordinated debt must be pari passu, and he says that the general pari passu under the insolvency scheme in respect of debts proved at the same time is subject to and does not trump the parties' actual agreement as to priority.

In our skeleton, in paragraphs 38 to 48, which for your Lordship's note is B tab 5, 19-20, and in our appendix A which I do not know if your Lordship's had an

opportunity -- that is in tab 6, we deal with the law on the interplay between the statutory scheme and contractual subordination. And it is important.

In short, in ex-parte Mackay in 1873, which is at authorities 1 tab 2, it was held that it is not possible to agree to contract to alter the operation of the statutory scheme. So that was the starting point. And then my Lord, your Lordship probably knows that in British Eagle in 1975, which is in A volume I at 26, the House of Lords held that it was against public policy for a debtor and creditor to contract out of the pari passu principle.

It was not until in Re Maxwell, that was in around 1993, and that is A tab 2/42, that we finally established -- and I say we because it was one of mine -- we finally established that a creditor can agree to subordinate his personal right. That decision was regarded as a watershed in the history of subordinated debt.

And in Waterfall I, which is in tab 6 at 146, Lord Neuberger at paragraph 66, and I am going to go to Waterfall I in a moment if I may --

MR JUSTICE SMITH: Yes.

MR PHILLIPS: -- said that a creditor can agree his claim will rank lower. It can only be agreed that a creditor

will rank higher if all creditors who rank lower agree. Otherwise, you cannot contract out of the pari passu principle. And if the parties infringe what Lord Neuberger there describes, that will trump the parties' actual agreements as to priority.

My Lord, I wonder, I find it a lot easier to do it by reference to the Insolvency Law Handbook and one of the editors Mr Haywood this morning has given me one which, if I may hand it up, you might find it easier as well.

MR JUSTICE SMITH: Thank you.

MR PHILLIPS: I will do it (Handed).

MR JUSTICE SMITH: Thank you. That is very helpful.

MR BELTRAMI: Not being so well-equipped, I hope they are all bundles. I'm sure they will be.

MR PHILLIPS: They are all in the bundle, it is just so much easier to do it from this.

When the creditor proves -- and what your Lordship is going to be looking for is Rule 14. It is just useful to have the whole of Rule 14 and that is, if you look at the page references in the middle, it is 11.62 and 11.63.

When a creditor proves, the treatment of his debt is governed by the statutory scheme, and I am just going to take your Lordship briefly to the rules and they are all

in the bundle, I'll give the bundle references. If we can start with 14.12 which is in A, tab 7, 171 -- A volume 7, tab 171 at 4289.

This is the pari passu rule and my Lord, your Lordship sees:

"Debts other than preferential debts [and those of course are the debts to the Crown, employees and so on, this is sub-rule 2] 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."

That is the start of that pari passu principle.

I think this is a good moment just then to turn up Waterfall I, which is in authorities tab 6 at tab 146.

MR JUSTICE SMITH: Authorities volume 6?

MR PHILLIPS: Yes volume 6. I am sorry --

MR JUSTICE SMITH: No, no.

MR PHILLIPS: It is volume 6, 146 and this is called Waterfall I.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: Your Lordship sees it went to the Supreme Court and I am just going to show you some parts of it as I go, if I may. I want to start with paragraphs 40 and 42 and the reason why I want to do

that -- which is on page 496 -- the reason why I want to do that is that your Lordship will see that there are three sub-debt agreements which are all on Standard Form 10, so that is what the Supreme Court were considering in this case.

It was at the level of LBIE so it was engaged lower down the chain of Lehman's regulatory capital.

Then at page, if I can go to page 503, it is in paragraph 66, which I did mention to your Lordship. And your Lordship sees Lord Neuberger says:

"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."

He then refers to ex parte Mackay.

"... that a person is not allowed by a 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 it should be treated as subject to two qualifications.

"First, it does not apply when 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 were detrimentally affected by his promotion have agreed to it unless there was a public policy reason."

It is really important that distinction between agreeing: I will prove after you, you, you and you. That you can do. You can only say I am going to -- I will only prove ahead of you if you agree.

That is an important distinction. Moving over the page on 503 to paragraph 70:

"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 the 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."

And then paragraph 72, you will see in paragraph 72 he says he restores paragraph 1 of the order made by Mr Justice David Richards:

"... because although I agree with the Court of Appeal that he was right as to the ranking of

subordinated, I disagree with the Court of Appeal and agree with the judge as to when it can prove for the subordinated debt."

For your Lordship's note, Mr Beltrami's skeleton argument at paragraph 64, and that is B2/217, in that paragraph he says that Lord Justice Lewison's second category explains how the subordination mechanism in Standard Form 10 operates and that is incorrect. That is part of Lewison that was expressly overruled in the Supreme Court. It doesn't work like that.

And then if I could just flip back, while we are in Waterfall I, to 64 on his conclusion as to priorities. I just want to show you G to H because what your Lordship will appreciate is that all the way through Waterfall I the court looked at the regulatory backdrop and it looked at FSA Standard Form 10, and you then get the conclusion on priorities.

This is Lord Neuberger:

"The purpose of the parties to those agreements [this is Standard Form 10] was to ensure that all those with claims on LBIE would have priority over the holders of the subordinated debt [which is the regulated 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."

In the light of Waterfall I, subordination operates through a subordinated creditor submitting a proof and being admitted to proof only after the relevant senior creditors -- senior liabilities or senior creditors have been paid in full or can be paid in full.

For your Lordship's note Deutsche Bank accepts that this is the way subordination works in paragraph 54 of their skeleton.

The contractual question which arises against the backdrop of the statutory scheme is to ask when subordinated creditors are entitled to be admitted for proof, which in turn requires identification of the senior creditors to which they are to be subordinated.

And as a basic premise, we submit that if A subordinates his debt to C and B subordinates his debt to C, A and B are entitled to prove at the same time and by operation of 14.12, which your Lordship has seen, their claims will abate pari passu, they will abate equally if there are insufficient assets to pay them in full. It is sufficient that they are contractually subordinated to the same creditor, C, and as a result they rank pari passu.

In our submission, in both ranking issues, on a true

construction of the instruments that is exactly what we see happening. The potential categories of senior liabilities to which the sets of instruments are subordinated are the same. The subordination categories are entirely symmetrical and as such the instruments subordinate themselves to the same categories of senior liability and the reasonable reader would consider that they are subordinated to the same senior liabilities and are therefore ranked -- and are therefore pari passu between themselves. Not that they are subordinated to each other or they rank pari passu.

By contrast, PLC's analysis is based on two subordinated debts having to express themselves to rank pari passu to each other in order to rank pari passu, and that is for your Lordship's note what they do in paragraphs 77 to 78. And that with respect is the wrong approach.

As your Lordship will see in the case of the FSA standard forms, two subordinated debts may be entirely silent about each other's relative ranking and yet it is now common ground that they will nevertheless rank pari passu between themselves and we say it is plain that this is because on a true construction they are subordinated to the same liabilities.

Before I go more into the construction points I just

want to say a little now about the regulatory framework if I may, my Lord.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: Now, we have dealt with the European framework in some detail in our written submissions, which is for your Lordship's note again 23 to 39, and we do not propose to repeat it in detail in opening because it is largely common ground but your Lordship will need to appreciate really what this means and what the effects of it are.

The starting point is that the core regulatory requirement under the EU Directives was consistent right through the period. A succession of directives contained the core subordination requirement that in the event of the bankruptcy or liquidation of the credit institution they, i.e. the subordinated regulatory loan capital, the subordinated capital which will count for the financial resource requirements of the bank or the institution, they rank -- and this is what every one of them says -- after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.

That is what the directives require. They picked it up from the Basel Accords, which I know your Lordship has and we have explained this, and that is what they

required. The regulatory sub-debt had to be subordinated to all other creditors, in other words to all of the claims they are there supporting. That is what they were there for. There was no requirement for regulatory sub-debt to subordinate to other regulatory sub-debt. Accordingly, the other respondents' cases necessarily imply that the Lehman Group was doing something more when it issued regulatory sub-debt, and your Lordship will see on standard forms, than it was required to do by the regulations themselves.

For present purposes the key point is that the EU Directives requirements as to subordinated loan capital were implemented in the UK in two phases by domestic regulatory regimes. The first was IPRU-INV and the second was GENPRU and I just want to look at each of those in turn.

IPRU. In 2001 the FSA introduced IPRU. This implemented the directives in the first relevant phase. The three instruments were -- three instruments were introduced during this period: the PLC sub-debt, the PLC sub-notes and the LHHI2 sub-debt. IPRU brought together a number of different handbooks from the self regulatory organisations and the most important SROs for current purposes are the SFA and IMRO.

Can I ask your Lordship to take up bundle J

volume 2, please. Chapter 10 of IPRU applied to the Lehman Group and that was taken from the SFA Rules when the FSA was formed in 2001.

If I could ask you to go to tab 10 at page 517, starting at 517, your Lordship sees 10.63:

"A firm may take into account subordinated loan capital in its financial resources in accordance with tables 10.62 ..." and so on.

"10.63(2). A firm may include subordinated debt in its resources only if it is drawn up in accordance with the standard forms obtained from the FSA."

So that is the starting point.

And then you see that the subordinated loans can be classified from 63(4) as long-term, short-term and so on.

So we then move to the annex D which is at page 726. Can I turn to 726. You see this is IPRU source book for investment business, required forms.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: And if you look on the right-hand side, do you see 5 is IMRO firms and you get 5.1, prescribed subordinated loan agreement.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: And then under 10 is "SFA firms" and you get a series of different forms, long-term, short-term and

consolidated supervision. As your Lordship will appreciate, consolidated supervision is introduced in this period post the BCCI collapse.

If I can then take you to 729, this is Form 10.1.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: Form 10.1 is the approved form of long-term subordinated loan agreement and if your Lordship goes to 736 -- 735, 735 the excluded liabilities. Excluded. They have agreed to exclude themselves from the support of the regulatory capital. "Excluded liabilities" means:

"Liabilities which are expressed to be and, in the opinion of the insolvency officer ... do, rank junior to the subordinated liabilities in any insolvency of the borrower."

Then over the page, "liabilities" means:

"... all present and future sums, liabilities and obligations payable or owing by the [borrower] (whether actual or contingent, jointly or severally or otherwise howsoever)."

Senior liabilities means all liabilities except the subordinated liabilities and the excluded liabilities. The subordinated liabilities is all liabilities in respect of the loan, that is this document, or each advance made under this agreement and all interest.

Now the starting point is that if debt does not fall within subordinated liabilities or excluded liabilities in those two definitions, then it remains within the senior liabilities. The debt within the category of senior liabilities could be within one layer or it could be some of that debt could be senior to others. You could have layering within the senior debt. So you could have what might be described as subordinated senior debt.

And your Lordship will be familiar that for example taking a security as part of the senior debt, it puts you at the top because you have security. So it is -- you can have layering between the senior liabilities.

The subordinated liabilities as your Lordship sees are defined to be the liabilities under the relevant agreement and we are going to come back to how that is to be properly construed and the exclusion of the junior debt.

Then, my Lord, if your Lordship would turn over to condition 5 on subordination. 738, thank you:

"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 ... of the Subordinated Liabilities is conditional upon ..."

And then the first is that you get the condition that you maintain 120 per cent of the financial resource requirement, and in 1(b), the borrower being "solvent at the time of and immediately after the payment by the borrower, and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent the borrower can make such payment and still be solvent."

And it then defines "solvent":

"The borrower shall be solvent if it is able to pay its liabilities other than subordinated liabilities in full, disregarding -- the first is "obligations which are not payable or capable of being established" and the second is the excluded.

So your Lordship sees that structure and your Lordship should have it well in mind when we then turn to look at the sub-debt and of course the sub-notes in this case.

So just briefly I am going to show your Lordship 10.7, Form 10.7 which is at page 780, because Form 10.7 is short-term subordinated loan agreement for purposes of consolidated supervision, and what I wanted to show your Lordship, if you go to 786 and following, you will see the same -- you see the same definitions, the same structure. If you go to 789, you see clause 5.

So I just want to pause, I just want to pause there if I may just at this point. First, as your Lordship will have seen, we say where two standard forms with identical subordination language are entered into by the same borrower, as happened in this case, they rank pari passu. That is now largely common ground as your Lordship knows. In other words, a debt on RSA -- on FSA Standard Form 10 may rank pari passu with other subordinated debts. Such debts will not be senior liabilities for the purposes of FSA Standard Form 10.

Second, it follows that the senior liabilities to which FSA Standard Form 10 debt is subordinated includes a potential category of subordinated senior liabilities which do not rank pari passu, nor express to rank pari passu with it, and are not expressed to rank junior to it. That is entirely possible. And that flows from the breadth of the definition of senior liabilities as all liabilities except the subordinated liabilities and the excluded liabilities.

And Deutsche Bank appears implicitly to accept this line of reasoning, for your Lordship's note paragraph 1771 of its skeleton, by stating that the broad definition of liabilities plainly encompasses the PLC sub-debt and the PLC sub-notes. And Deutsche Bank of course are arguing that there are some subordinated

debts, the PLC sub-notes, that rank as senior liabilities, so you can have subordinated senior liabilities.

The third significant point is that where two debts are subordinated to the same categories of senior liability which the standard forms are, it is the same language, the same definitions, the standard forms are dealing with the same categories of senior liability, they do not need to express themselves as ranking pari passu with each other in order to rank pari passu and the Standard Form 10 are absolutely on point on that.

In a nutshell we say those three core propositions provide the complete answer to the PLC ranking issue.

Once one accepts that the PLC sub-debt must be capable of ranking pari passu with other subordinated debts the pari passu construction is the only plausible outcome.

Can I now show your Lordship chapter 5 of IPRU and that is at tab 18 of this bundle. Chapter 5, my Lord, applied to former IMRO firms and you can see it from the top of the form. If I can just show you at page 956, if you look at 5.2.54:

"A qualifying subordinated loan must be in the form prescribed by the FSA for the purposes of this Rule."

Annex D is at 1005. If I can show you 1005, this is the required forms. And Standard Form 5 is on 1007, so you can see "prescribed subordinated loan agreement"; and, my Lord, if we can turn to 1009, which is the definition of senior creditors:

"All such persons who are (a) unsubordinated creditors of the Borrower; or (b) subordinated creditors of the Borrower other than those whose claims are express to rank and do rank pari passu with or junior to the claims of the Lender."

And for your Lordship's note, we are not the only party referring to chapter 5. Others, particularly Deutsche Bank, have relied on chapter 5, for your Lordship's note 241-243.

Two observations. One, both FSA Standard Form 10 and FSA Standard Form 5 had to implement the same regulatory requirements from the EU Directives. This was the UK's implementation of those requirements. They therefore had to achieve the same subordination outcome, they were simply two ways of implementing the same subordination requirements.

Form 5 expressly includes "subordinated creditors other than" in its definition of senior creditors, which makes express the same potential category of senior subordinated liabilities that is necessarily present in

the FSA Standard Form 10 for the reasons I have explained to your Lordship. They were part of all liabilities. All Form 5 did was separate it out. And your Lordship has probably already seen where this goes. That is what Form 5 did.

Now, I do not know if this is physically possible but, my Lord, could you imagine that you have got Form 10 on one side and Form 5 on the other side. Assume that one debt could issue debts on both Form 5 and Form 10. Assume it did so sequentially with Form 5 issued second in time after Form 10. Form 5 is the one that refers to "subordinated creditors other than". The reasonable reader would not take Form 5 to be subordinated to Form 10 merely by virtue of the inclusion of the words "subordinated creditors other than". They merely separate out a potential category of senior liability, in other words liability other than the subordinated rate cap.

And they would not of necessity be referring to existing subordinated debt under Form 10. It is just standard forms.

Rather the reasonable reader would take both standard forms as giving effect to the same regulatory requirements to be subordinated to the same categories of senior liabilities and not to each other.

Your Lordship will see that PLC's case on the LBHI2 ranking issue turns entirely on a difference of wording and the inclusion of the words "subordinated creditors other than" in the LBHI2 sub-notes. We say that this linguistic difference is immaterial because it has no impact whatsoever on the substance of the subordination or what the two subordination clauses would convey to the reasonable reader, which namely is subordination to the senior liabilities.

Just to say something about GENPRU. On the 31 December 2006 the FSA introduced GENPRU and this implemented directive 2006 -- 48 of 2006 on credit institutions and 49 of 2006 on investment firms.

Only the LBHI2 sub-notes were issued under this new regime and the requirements of the directives remain the same, namely that the regulatory subordinated debt was to be subordinated to all other creditors. For the first time standard forms were not required. Instead, there was to be a lawyer's opinion as to compliance. And for your Lordship's note that is in GENPRU 2.2.164 which is at tab 11, page 845. For my sins I am just turning it up now.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: On 845 "General conditions". And what they have put and this is the note. Yes, sorry.

If you look at 844 and look at sub 12:

"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 understood, 9, have been met."

So they then required an opinion from a properly reasoned independent legal opinion from a suitably qualified person and if your Lordship looks over the page, they explain this. It is three bits down. 2.2.164:

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

So that is a bit of a whistlestop tour through the regulatory background and your Lordship will immediately appreciate that is very important in the present context.

I want just to turn on to contractual interpretation if I may.

MR JUSTICE SMITH: Yes, thank you.

MR PHILLIPS: The key contractual question relates to establishing who are in each case the relevant senior

liabilities or senior creditors that the subordinated creditors rank behind, and we address the law in pages 39 to 49 of our submissions.

We set out the starting point in paragraph 117. If I can just summarise it. As is well known, the court must consider the language used and ascertain what a reasonable person, a person with all the background knowledge which would have been reasonably available to the parties in the situation they were in at the time, would have understood the parties to have meant.

And we refer to Wood v Capita Insurance. Sorry, I will just refresh your Lordship with it.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: It is in volume 6 of the authorities at tab 132. The relevant -- the relevant part is on internal page 1179 starting at paragraph 10. And, my Lord, if you just cast your eye over it your Lordship will be familiar where it identifies the court's task in identifying the objective meaning of the language. It is:

"... not a literalist exercise focused solely on a parsing of the wording of a particular clause ... the court must consider the contract as a whole and ... give more or less weight to elements of the wider context ..."

Then he refers to the factual background known to the parties at or before the date of the contract, giving evidence of prior negotiations.

And then picking up at F in paragraph 11, where Lord Clarke stated in Rainy Sky a unitary exercise but their arrival means the court would give weight to the implications of rival constructions for reaching a view as to which construction is more consistent with business common sense.

And then in 12:

"The 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."

And then he says:

"To my mind, once one has read the language in dispute in the relevant parts of the contract that provide its context, it does not matter whether the more detailed analysis commences with a factual background and the implications of rival constructions or a close examination of the relevant language in the contract, so long as the court balances the indications given by each. Textualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation."

So your Lordship sees that one has got textualism, one has got contextualism and they are not in a battle. It is not one or the other. One has to look at both and one has to consider on an iterative process where one goes and in the context of what are standard forms based on the UK's implementation of EU Directives, it cannot possibly be that one just looks at the language without looking at that context.

A key legal issue that your Lordship will need to consider in this case is the extent of the application of the factual matrix and there are very divergent views. PLC and GP1 place great weight on Lord Collins in Sigma Finance which your Lordship will find in volume 4 at tab 90 of the authorities. It is the judgment of Lord Collins. It is worth just casting one's eye over 35 where he says:

"An over-literal interpretation of one provision without regard to the whole may distort or frustrate" -- I am sorry, my Lord.

MR JUSTICE SMITH: No, yes, I have it.

MR PHILLIPS: "... may distort or frustrate the commercial process."

And then you get in 36, your Lordship sees:

"Sigma financed its investments over a 13-year period by debt securities issued or guaranteed by it."

So you will see the factual context. And then:

"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. The instrument must be interpreted as a whole. In 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."

And of course one has got, again, a number of layers to this. One has the regulatory context, one has the fact that nearly all of this was internal facing and one has the waiver directions which I have not shown you yet but that is what is publicly known is wider than just you look at the document itself in this particular case.

Deutsche Bank of course has adopted a more expansive

approach and it relies on the so-called commercial incentives that it's claimed motivated my clients to want to prioritise the PLC sub-notes over the PLC sub-debt and the LBHI2 sub-debt over the LBHI2 sub-notes.

But in any event, both PLC and Deutsche Bank through Ms Dolby and Mr Katz rely on factual witnesses whose evidence considers in some not inconsiderable detail the background and the purpose of the relevant instruments and we will be looking at that and your Lordship will be able to form a view about the level of assistance your Lordship gets from it at the end.

Our position is that the instruments were in reality only addressed to internal entities forming part of the Lehman Group and your Lordship might note that Deutsche Bank describes them as internal in both paragraphs 32 and 50 of their skeleton. Both the PLC sub-notes and the LBHI2 sub-notes were not public documents and were never intended to be traded. Ms Dolby's evidence is that there was never any intention to trade them outside of the Lehman Group. The only reason for putting the notes in eurobond form and listing them was to secure a UK tax advantage. Your Lordship will pick this up from the evidence. And as a matter of fact, all of the notes have remained

within the Lehman Group at all times.

Accordingly the factual matrix in this case is the knowledge reasonably available to the centralised decision-makers within the Lehman Group and it includes evidence of the genesis and purpose of the transactions. It is different from Sigma. We have that regulatory background, we have genesis and purpose which we take from that. It's different.

Even if the respondents are correct and the instruments were intended to be traded, it does not mean that the factual matrix is altogether inadmissible.

MR JUSTICE SMITH: What you say is that theoretically speaking they could have been traded but the intention was they never would be.

MR PHILLIPS: That is right, my Lord. It was for a UK tax advantage. And your Lordship will see the material that goes to the listing of it on the Channel Islands Stock Exchange, CISX as it appears.

So we then just draw your Lordship's attention to Mr Justice Briggs as he then was in LB Re Financing No 3 which is in volume 4, tab 98. I do not intend to turn it up at this point but he said the identification of the relevant audience is important because it serves to identify the range of background facts relevant to the interpretation. GP1 accepts that is the correct test.

We say at the very least the relevant audience are sophisticated institutional investors likely to acquire another institution's subordinated regulatory capital, which means at the very least the regulatory background including the standard forms and the system for waivers is admissible.

I am sorry, I am reminded I have not stopped for the transcribers.

MR JUSTICE SMITH: Not at all. I was going to pick you up at some point between five to and midday, but is now a good time?

MR PHILLIPS: Now is a good time, my Lord.

MR JUSTICE SMITH: We will adopt the convention then of rising for five minutes mid-morning and mid-afternoon for breaks.

(11.50 am)

(A short break)

(11.57 am)

MR PHILLIPS: My Lord, would you mind taking up bundle E, please, which is the core transaction documents.

MR JUSTICE SMITH: Bundle E.

MR PHILLIPS: Yes, please, my Lord.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: I am now looking at the PLC ranking issue. The PLC instruments were the first in time and we were

dealing with those.

So if you could go first to tab 6, there were -- as your Lordship may have picked up, there were three loan facilities entered into between PLC as borrower and LBUKH. That is important. There were two long-term facilities, that is tabs 6 and 7, and then there was an 8 billion short-term facility, tab 8.

Tab 6 and 7 are on Form 10.1 and tab 8 is on 10.7.

Your Lordship will see, if we can just do something of a page turn, that just taking it from on tab 6, we have variable terms in schedule 1 and those set out the variable terms and can I just draw your attention at the bottom of the page, do you see there is a date, 30.10.98?

MR JUSTICE SMITH: Yes.

MR PHILLIPS: It appears somebody picked up the form that was effective at 30 October 98 and so you have the variable terms, and then when we get to page 87, we get to the standard terms. Before we look at these, despite some confusion -- as a starting point and we really do need as it were to nail this point down, despite some confusion in the position papers, the other respondents do appear to accept that FSA standard form debts rank pari passu amongst themselves.

I start with GP1 and I think it is worth just

looking at these. If you have got bundle B, GP1 in tab 4, at paragraph 40.

MR JUSTICE SMITH: Bundle B tab 4.

MR PHILLIPS: Bundle B tab 4. Please keep bundle E.

At paragraph 46 where they say, at paragraph 46 on page 18:

"Save for other debts which were expressed to rank more junior to the PLC sub-debts prima facie locked in a ... race to the bottom, as between themselves therefore circularity problem."

And then in 59.4, at page 22:

"The PLC sub-debts cannot on their terms endure a pari passu ranking ..."

Yes, I am sorry, I should have shown you 47, where they start by saying a pari passu solution is not an unattractive solution, it may be appropriate to view them as falling due at precisely the same level in the Waterfall, there being no other way to distinguish between them and no further for any of them to fall than to the bottom such that 14.12 then applies.

So they then come to that conclusion and pick it up again in 48 and in 594.

I will just leave that one for your Lordship's note.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: And then the bottom of the path thesis is of

course completely unarguable once it is conceded that they can rank pari passu, that there is that possibility.

Deutsche Bank in tab 3 at paragraph 180:

"Deutsche Bank does not dispute that the three tranches of the PLC sub-debt rank pari passu between themselves, although technically it is not a matter that arises for determination of these proceedings."

Well, of course it is because your Lordship will want to understand why, everyone can see that is the answer but then you understand why and we move from there.

And then PLC, which is in tab 2, and it is paragraph 662:

"Given such an impossible circularity, the interpretation of the LBHI2 sub-debt agreements must yield to business common sense. Though it does not especially matter for present purposes how this is achieved, as there is no dispute between the sub-debt agreements, the most likely interpretation is that for the purpose of ranking, the other sub-debt agreements executed in the same form on the same date are to be treated as subordinated liabilities and that by way of implied term the three identical agreements carry a pari passu ranking inter se. Such an implication

would satisfy the stringent test for the implication of terms..." and so on.

So everyone agrees and gives slightly different reasons.

But these concessions are hugely significant because once it is accepted that this Standard Form 10, the standard form debts ranked pari passu with each other, it follows that Standard Form 10 debts are capable of ranking pari passu with other subordinated debts, and of course one of the points taken against us is that they are incapable of ranking pari passu with other subordinated debts because they don't refer to subordinated debts. Well, I am sorry, that is gone. So it is possible.

And the suggestion that different tranches which your Lordship has just seen need to be executed on the same day for them to rank pari passu is with respect unduly restrictive and we say wrong. As your Lordship has seen, they were not all executed as a matter of fact on the same day; there was a gap between July 2004 and October 2005 until the third PLC sub-debt agreement, and it is a nonsense to suggest that first two rank pari passu and the third one doesn't.

So the PLC sub-debts can rank or expressed to be ranked pari passu with other sub-debt and we say it will

do so when the other sub-debt is subordinated to the same senior liabilities.

And, my Lord, just looking at the standard terms -- sorry, we are back in bundle E/87 -- what your Lordship sees on page 87, "excluded liabilities"; on page 88, "liabilities", "senior liabilities", "subordinated liabilities" and 89 "subordination clause 5". And your Lordship has seen where it comes from.

Turning to the sub-notes. They are in tabs 9, 12, 13 and 14. And there were four subordinated notes issued by PLC to Lehman Brothers UK Capital Funding LP, Lehman Brothers UK Capital Funding II LP and Lehman Brothers Capital Funding III LP. They are the limited partnerships. And they were issued on 29 March, 19 September, 26 October and 20 February.

To obtain a discrete tax benefit, the PLC sub-notes had to be drawn up in note or bond format. They could not therefore be drawn up on FSA Standard Form 10 without some amendment. And that required the Lehman Group to submit a waiver application to the FSA, the waiver being a waiver of Rule 10.63(2) which required all of the regulatory sub-debt to be issued on the standard forms. So there had to be a waiver.

The operative subordination provisions and definitions in the PLC sub-notes are materially the same

as those under Standard Form 10 except they were in bond format and there was no separation of the standard terms and the variable terms. So if I could just ask your Lordship to turn to 127 -- it is in tab 9, I am sorry, my Lord. What I have tended to do for the purposes of oral submissions is just focus on one of, because otherwise we would be looking at all four.

So at 127, your Lordship sees the terms and conditions of the notes and your Lordship sees there on that page the definition of excluded liabilities, which is standard, if I can put it that way. At 128, the senior liabilities means all liabilities except the subordinated liabilities and the excluded liabilities. And then subordinated liabilities means all liabilities of the noteholders in respect of the notes and all other liabilities which rank or are expressed to rank pari passu with the notes.

And then if we can look at the status and subordination clause in 3. Your Lordship sees they are direct unsecured subordinated obligations of the issuer and the rights and claims of the noteholders against the issuer ranked pari passu without any preference among themselves.

Now the reason for that is that these are bonds, so there are more of them. And so it focused on the

ability of the various bonds to rank pari passu amongst themselves. The rights of the noteholders in respect of the notes are subordinated to the senior liabilities, and your Lordship has seen the definition, and accordingly payment of any amount in respect of the notes is conditional upon ... and then you get the 100 per cent of the FRR requirements, and in 2, the issuer being solvent at the time and immediately after, which your Lordship will see, and then (b):

"For the purposes of condition (3)(a) above, the issuer shall be solvent if it is able to pay its liabilities other than subordinated liabilities in full disregarding obligations which are not payable or capable of being established ... and (ii) to be excluded liabilities."

So there was one definitional change to the PLC sub-notes and that relates to the definition of subordinated liabilities which I showed your Lordship. The definition was amended to read "and all other liabilities of the issuer which rank or are expressed to rank pari passu with the notes".

In view of the respondents' concessions we say it is plain that there is an exact symmetry between the subordination provision of the PLC sub-notes and the PLC sub-debt and there is no difference whatsoever in their

subordination outcome. The sub-debt can rank pari passu with other sub-debt; the sub-notes can rank pari passu with other sub-debt.

Unsurprisingly, that is exactly what the Lehman Group told its regulator and the outside world in the waiver applications that led to a waiver direction which is published. The waiver direction is published.

Can we just have a look, there are three documents I think it is useful to see at this stage. Could your Lordship take up bundle F2, please. If your Lordship could turn to page 769, this is a letter sent by Lehmans to the FSA, your Lordship sees at the top, on 27 April 2005. It was in fact submitted on the 28th and we know that from the following page, which is an e-mail, and your Lordship sees the e-mail is the next day, April 28, "Following on from our ..." it is the one in the middle. It says:

"As you recall, our request was for a waiver from the normal loan documentation on the grounds that the debt had been structured in such a way as to provide comparable protection to PLC. You asked whether there is any precedent that we could point to and we have been advised by Allen & Overy that they successfully filed a similar application in Collins Stewart Tullett. This has been noted in the waiver application form."

I will show that to your Lordship in a minute. And then they send a covering letter with the waiver application form. Your Lordship has seen the covering letter at 769 and it refers to the 225 million note that your Lordship has just been looking at. I am sorry.

MR JUSTICE SMITH: Yes, I have it.

MR PHILLIPS: In the middle:

"We now enclose the waiver application relating to chapter 10 of the FSA's interim IPRU. The enclosed waiver application is supported by copies of the following documents."

So you see what they send: the offering circular, the mem and arts standard terms, 10.6 annotated to show cross-references to the relevant terms and conditions of the notes, and a letter confirming that the terms and conditions are materially identical to the standard form.

The form, perhaps somewhat irritatingly but never mind, is in bundle F10. I am sorry because I am going to have to go back to F2. But it is at 5911 -- it is at 5907.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: So this is the waiver application form. Your Lordship has seen how it got sent to the FSA and just turning the page, as your Lordship sees, it sets

out -- it answers various questions and sets out the details, and if we turn to 5910, "Rule to which this application relates". 10.63(2)(a), 10.63(3) of IPRU, that is the standard terms provisions, and then if we look at the answer to 17B, the relevant -- the information available, please explain why you think this precedent is relevant.

So in answer to 17, "Is your application based on a precedent?", "Yes". "Tell us why you think it is relevant". Relevant since in the case of Collins Stewart Tullett the transaction was documented in a bond format. And then over the page:

"Please give a full and clear explanation of why you are applying for waiver or modification. You may attach any documents you wish to submit."

They then explain:

"Lehman Brothers is an unregulated holding company in a number of FSA regulated entities subject to supervision ... the issue by Lehman Brothers Holdings of dated subordinated eurobonds would augment the regulatory capital of Lehman PLC Group on a consolidated basis. We are applying for a waiver from that rule on the basis that the subordinated loan capital it is seeking to raise is not provided in the form of subordinated loan from a commercial bank, rather raised

by way of dated subordinated bonds listed on the Channel Islands Stock Exchange. Consequently it would be inappropriate to use pro forma documentation applicable only to loans. Applying for the waiver in respect of 10.63 on the basis the bonds were purchased by Lehman..."

And I am being told off by the team for reading too much of it. But your Lordship can see that what they were applying for was a waiver of the standard form. They based it on a precedent and they did it because they wanted to put it into bond format.

So if we can go back to F2 at 777. Your Lordship sees on 777, 26 May:

"I am writing to inform you that your application for a waiver modification has been approved. Please find enclosed your direction [and so on]. The direction will be published in full on the FSA's website."

Your Lordship might want to note that. Then turning over the page, your Lordship sees the direction, and the rules waived or modified: the FSA, first of all, says it is solely in relation to the 225 and then the modification:

"... if it is drawn up in accordance with the requirements set out at the end of this rule 10.63(2)..."

And I will show that to you in a moment. Then conditions:

"The direction is conditional upon the firm obtaining a legal opinion from its external legal advisers that the requirements of 10.63(2) as modified are met."

And 2:

"The loan capital referred to in paragraph 3 of this direction would meet the requirements of lower-tier sub-ordinated loan capital under IPRU."

And it is a condition. Over the page, this is the new text. In (a):

"The requirements referred to in paragraph A are as follows: The degree of subordination of the loan capital is no less than that provided for by Form 10.6."

And then in (e) taking account both of the provisions of the loan documentation:

"The loan documents are, in substance, if not in form, the same as 10.6 except to set out in the following table..."

And it then says:

"The definition of 'subordinated liabilities' may be changed to reflect borrowing in a bond rather than a loan."

My Lord, in relation to condition 4 on the legal

opinion, your Lordship may have picked up from GP 1's skeleton, in paragraph 22, that they said that the draftsman's subjective intention is irrelevant. Sorry, this was a condition required by the FSA. This is not just Allen & Overy's subjective view on how this worked.

Sorry, while I make that point, I am just going back to 766, in F2, which is the A&O opinion letter. And they confirm subject to set out below, the terms and conditions of the issue of the notes are materially identical to the corresponding standard terms in the FSA's Form 10.6 contained in the IPRU handbook."

That is the opinion that was required. That is the opinion that is given. And the requirement that there should be such an opinion is in the direction which is published. In our submission, these materials would put it beyond doubt for the reasonable reader that the PLC's sub-debts were merely replicating the subordination provisions of the PLC sub-debt. The definition of subordinated liabilities under the notes makes clear what is obviously and necessarily possible under the sub-debt -- I should have said -- I misspoke. I should have said "sub-notes", not "sub-debt" when I said that.

In light of this:

"1) by virtue of using materially the same subordination language and subordinating to the same

categories of senior liabilities, the reasonable reader would conclude that the PLC sub-debt and notes ranked behind the same senior liabilities. 2) the reasonable reader would not conclude the additional words in the PLC sub-notes definition of subordinated liabilities in and of themselves have the effect of subordinating the sub-notes to different senior liabilities to the PLC sub-debt. These were taken straight from precedent to secure the FSA waiver and, accordingly, the PLC sub-debt and the PLC sub-notes proved behind the same senior liabilities and they rank pari passu.

I will just say something about the dividend stop if I may?

MR JUSTICE SMITH: Yes.

MR PHILLIPS: Deutsche Bank advance a discrete factual argument that LBHI was commercially motivated to prioritise the PLC sub-notes over and above the PLC sub-debt. It is far from clear how this argument operates as a matter of contract, why are the commercial incentives of LBHI relevant to PLC-issued instruments. In its position paper the commercial motivations argument was said to be based on two reasons, 1) was the dividend stopper and 2) was tax reasons.

The tax reasons were set out in some detail at paragraph 52 of Deutsche Bank's position paper and that

is at bundle A, tab 8, 145-6. I do not ask your Lordship to turn it up. We explained in our reply position paper that that was untenable; it has now been dropped. That leaves the dividend stopper. The argument runs as follows: there is a dividend stopper at condition 26 of the terms of the ECAPS. That is an undertaking that where there is no distribution to the ECAPS holders, LBHI cannot declare or pay a dividend on its common stock and it is therefore argued it would have been commercially damaging to LBHI for the dividend stopper to be triggered. LBHI would have therefore prioritised cash flows to the ECAPS holders and thus to the PLC sub-notes to avoid it being triggered.

There is no contemporaneous written material whatsoever where this alleged rationale is set out. The whole argument is based on the evidence of Mr Katz, it is obviously unsustainable on the documents and appears to be a recent invention. We will be exploring that in cross-examination.

Can I then move on to the LBHI2 ranking issue, part 1, which is before the amendments. If I may invite your Lordship to take up bundle E again. The background to this, my Lord, is what the parties refer to as the 2006 restructuring and it is common ground that the 2006 restructuring was tax driven. The LBHI2 sub-debt

comprised the following: in tab 1, a 4.5 billion long-term subordinated loan facility entered into on 1 November 2006; in tab 2, a 3 billion long-term subordinated loan facility entered into on 1 November 2006; and then in tab 3, an 8 billion short-term subordinated loan facility entered into on 1 November 2006.

The terms of the LBHI2 sub-debt were in Standard Form 10; it is either 10.1 if it is long term, or 10.7 if it is short term. Can I look at tab 1, please.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: I want to look at 7 and 8. Your Lordship sees the standard terms and the standard terms are in terms that your Lordship is familiar with and on page 10 we have condition 5 and we make the same submissions on the meaning of these tranches of sub-debt on Form 10 as we did in relation to PLC on Form 10. The sub-notes comprise a eurobond in the sum of 6.139 billion during 2017 and, issued by LBHI2 as borrower, ultimately to SLP3.

At E4 we have the offering circular of 26 April 2007 and you see the date at the bottom there. The background to this is what the parties refer to as the 2007 restructuring. The key features were 1) the sole objective of the 2007 restructuring was to reduce LBHI's

consolidated overall profit and loss charge from a US perspective and therefore to secure a discrete US tax benefit.

It involved re-routing part of the Lehman Group's subordinated debt through two new Scottish partnerships established outside the regulatory chain and to achieve this a substantial part of the LBHI2 sub-debt, in the sum of 6.139 billion, needed to be refinanced and replaced by a 6.139 billion quoted eurobond issued by LBHI2 in the same amount.

The terms of the LBHI2 sub-notes were not on standard or prescribed forms because, as your Lordship has seen, GENPRU did not require the use of standard forms. Instead GENPRU provided that the firm had to obtain the properly reasoned independent legal opinion from the appropriate lawyers. And your Lordship has seen rule 2.2.159; they had to have that opinion to show that the requirements had been met. And it may or may not be watertight. It is similar to the process that one saw in relation to the waivers. When you stepped outside the standard forms you would have to get an opinion from a lawyer and they then moved from the standard forms but you got an opinion from a lawyer.

Now, if I could then go to page 55. As with the LBHI2 sub-debt, which is subordinated to the senior

liabilities in condition 5, the LBHI2 sub-notes are subordinated in right of payment to the senior creditors. And your Lordship sees that in the second sentence the rights of the noteholders against the issuer in respect of the notes are subordinated in right of payment to the senior creditors."

So one gets that. The senior creditors, your Lordship sees, are defined in the body. So one doesn't go back to definitions but they were defined as creditors of the issuer. So it is all creditors of the issuer, who are unsubordinated creditors of the issuer; that is the first category, or who are subordinated creditors of the issue. So it can be some subordinated creditors, similar to what your Lordship has seen in Form 5, other than those whose claims the claims of the noteholders are expressed to rank pari passu; that is the first lot, expressed to rank, and those whose claims rank, or are expressed to rank, pari passu with or junior to the claims of the noteholders.

So the first lot, those whose claims -- the claims of the noteholders are expressly ranked pari passu, you will find an expression of pari passu in the terms of the notes because it is saying the notes do that, and then it is: and those whose claims rank or are expressed to rank. So it might be elsewhere, or it might be by

operation of construction together with the rules and of course or junior. So that is the same as the excluded liabilities.

The definition of senior liabilities is in materially similar terms to the definition of senior creditors in FSA Standard Form 5 because that is the one that had the "other than" language. Included subordinated expressly, you had "other than". And we note that the sub-notes from a commercial perspective are in materially the same terms as the sub-debt, i.e. with exactly the same interest coupon, which is not something I am showing your Lordship in detail, and that should not come as a surprise. They were intended to refinance a substantial part of the LBHI2 sub-debt. So the fact that the commercial terms are materially the same is not a surprise.

On analysis, PLC's case in relation to the LBHI2 ranking issue revolves around little more than the inclusion of the words your Lordship has just been looking at, "subordinated creditors other than..." in the definition of the senior creditors.

And PLC describes it as the principal determinant of the priorities issue; those words. They say that at paragraph 73 of their skeleton. And they argue that ultimately the answer, as a matter of language, turns on

this difference of wording and they say that in paragraph 79. What the difference of wording is said to boil down to, which they say in 81.3, is the reasonable inference that in drafting of the LBHI2 sub-notes the drafting of the LBHI2 sub-notes reflected an acknowledgement of subordination to the existing LBHI2 subject and the reasoning goes something like: it refers to subordinated debt, there was only the LBHI2 subordinated debt, ergo it refers to the LBHI2 subordinated debt. And the argument goes that therefore that difference of language subordinates the note to the debt. And we submit that is overly simplistic and ultimately misconceived.

The phrase "subordinated creditors other than" has to be put into its proper context. Your Lordship has seen where it came from in Form 5, and the regulatory context, and the reasonable reader would make no such reasonable or natural inference for at least the following reasons, and we have a few: first, the LBHI2 sub-debt is not cross referred to expressly or referred to by name in any way and of course your Lordship has in mind this is not a standard form taken off the shelf.

Second, the notes used a form of definition that was current under FSA Standard Form 5 and had exactly the same subordination effect as FSA Standard Form 10 and it

is wrong to suggest that the inclusion of that definition led to a default position, which is how they describe it in paragraph 814 of their skeleton, of sub-ordinating one dated regulatory sub-debt to all other dated regulatory sub-debt.

Third, the reasonable reader would conclude that the sub-note envisaged exactly the same categories of senior creditors as the sub-debt for the reasons that we have explained to your Lordship placing them at the same level of the Waterfall and not subordinated to each other. Both instruments are subordinated to unsubordinated creditors, statutory interest and non-provable liabilities, which your Lordship has seen in Waterfall I, as per Waterfall I. They are both potentially subordinated to subordinated senior liabilities, other than the subordinated creditors, and it says you are subordinated to subordinated liabilities which can be senior, so they're subordinated senior liabilities, other than subordinate -- creditors who rank pari passu with you, which is the subordinated creditors, or creditors who have agreed to rank junior. And that is exactly the same as the structure your Lordship has seen right through.

So they are both -- one gets that category on the face of the LBHI2 sub-notes just as is there on the face

of FSA standard form 4 and one gets that category under the LBHI2 sub-debt by eliminating the excluded liabilities and the subordinated liabilities for all liabilities. However, both instruments are not subordinated (a) to creditors that rank or are expressed to rank pari passu, and (b) those that rank are or expressed to rank junior.

The fourth point is the reasonable reader would have it in mind that the whole transaction was focused on securing a US tax advantage and that no part of that purpose required subordination to be unrefinanced LBHI2 sub-debt.

When one goes through the two subordination structures, it is plain that the structures envisaged are symmetrical. They are subordinating the instruments behind the same things and to illustrate that we have, if your Lordship could turn up bundle B, tab 7, at appendix B, to our -- I am sorry.

MR JUSTICE SMITH: No, I have it. Yes.

MR PHILLIPS: Appendix B to our skeleton is a comparative table. And you can see the symmetry between all of the provisions and you can see that what one has, when one looks at the definition of subordinated, one starts with the ranking issues and then one moves on to the LBHI2 ranking issues, and one sees the definitions there of

the senior liabilities, the liabilities, the subordinated liabilities and the excluded and one then sees how that is put when one looks at the senior creditors; it means creditors of the Issuer, unsubordinated creditors, or subordinated other than the pari passu or the excluded. It is the same structure.

And in our submission, those forms produce the same ranking result which is the pari passu construction that the reasonable reader would make --

We draw the conclusion, sorry, we draw the conclusion from the common ground between PLC and SLP3 that the LBHI2 sub-notes, the fact that the LBHI2 sub-notes were refinanced in the LBHI2 sub-debt which ranked pari passu inter se, so PLC's case demands that the reasonable reader would draw the improbable inference that the words it alights on, which your Lordship has seen, of themselves altered the existing pari passu ranking. And we say that is implausible.

And also it depends critically on the senior subordinated debt only being either the existing -- not either -- being the existing and regulatory subordinated debt and that is just wrong because it was possible either at the time or later for other subordinated debt to come into existence. And if that subordinated debt

did not form part of the lower tier 2, tier 3 capital, it would be senior to the regulatory capital, and that is not surprising because that is what the directive required. This regulatory capital was supposed to be subordinated to all other creditors.

We have identified other candidates for potential subordinated debt that would be senior to the lower tier 2, tier 3 subordinated debt.

First of all, regulatory subordinated debt was not the only kind of subordinated debt. It was obviously possible for credit institutions and investment firms to hold non-regulatory capital subordinated debt. There is no evidence, no-one has put in evidence that LBHI2 held such debt. But, paragraph 44 in our submissions, and your Lordship gets it from the MCC case for example, that was a subordinated guarantee. It was commercial. It had nothing to do with subordinated capital. And of course the other thing that it might have had in mind is flexibility. The flexibility for future possible layers of regulatory capital.

Your Lordship has already seen from the history that tier 3 regulatory capital comes out of bar 2, so it comes in much later, and you want to be able to put that in above your tier 2.

And then there was an introduction of something

called TLAC which is supposed to be senior to, and we put all the relevant provisions, senior to tier 3. So one had to have flexibility for that.

I am minded tier 3 ranked together with lower tier 2.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: Sorry, I misspoke. What I should have said is you have seen the introduction of tier 3 which is another different type of regulatory sub-debt. In fact, the tier 3 is much more short term, so it is two years sub-debt but you actually put in place when you have particular types of higher risk and so you cover it with tier 3. That is really nutshelling that down but that is what tier 3 is there for.

And for your Lordship's note Maxwell is in volume 2 of the authorities at tab 42.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: So my Lord that brings me to the LBHI2 ranking issue part 2, which is the amendments.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: In mid-2008, the relevant decision-makers within Lehman decided to amend the LBHI2 sub-notes. The amended process was delegated to A&O as the Lehman Group's external legal adviser. The aim and genesis of the amendment was the deferral of the

interest otherwise payable by LBHI2 to SLP3 to obtain a discrete US tax benefit. That purpose was the sole purpose stated on the face of a number of public documents and all internal documents -- sorry, that it is stated.

MR JUSTICE SMITH: When you say delegated to A&O, that is probably a matter that will be covered in the evidence in terms of controlling mind and --

MR PHILLIPS: Yes.

MR JUSTICE SMITH: -- whose thinking I must have regard to for purposes of rectification.

MR PHILLIPS: Absolutely. Yes. When I come on to just touch on rectification, which I should do after the short adjournment, I will be looking at that. When I say delegated to A&O I do not mean that A&O were authorised to make all the relevant decisions. It's the process.

MR JUSTICE SMITH: No, it was simply a job they were given, yes.

MR PHILLIPS: They were given that job. And your Lordship will see all that. So if I could then just in bundle E, if we could then turn over to tab 5.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: I do not know if this is useful but one or two of the parties have referred to a version at bundle F,

V5, 2847 which has a lot of lining on it so you can instantly see what the amendments are. I do not know how useful it is but I will just mention that.

The amended LBHI2 sub-notes are structured so that the -- in a winding up the sub-notes rank above a layer of debt that ranks above the preference shares. That is what these amendments do and I will show that to your Lordship.

Can your Lordship sees there is the written resolution.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: And the amendments for present purposes are in clause 3(a) and just running down clause 3(a) your Lordship sees that in the fifth line, after it says "payment of principal and interest", the words "and interest (including arrears of interest as defined below)", those are new, as are the words "subject has provided below".

And what one gets from the first two lines is the conditionality that your Lordship has seen. So it says:

"Accordingly, payment of the principal and interest in respect of the notes is conditional upon the issue of being solvent at the time of and immediately after such payment", then it goes on and says "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."

And then we get to the new part which is everything from "The conditionality referred to above", which is that, down to the end of what we call the confirmatory note at the bottom of the page. Those are the relevant amendments at this stage.

Let us just have a look at what was done.

"The conditionality referred to above [which is the conditionality we have looked at] shall not apply where an order is made by a competent court for a resolution passed for the winding up or dissolution of the issuer except for restructuring."

That is the winding up point. I do not want to go into too much detail on that at this point. Then you get this:

"If at any time an order is made by a competent court or resolution passed for the winding up or dissolution of the issuer [so this is the new condition], there shall be payable by the issuer in respect of each note in lieu of any other payment to the issuer", so it is a payability condition that kicks in, "there shall be payable", "such amount, if any, as would have been payable to the noteholder [so it identifies an amount that 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 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 ..."

Now that is very important because it is described as a preference share but you will now see where the payability condition provides payment should in fact be made.

First is:

"The holders of all other classes of issued shares in each case for the time being in the capital of the issuer."

So all of the shares, so it is payable above all of the shareholdings. And second, above something called the notional holders.

And then it goes on to say:

"... 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) ..."

That in other words means the whole of the sum outstanding. That is what your claim is and you have to apply the payability condition to the whole of your

claim for all the sums outstanding.

"For the purposes of the above provisions, the notional holder ..."

Now your Lordship has seen that the right, the payability right is a right to be paid above something called the notional holder. So you have to look at what the notional holder is:

"'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."

So we get yet another definition because we are being told that it is a creditor and it is a creditor who holds something called a notional share and. The notional share is:

"... 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 the capital of the issuer but not further or otherwise."

So I will come on to the confirmatory note in a moment. The key subordination provision which your Lordship has seen, and this is the important starting point, remains the same. The LBHI2 sub-notes remained subordinated to the senior creditors. The

solvency condition on a winding up was disapplied and replaced by a payability condition and your Lordship will see why it was that a Mr de Haan, at Allen & Overy, thought that the solvency condition could give rise to a tax problem as it was.

It was replaced by the payability condition. Under the payability condition, the noteholder would get paid and ensuring he would get paid was Mr de Haan's concern, and the amount was as if he held one class of preference shares having a preferential right to return of assets in the winding up over, and so you have to say, right, he has called it a preference share but what it has got is it has a right to be paid over and you then have to look at the over. First is all the shares, all the issued shares; second, above the notional holders, who are they? They are creditors. And that is a really important point. Those notional holders are creditors. And they hold a notional share and the notional shares are hypothetical shares that rank above all other preference and ordinary shares.

So it is creditors in a layer above all the other shareholders including preference shares. So the notional shares are the upper tier 2 debt. That is what you get from this.

The LBHI2 sub-notes after the amendment rank above

the upper tier 2 debt and behind the same senior creditors, in other words where you would expect to see a lower tier 2 debt ranking. There was no change to the ranking after this amendment.

The preference -- the preference share concept is merely hypothetical or notional. It is one that is -- and that is clear from the fact that this share is said to have a right of return over the assets of creditors which a preference share cannot and if it was an actual preference share it would have the rights of a preference share, it would not have rights that slotted it in above that class of creditors that is above the shareholders.

Mr Beltrami's skeleton asserts, and this is paragraph 85.3(c) at bundle B, tab 2/31, that the amendment regulates noteholder claims behind all other creditors. And that submission is entirely at odds with the plain wording of the amendment, it does not do that, which states that there are other creditors who will be paid below the noteholder claims.

My Lord, when your Lordship comes to construe these amendments it is important to look -- it is important, my Lord, to look at the rights that the noteholders are given, i.e. as creditors who are entitled to be paid at a certain level.

My learned friend, Mr Beltrami, confuses the status described, in other words preference shareholder; he confuses that status with the rights to payment that the noteholders are given in a winding up and having in mind of course this is in the context of a creditor agreeing to subordinate his debt. You do not cease to become a debtor and become a preference shareholder. The noteholders do not -- cease to become a creditor, sorry, I misspoke -- and become a notional shareholder.

The noteholders do not become actual preference shareholders and their rights are not a consequence of status as a preference shareholder; that is the crucial point. We cannot look at the words "preference shareholder" and say right, what are the rights that result from the status of a preference shareholder, because that is not what the draftsman did.

And we then get -- so we have to look at the rights and the rights are to payment at a particular point and your Lordship can see that that particular point is behind the senior creditors and before certain other creditors who are the upper tier 2.

And then we go to the confirmatory note. It is very unusual but at least we can see the draftsman writing down what he intended. It says this:

"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) ..."

So where they qualify as upper tier 2 capital and tier 1 capital. It is exactly what he says. He says this is intended to come in above the upper tier 2 and tier 1 capital within the meanings given to that in GENPRU.

So that says, that is what he meant, it ranks above upper tier 2 regulatory capital including debt and tier 1 and the only conclusion that can be drawn in our submission from that is that the amended sub-notes would continue to rank for insolvency purposes with the lower tier 2 sub-debt.

My learned friend Mr Beltrami, in footnote 72 of his skeleton, takes the point and I think this is probably worth turning up, PLC is in tab 2, bundle B. Footnote 72 which is on page 32. In footnote 72 my learned friend says:

"SLP3 has previously argued that the final paragraph, with its reference to the LBHI2 Sub-Notes ranking above 'holders of any securities', does not mean what PLC says it does because 'securities' means shares

and debt, not shares alone ..." and they refer to our decision paper. "This is simply wrong as a matter of ordinary language, and GENPRU 2.2.176G ... referred to by SLP3 does not say that securities includes debt, rather it confirms that some debt may be eligible Upper Tier 2 regulatory capital. SLP3 fails to mention that 'securities' is in fact defined in the Handbook containing GENPRU to include shares, debentures, warrants etc, i.e. in the ordinary way not including debt."

And the handbook is J2 at page 12 where you will find that -- tab 12, where you will find that reference and of course they rely on the definition. It includes debentures. A debenture is a debt secured on the assets of a company. It is a debt.

Does your Lordship want to have a look at J2/12? It is 894. Security. It is on 894. Security. And it includes all the various -- it is including a debenture. So it is simply wrong to say that it cannot include debt; a debenture is a debt which is secured on the company's assets.

My Lord, would that be a convenient moment?

MR JUSTICE SMITH: Yes, indeed. We will resume at 2 o'clock.

(1.00 pm)

(Adjourned for lunch)

(2.00 pm)

MR JUSTICE SMITH: Mr Phillips.

MR PHILLIPS: My Lord. There are three issues that arise on the 2008 amendments for your Lordship, which is first of all whether the 2008 amendments altered the pre-existing priorities; secondly, whether they were engaged; and thirdly, whether or not there should be rectification. I am going to address each of those in turn.

The first point in relation to they do not alter priorities on rank -- they did not alter priorities on ranking, at this point I will just make three big points.

One, the key subordination provisions did not change. They include the core subordination language in condition 3(a) that the rights of the noteholders against the issuer in respect of the notes are subordinated in right of payment to the senior creditors, the definition of solvency and the definition of senior creditors.

Two, it is plain from the language of the amended condition 3 that the LBHI2 sub-notes remained at the same place in the Waterfall; the LBHI2 sub-notes continued to rank above other creditors, they were not as the other respondents maintain demoted into the

equity, they did not acquire the status of actual preference shareholders.

And three, in footnote 71 of my learned friend Mr Beltrami's skeleton, which is at tab 231. It says that these creditors are, I am quoting, "a special type of creditor", whatever that may mean. I do not know if your Lordship would just like to turn that up.

MR JUSTICE SMITH: Yes, I have it.

MR PHILLIPS: Yes. They describe them as a special type of creditor. But the short point is that no shareholder's claim can rank above that of a creditor and it is a complete non sequitur to say, as PLC does, that the LBHI2 sub-notes are deemed to be at the level of actual preference shares.

So that is what we say in relation to the submissions, that it does not alter the priorities. In relation to "are not engaged", we deal with this in paragraphs 391 to 404 of our skeleton and we will develop those arguments in closing. I think I will leave it there at that point.

And should be rectified. Finally, if we are wrong so that the 2008 amendments altered the priorities, we submit that the 2008 amendments should be rectified to give effect to the common intention of the parties, which was to do no more, no less than to enable

a deferral of the payment of interest to obtain a discrete US tax benefit. This common intention was inconsistent with the legal consequence of altering the priorities.

Now, PLC make a lot of the insufficiency of the evidence before the Court and for your Lordship's note they say that in paragraph 170, the paucity of evidence; in paragraph 171 they describe the deficiency of evidence. Indeed, remarkably PLC even asks your Lordship to make adverse inferences against SLP3 for not calling those who they described as critical witnesses, which is Rush, Jameson, Triolo and Upton. They do that in paragraph 171.

We would make the following initial observations: first, your Lordship is going to hear evidence from Ms Dolby. She was the team leader of the cross-departmental group that acted on both sides of the transaction. Your Lordship will also hear evidence from Mr Grant, now a partner in the capital markets team at A&O; he was the senior associate who drafted the amendments including the extensive amendment to condition 3. PLC claims the evidence of these two individuals is irrelevant, and we submit that is plainly not the case.

Secondly, my Lord, your Lordship has all of the

disclosure in relation to the 2008 amendments because your Lordship has everybody before your Lordship.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: A curiosity of the case is that LBHI2, which was the other party, is neutral on the rectification issue and as such LBHI2 has not needed to call evidence from its own witnesses.

And fourth, cross-examination. Cross-examination of each critical witness is not critical in any event. The recent case of Murray v Oscatello, which I am going to show your Lordship shortly, is a case in point. There was no witness evidence at all in that case and yet the court still ordered rectification.

Your Lordship will consider this issue in the light of the Court of Appeal's recent and comprehensive decision in FSHC, the Four Seasons case.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: I will just give your Lordship the reference which is in authorities volume 7, tab 154. I am not going it take your Lordship to it at this time but the Four Seasons case has clarified it is the subjective and not objective intention of the parties to do no more than and no less than this, and this is a no more no less case. Like the Four Seasons case, the common intention of the parties, and your Lordship will see it

from the whole suite of documents and all the witnesses who your Lordship will hear from, the common intention of the parties as expressed between them was to do no more, no less than defer interest. It was not part of the common intention of the parties that SLP3 should be demoted or relegated below LBHI2 in the event of an insolvency. The mistake was one about the legal effect of the 2008 amendments, not merely their commercial consequences.

PLC suggests, incorrectly, that an absence of positive intention is insufficient to form the relevant intention. They say that in page 122 and they cite Chitty on cases where there had been a failure or oversight to include a term and that is not our case. This case, like Four Seasons, is one where the absence of any discussion about a fundamental change to the parties' obligations constitutes convincing proof of the actual common intention and we have dealt with that in the skeleton, for your Lordship's note it is 413, and in that respect the case has much more in common with the pensions cases than -- which were analysed -- it has quite a lot in common with the pensions cases which were analysed in Four Seasons, my learned friend Mr Arden agrees with us on this point, paragraph 56 of his skeleton, and that is because the 2008 amendments did

not require true bilateral negotiations or agreement. All that was required under the notes was SLP3's consent to the amendment proposed by LBHI2 and the only amendment that was proposed was to enable the deferral of interest payment.

Can I just show your Lordship two documents from which your Lordship will see that the purpose and intention behind the amendment was to do no more, no less than to defer interest. If you just take up F6, please.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: The first is 3325. Does your Lordship have 3325?

MR JUSTICE SMITH: I do.

MR PHILLIPS: It's LBHI2's board minutes. And at the end of paragraph 1, so they consider the amendment:

"The purpose of the amendment was to allow the company to defer cash settlement of the interest on the notes at its discretion."

The first one. Second one is 3503. This is Delaware, the Delaware consent and if I can -- again I just pick up in the fifth paragraph, fourth recital, fifth paragraph, at the end, last sentence:

"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."

And I am just showing you those two at the moment, my Lord.

If the -- if -- the effect of the 2008 amendments was to alter the ranking priorities and to engage the juniority construction then that was not the common intention of the parties and the court should rectify.

Finally, on rectification, my Lord, your Lordship asked this morning whether the decision making was delegated to Allen & Overy and of course I answered that that was not the case. Our case on attribution of knowledge is dealt with in paragraphs 434 to 438 of our skeleton argument. We say that the relevant decision-makers were Ms Dolby and Ms McMorrow and that they had the same intention of deferring interest without more; that is the starting point. If they were not the actual decision-makers, we say the intention and knowledge of Ms Dolby and Ms McMorrow was adopted and given effect to by the board of LBHI2 and SLP3 and alternatively the evidence will show that the board of LBHI2 and SLP3 shared the knowledge and intention of Ms Dolby and Ms McMorrow and that, if I can turn up Oscatello, which is in volume 6 of the authorities, at 142, it is paragraph 198, I think it is worth just pointing out that what your Lordship gets from

Mr Justice Mann's judgment is a distillation of the principles.

If your Lordship just casts your eye over (a), (b) and (c), in (c), 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.

The intention of a mere negotiator may be relevant if it is shared with the actual decision-maker, but as it seems to be that is because the intention has become that of the actual decision-maker.

Then where the person who would normally be expected to be the decision-maker 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 the person is the decision-maker, so that is delegation, or if that description is not apt because the technical decision-maker simply adopted the intentions of the negotiator.

So that gives us the framework.

And what is telling is that nowhere in all of the materials is there any evidence that anyone at all intended to alter the ranking and your Lordship will become familiar with that. Absolutely nothing.

Can I then move on to the release issue, please, my Lord?

MR JUSTICE SMITH: Yes.

MR PHILLIPS: The release issue is whether all of the PLC sub-debt which has an aggregate face value of US$1.9 billion has been released as a result of the effect of section 8.02 of the Settlement Agreement. It is said that a release executed in October 2011 released claims that were acquired by LBHI from the original lender under the PLC sub-debt, which is LBUKH, in April 2017; so six years later they acquired by assignment from LBUKH the sub-debt and it is argued that that was released.

Our position is that the language, and I will take your Lordship to it in a moment, very plainly does not release after acquired claims such as the PLC sub-debt and that is also the only construction that accords with common sense.

Deutsche Bank argue that LBHI has released the PLC sub-debt and dismisses the release as a mistake, in paragraph 71 of their skeleton, which merely reflects that LBHI entered into a bad bargain. And that is paragraph 132. The release issue will largely turn on expert evidence of New York law. Our expert is Judge Allan Gropper. Judge Gropper is a former NYC bankruptcy

judge who sat in the Southern District of New York for 15 years. The Settlement Agreement was approved by the bankruptcy court in the Southern District of New York.

The Deutsche Bank expert is Judge Robert Smith, who is a former Associate Judge of the New York Court of Appeal.

One potential area of disagreement is the admissibility of evidence of subsequent conduct, the so-called practical construction point. Judge Gropper says you can admit this in any event and Judge Smith says that you can only admit this when there is ambiguity.

Our primary case is that the scope of the release is clear from the wording and therefore your Lordship does not need to consider the subsequent conduct of the parties; you get all you need from the words. However, if we are wrong about that, and there is an ambiguity, then it is actually common ground that the extrinsic evidence of post agreement conduct is admissible.

So it actually means that there is no need for your Lordship to determine the issue of whether or not subsequent conduct is admissible in any event because if 802 is not ambiguous your Lordship is not going to need it, and if it is ambiguous it is common ground between the judges that extrinsic evidence is admissible and

I hope that that helps your Lordship in relation to that issue.

Can I just show your Lordship the Settlement Agreement. It is in bundle E at tab 16. Your Lordship sees that there is the Settlement Agreement and it is made on 24 October 2011 by amongst others the debtors and they are then set out in footnote 1 and it includes my client LBHI as the first of the debtors. The debtors are the US entities and the UK administration companies. And if you drop down to 3, it then identifies the various UK administration companies and five lines down, does your Lordship see LBUKH, Lehman Brothers UK Holdings Limited, so that is the assignor.

So those are the parties. I am sure we will look at this in more detail. And if I could take your Lordship to page 459, please.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: I just want to show your Lordship three of the recitals in this case starting from the recital at the top:

"Whereas the UK affiliates filed proofs of claim listed in schedule 1 attached hereto against certain debtors [that is the US entities] on behalf of themselves and/or to preserve rights of certain other entities with beneficial interest held through certain

UK affiliates."

Then the second:

"Whereas certain of the debtors have asserted that they have claims against certain UK affiliates including claims asserted by LBHI against LBIE and certain other UK affiliates in respect of the intercompany funding claims."

So you have those two recitals, and then the last recitals at the bottom:

"Whereas the debtors and the UK affiliates desire to resolve all disputes and all other outstanding issues among them except as expressly excluded and to avoid extensive and expensive litigation thereon."

And your Lordship sees and we obviously place emphasis on the desire to resolve all disputes and all other outstanding issues among them.

Then if we can go forward to 498. This is 802 and this is the release granted by the debtors. This is the US entities. What it provides is "upon occurrence of the effective date" and your Lordship will see that is 6 March 2012, and then except in relation to there are some allowed things but then 1, 2 and 3, exceptions.

"Each debtor on behalf of itself, its estate, its successors and assigns ..." and it includes various trustees, and then further down "hereby fully and

forever releases, discharges and acquits each debtor released party ..."

Which is defined at 462. I think it might be worth just looking at that on 462. It is at the very bottom of the page. It is "Each UK affiliate and each of its joint administrators, joint liquidators ..." and so on.

MR JUSTICE SMITH: I have it yes, thank you.

MR PHILLIPS: Yes, so it is worth just seeing that. So the debtors:

"On the ... effective date ... each debtor ... releases ... each Debtor Released Party ..." so that is the US debtors and releasing the UK affiliates and so on, debtor release parties, "... from all Causes of Action ... whether at law or in equity, whether based on contract (including quasi-contract, guarantee, indemnity or estoppel), statute, regulation, tort or otherwise (excluding fraud ...) ... accrued or unaccrued, foreseen or unforeseen, foreseeable or unforeseeable, known or unknown, matured or unmatured, fixed or contingent, liquidated or unliquidated, certain or contingent [so that you have to fall within one of those], 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."

So it gives you the scope of the sorts of claims and it then gives you the facts that they should arise out of.

The key point, my Lord, sorry am I going too --

MR JUSTICE SMITH: No no.

MR PHILLIPS: The key point my Lord that we will be exploring in cross-examination is the issue of whether the scope of section 802 extends to after-acquired claims. And your Lordship will need to consider 1) whether it was part of the purpose, context and desire behind the agreement to release after-acquired claims; 2) whether the concept of after-acquired claims falls within the words unforeseen, unforeseeable, unmatured and unapproved, and 3) the concept of whether an after-acquired claim falls within the key words "connected with, alleged in or related to any facts or circumstances in existence prior to the date hereof". And I think your Lordship can see what the battle lines are, but that is a matter for discussion with the judges when they come to court next Friday.

We say that the answer to all of these questions is no. There are two major points we will be exploring. The key words relate to pre-existing facts and pre-existing rights and obligations between the parties to the Settlement Agreement at the time of the agreement

and they are released on the effective date and there were no pre-existing facts or pre-existing rights and obligations between LBHI and PLC in respect of the PLC sub-debt at the time of the agreement.

So that, my Lord, is the release issue and that brings me finally to the discounting issue.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: On the discounting issue, my Lord, there is an issue about the effect of Rules 14.44, and 14.23 of the 2016 Rules on the PLC sub-notes and whether they should be discounted and whether a claim can be made for future contractual interest.

There is a lot of detail that has gone into Deutsche Bank's submissions and we will respond to all of those points when we have put in our written submissions in closing. But there are three short points to make at this stage. The first point is if your Lordship would take up the authorities bundle 6 at tab 146. This is Waterfall I.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: And I just wanted to turn up paragraph 194 in the speech of Lord Sumption, in paragraph 194, and he talks about non-provable debts being recoverable from a surplus and then he says this, and this is very important. It is --

MR JUSTICE SMITH: Which letter are you at?

MR PHILLIPS: I am sorry. Just above B, three above B:

"It is axiomatic that where the insolvency rules deal expressly with some matter in one way it is not open to the court to deal with it in a different and inconsistent way."

So that is the starting point and then, my Lord, if I can just show you two rules. The first is Rule 14.44 which is in the authorities bundle 7 at tab 17, or it is on page 1175 of the Red Book. 14.44:

"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 the other creditors, but subject as follows ..." and it is this:

"For the purpose of dividend (and no other purpose) the amount of the creditor's admitted proof must be [and your Lordship will note the words, mandatory] must be discounted by applying the following formula -- X/1.05 to the power of n -- where (a) 'X' is the value of the admitted proof; and (b) 'n' is the period beginning with the relevant date [which is the date on which the insolvency relates back to] and ending with the date on which the payment of the creditor's debt would otherwise be due [and as your Lordship knows that is 2035 and

2036] expressed in years (part of the year being expressed as a decimal fraction of a year)."

So there is mandatory discounting and Parliament in the rules has provided for the calculation.

The PLC sub-notes are contractual, provable debts payable at a future time. The rights arise under a legal obligation in existence prior to the administration. The fact that it is not payable until lower in the Waterfall than non-provable debts, which is the point effectively that is taken, cannot alter that analysis. It does not alter the analysis that they are provable debts just because in the Waterfall they are placed below non-provable debts; in fact that would apply to all subordinated regulatory capital.

In paragraph 205 of its skeleton Deutsche Bank accepts, and I am quoting:

"If the claim under the PLC sub-notes is properly treated as a future provable claim, such discounting is unavoidable."

And for your Lordship's notes that is B tab 374.

The second rule that I wanted to just show your Lordship is 14.23, which is in volume 7 at tab 17, 4291 or in the Red Book at 1168.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: What this provides, which is the current rules

in relation to interest, is, first of all:

"Where a debt proved in insolvency proceedings bears interest [and your Lordship will note the words 'bears interest'], that interest is provable as part of the debt except insofar as it is payable in respect of any period after the relevant date."

So interest that has become due before the relevant date is provable. Then in (2):

"In the circumstances set out below, the creditor's claim may include interest on the debt for periods before the relevant date being not previously reserved or agreed." That then deals with other pre-existing interest. "If it is due by virtue of a written instrument payable at a certain time, interest may be claimed for a period from that time to the relevant date."

And then if it is due otherwise, it may only be claimed if a demand for payment has been made. And then interest, under 4, may only be claimed for the period from the date of the demand.

Then it deals with the rate of interest.

Then you get to 7:

"In an administration any surplus remaining after payment of the debts proved must, before being applied for any other purpose, be applied in paying interest on

those debts in respect of the periods during which they have been outstanding since the relevant day." So there is a system for payment of interest post administration. "And all interest payable under subparagraph (a) ranks equally, whether or not the debts payable rank equally and the rate of interest is either the greater of the rates specified under (6) [which is the judgment debts rate] and the rate applicable to the debt from the administration."

So statutory interest. So contractual interest is only provable up to the date of the administration, statutory interest is then payable on the debt. This was confirmed by David Richards, Mr Justice David Richards in with a Waterfall IIA, and in paragraph 277 of its skeleton Deutsche Bank accepts that Rule 14.23 provides a complete code for the recovery of interest on proved debts in an administration, and that is at T3107.

So they have to, Deutsche Bank have to persuade your Lordship that interest is not interest for this argument to get off the ground. Your Lordship notes 14.23 is concerned with a debt that bears interest; that is what the rule says. Clause 5 of the sub-debt in question says, and I am quoting, "the note bears interest".

That is all I will say about the discounting issue

for now. In our submission there is a mandatory code in the Insolvency Rules and it has to be applied.

My Lord, I have gone two minutes and 16 seconds over my allotted time. Those are our submissions in opening.

MR JUSTICE SMITH: I am very grateful, thank you very much.

Submissions by MR BELTRAMI

MR BELTRAMI: My Lord, as your Lordship is now aware there are essentially three issues or three sub-issues on the LBHI2 priority dispute.

The first is as to the interpretation of the 1 May 2007, ie on the unamended form of notes, which is relevant because certain parts of the wording is unchanged and also because it sets the context for the rest of it.

The second question is interpretation as at 3 September 2008, i.e. following the amendments, because that produces the notes in their current form.

And the third is the question of rectification, the necessary premise of that question arising in these circumstances, and only in these circumstances, that under the unamended form of notes the ranking was pari passu, by mistake the amendments gave priority to the sub-debt, and therefore my learned friend seeks deletion of virtually the entirety of clause 3 of the amendments as giving rise he says to the actual

intention of the parties.

Those are the three issues as your Lordship is aware.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: Before addressing each of those and I hope more to, if I can, sketch out the issues to the court which I hope is helpful rather than argue all the points to the end of the degree, some things on the factual context which I hope is going to give assistance. There may be some debate to the admissibility of the question of interpretation of some of the background but it is all certainly admissible on rectification. But in any event I think it is important for the court to see it at the moment.

Can I take your Lordship in terms of the factual background, and we can do this by charts which I hope are going to be more useful, F3/1748. By charts, because there are four stages of transaction which may or may not be of relevance but at least give the context of the discussion we are going to have.

F3/1748 is an e-mail and attached to the e-mail at 1749 is a chart and in the chart can I ask your Lordship to look at the left-hand picture. This is the structure as at September 2006. That is the date of the e-mail of September 2006. So this is the then original structure

before things started to be made. Changes started to be made.

The left-hand column, left-hand picture, indicates the funding structure at the time and going from the bottom, your Lordship is aware of LBIE being essentially the operating company which received the money to use, if you like, the other companies being intermediate holding companies, and you can see there that LBIE on the right-hand side has received $5.4 billion of -- that is fact sub-debt from PLC.

So at that stage there were sub-debt agreements between PLC and LBIE for that amount. The picture is not perfect but if you find the PLC and go to the left, you will see a figure 4693 which then follows up to the top and the 4693 are sub-debt agreements starting from LBHI at the top all the way down to PLC.

So LBHI funded PLC and ultimately LBIE through a sequence of sub-debt agreements being these agreements on the left-hand column. So it is 4. 6 billion, straight from America, all the way through these no doubt tax efficient holding companies to PLC, then sub-debted on, if I can coin that verb, to LBIE.

So that was one way in which LBIE was funded.

The other way it was funded, actually there are two other ways. If you look at PLC on the right-hand

column, the 2.25 billion, that appears to be preference shares into PLC but we do not have to worry about that. Nothing turns on that. On the left-hand side in the PLC column there is a 1.13 billion, and that is ECAPS funding.

So the ECAPS funding comes in to PLC and it is a combination of the 1.1 billion and the 4. 6 billion and I suppose also the preference shares that eventually get pushed down to LBIE, albeit that 4.5 billion is the number that actually goes into LBIE.

So the existing position before any changes were made, you have sub-debt agreements going down the chain from LBHI to PLC and ultimately to LBIE, and you have the ECAPS funding as an alternative means of funding into PLC, and the totality of some of the totality then gets pushed down to LBIE.

So that is the September 2006 position.

Changes were made in November 2006. So the first set of changes. And can you go to bundle F4/2047 which is another chart, fortunately not quite so big. It is the position as at January 2007. So the November 2006 changes have been made to the position in January 2007. So that is why I chose this, to see the changes that have been made. And there are two relevant changes.

Before we go on to the changes, you will see it is

a similar sort of diagram. You still have the ECAPS funding into PLC and you still have on the left, the intermediate left-hand column, the sub-debt funding into PLC which has risen to 6.139 billion by this stage.

By January 2007 that sub-debt funding has increased. The ECAPS funding, the numbers are a little bit different as well, but the same idea. PLC is still being funded by the ECAPS and by the sub-debt.

But the two changes in November 2006 were first of all if you find PLC and you go down from PLC, you see two intermediate companies between PLC and LBIE. Mr Phillips was right, my understanding is there were tax drivers for a lot of this, but they inserted two intermediate companies, LBHI1 and the now famous LBHI2, in order that the funding, instead of going directly from PLC to LBIE, go via LBHI2 to LBIE. So that was done by replacing the PLC to LBIE sub-debt instruments with PLC to LBHI2 sub-debt instruments and LBHI2 to LBIE sub-debt instruments.

So the structure changed by interposing that intermediate company at that stage but otherwise the structure is the same.

And the other change at this stage, if you go down to the LBIE bit, it is no longer funded entirely by sub-debt. The right-hand column means it is funded by

5.1 billion of sub-debt but on the left-hand side you will see a figure of 2 billion. They replaced 2 billion of sub-debt into 2 billion of preference shares in LBIE. So two changes in November 2006: the interposition of LBHI2, which required a recasting of the agreements; and the change of sub-debt into preference shares at LBIE.

And the last thing on this page, just to ask you to bear in mind that 6.139 billion figure because that is what becomes relevant at the next change which was in May 2007. If you go here to the chart, it is the next page, 2048.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: This says "proposed structure" but my understanding is that certainly so far as material it is the actual structure. I could not find a post structure chart. If you find PLC in the left-hand picture, about three up, it is still being funded by ECAPS, the 1.2 billion ECAP is still there, that has not changed at all with any of this, and it is still funding LBHI2 and LBHI2 is still funding LBIE and I will come back to that in a moment. But what has happened is that the PLC to LBHI2 lending has changed in that the 6.139 billion existing sub-debt gets moved into the sub-notes ultimately held by SLP3. And the residue of the funding stays as sub-debt. And it seems -- I mean we may look

at this in evidence in due course, it seems that the residue of the funding reflected the ECAPS bit. Not entirely clear, some of the numbers do not entirely match up, but it looks as if they separated out the ECAPS funding, kept that as sub-debt, and the purely internal Lehman funding moved into the notes.

So that seems to be what happened in May 2007. And the other change at this stage, if you go down to the LBIE box all of the funding was then put into preference shares, so all the sub-debt into LBIE was replaced by what was then 7.1 billion of preference shares. So that was the other change at that stage.

So November 2006 we saw, May 2007 we saw and then September 2008, as your Lordship is aware of the amendments, the notes. So those are the three movements of transaction that your Lordship will be having to consider.

That is the very broad factual background. The regulatory background which we accept is potentially part of the admissible factual matrix at the moment we can take quite shortly. Mr Phillips said all the funding under sub-debts or sub-notes was applied as regulatory capital for the purpose of satisfying capital adequacy ratios, and therefore needed to be compliant with first IPRU and then GENPRU.

The principle underlying the rules which then implemented the EU legislation was that all regulatory capital had to rank behind unsubordinated creditors in an insolvency. That was we say the fundamental principle. That was achieved under IPRU by the use of standard forms which had that effect through the wording, which we will have to look at, and achieved under GENPRU by the specific requirement to that effect in rule 2.2159.

So there was a rule under GENPRU, you must be subordinated to other creditors. But neither IPRU nor GENPRU said anything at all about ranking as between subordinated debt, which is the issue for the court. That was purely a commercial matter for any borrower and turns on the actually wording of the contracts in their context, et cetera of course.

But that is why we say the regulatory background is admissible and relevant but not very relevant because it does not actually deal with what we have to deal with, but that is what we say about regulatory for the moment.

With that background can I move on to the first topic: interpretation as at the date of the original notes on 1st May 2007.

Some initial introductory points on this. First, it seems to be recognised -- I will come back to this --

that parties are able by contract to subordinate their debts to other debts, including other subordinated debts. So you can have layers of subordinated debt.

Can I ask you to go to authorities bundle 5, tab 129. Mr Phillips made a point which we say is wrong, so we want to get this right.

Tab 129 is the Court of Appeal in Waterfall I.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: And at paragraph 38 of that, of Lord Justice Lewison's judgment, which is page 3042.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: The judge was addressing the question how do you go about subordinating debt. And he said there are three ways of doing it. A number of different ways in which subordination agreements can be drawn. And he says there are three of them relevant for present purposes; first, second and third. The first is a holdover clause, the third is a trust clause, the relevant one is the second one, at letter E.

The second is an agreement which expresses the subordinated creditor's right to repayment as being contingent on the satisfaction of a condition or conditions. In our case the right to repayment under clause 4, but that is subject to clause 5 which was the solvency condition that he was looking at.

So all he is saying there is there are ways of doing subordination and one way -- the other two do not apply to our case -- one of the ways of doing it, one of the three ways of doing it is to make your agreement conditional, the condition being solvency in that case.

Now, Mr Phillips said this was said to be wrong in the Supreme Court. No is the answer to that. This is nothing surprising or in any way unusual. After describing how subordination provisions can take effect, Lord Justice Lewison then went on to ask a different question, if we go to paragraph 41, which is:

"If you do have a subordinated agreement, how does that take effect in terms of a proof? Are you able to prove at all until all the conditions are satisfied or do you prove and it is given nil value?"

And he says in 41, if you go down about six lines:

"Mr Snowdon said correctly in my judgment...(Reading to the words)... has been satisfied."

So he is saying in the insolvency world, once you have a subordination agreement, you can prove it but it is valued at nil and you can back up the conditions satisfied, as opposed to the alternative which is what Mr Justice David Richards upheld, which is you cannot prove at all. You are unprovable until your condition becomes clear.

It was on that point that the Supreme Court disagreed with Lord Justice Lewison. If you go, please, to authorities bundle 7 -- sorry, authorities 6/146. No, I am completely lost now. 6/146 and if you go, please, to 68. Lord Neuberger's judgment, page 3611. The first thing, he doesn't address at all the paragraph we looked at about how you subordinate what your contractual mechanism is. He is asking, you can see the title of that bit of the passage, "When can LBHII2 lodge a proof?" and that is what he is addressing. And he discusses that point at paragraph 68, the bottom of paragraph 68, he refers to paragraph 41 of Lord Justice Lewison which is the one I just showed your Lordship about the lodging of a proof; not paragraph 38, which is how you do it in the first place. At 72 he decides that he agrees with Mr Justice David Richards that you cannot prove at all until your condition becomes clear.

So yes, Lord Neuberger disagreed with Lord Justice Lewison on the question of technicalities of proof but he did not even touch the question of -- the anterior question is how on earth do you do this in the first place? Because how on earth you do this in the first place is the contractual measure, you make it conditional on something. In that case conditional is

insolvency, which is what we have here.

It is all very well to say you are subordinated. How do you implement the subordination? You do it by making your agreement conditional on solvency. And all these agreements that we will look at, they all have that in them. That is the mechanism for subordination of debt which is adopted by Lehman in these contracts.

So a bit of a diversion but important to understand what it is we are looking for. We are looking for the conditionality to implement subordination.

So still on the background. The second background point is that a consequence of contractual subordination, as Lord Justice Lewison described it, is that what would otherwise be the default pari passu rule is displaced. Yes, as a rule under the Insolvency Act but that is subject to the parties' agreement.

I won't take your Lordship to Gold and Key, we cited it but I do not think it is going to be in dispute, that pari passu under the Insolvency Act isn't a rule which overrides a contractual determination, it fills a space if there is no contractual determination. The contract determines if it is going to determine what the ranking is.

Mr Phillips this morning referred your Lordship to ex parte Mackay and to Waterfall I in support of

a distinction which he said was very important, which is that a creditor is able to agree to prove behind other creditors but he cannot agree to prove above other creditors except with the agreement of others.

No doubt correct. Correct but irrelevant because what we are concerned with is that these parties agree to prove behind. That is what we are dealing with, it is a contractual question.

The third background point here is that, tying into that contractual question, each of these instruments provides a comprehensive and exhaustive regime for its ranking against all other debts including all other subordinated debts. Your Lordship saw that from the -- if you just think back to the sub-debt agreements -- all other debts are either senior, subordinated or excluded. There is no fourth category in the sub-debt agreement. You have to mark out which is which and which it falls into, and that determines the ranking of all other debt as against the sub-debt, and it is the same with the sub-notes.

Now pausing there. It does mean that the question for the court, your Lordship will have to determine which is the appropriate category into which each instrument falls in the other instrument. So whether the sub-notes are senior subordinated or excluded within

the sub-debt and vice versa. That is the ultimate question for the court applying the contracts which the parties signed up to and that is not a question, I am afraid to say, on which SLP3 provides assistance for the court.

You will not find in my learned friend's written submissions or the oral submissions this morning any explanation as to which category the various debts fall into. And that is because we say -- I will come on to this in a minute -- they fail properly to engage with the necessity of the construction exercise we have to do.

So with that background, how do we identify the issues for the court to determine this question? The issues in priority focus on two aspects of the instruments as your Lordship is now familiar with them, what I might call the referential aspect, which refers to the other one, and the solvency condition. Though obviously each instrument needs to be construed as a coherent whole, ie by reference to both of those bits, and also because they interact with each other, they have to be construed together in a way that works.

Of those two aspects, the referential aspect and the solvency aspect, it may not matter very much but the solvency condition is probably the right starting point

because that, as we saw from Lord Justice Lewison, is how you implement subordination in the first place. So that is how you do it. We say it makes sense to see how it is done here because the solvency condition ensures that if there is a deficit in assets, more senior creditors are paid first because you cannot pay the subordinated one until the other ones are done because you are otherwise in breach of the solvency condition.

So it is a simple way of achieving subordination and therefore we would say the correct starting point to see what was achieved here. Can I ask you then to turn up the sub-notes themselves at bundle E/4.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: E, tab 4, page 55.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: Your Lordship may have already read this, but the notes do contain a solvency condition, in fact they contain two solvency conditions, both of which need to be satisfied because there is an "and" between them.

The first solvency condition, this is (3)(b), is that the issuer must be able to pay its debts as they fall due. The second solvency condition is an assets and liabilities test.

As I say, both must be satisfied. The first issue for the court in this priority dispute, and I apologise

for making it as simple as this, is whether the words "its debts" mean what we would say it should mean, i.e. its debts i.e. all of its debts, in effect tracking section 123 of the Insolvency Act, or whether it means its debts to senior creditors.

Because SLP3's case -- my learned friend did not deal with it this morning but it's in writing -- is that that is what that must mean. "Its debts" must mean its debts to senior creditors, because otherwise he loses. Because "its debts", if it includes all debts, it includes all other subordinated debts, and therefore by reference to this solvency condition, if it includes its debts, other subordinated debts, it therefore includes the sub-debts, and therefore nothing can be paid on the sub-notes if the issuer is unable to pay all the other debts including the sub-debts.

And that is the mechanism by which subordination works. When applied to this wording, we say it is a mechanism by which subordination ensures that this document falls to the bottom of the queue, because nothing can be paid until all the other debts are capable of being paid.

The reason my learned friend has to change the wording is he wants to exclude the sub-debts from that definition, say no no, it is not its debts, it is its

debts to senior creditors. But we can argue about it later on. It is not what it says. There it is.

If we are right on that, it means that this is an express subordination in the notes because you are subordinated to all the other debts because you cannot get a look-in until all paid.

So you then marry that up with the referential bit of it. There is an express subordination here through the solvency condition; you go back to the sub-debt, this is an excluded liability because of an express subordination. They both work together.

So that is the first point, my Lord. The solvency condition we say gives you the answer to this and cuts through a lot of it.

Only if I am wrong on that, if you like, and if my learned friend Mr Phillips is right, says no, no, no, this should mean its debts to senior creditors, what that means is the solvency condition itself doesn't give you the answer because that doesn't help you in the ranking inter se point. So then you have to go back to the referential bit and say does that give you the answer?

That's a point, your Lordship has seen our skeleton, we say there is a difference in the wording of the two instruments. Whereas this one is expressly referable to

subordinated debt, unless, the other one doesn't have that express caveat in it. We say that makes a difference between the two. I accept, and I have to deal with this in closing, that the contrary argument to that is if you actually look at the sub-debt agreements it includes subordinated debts potentially. And I have to deal with that argument and I have to deal with it in closing.

But that is the issue on the second point if you like: does the difference in wording -- this one actually makes it clear that it is "subordinate to other subordinated debts unless", whereas the sub-debt agreement doesn't make it clear or at least it is harder to find. And that is the point on that. Does that make a difference, or do you find some other solution and if so, how?

Because of course one has to compare alternative outcomes here because the alternative outcome is that wording makes a difference. Or you have to do quite a lot of surgery to the words to end up with a pari passu outcome. But it is a contractual outcome, I have to develop that more orally in closing, but that is the issue on that point: does that difference in wording make a difference or do you have to do something else to the wording to find the answer?

We also say allied to that there is a timing issue as well, but that in a sense adds to the wording. The wording we would submit is where the real meat of it is found.

What is the case in response? I think with all respect that the case in response is this: you can start as a matter of contract and look at the words as a matter of contract, but at some point you sort of stop as a matter of contract and you get ejected into the pari passu rule. So it is a sort of halfway house. It is not a contractual answer, it is an Insolvency Act answer. And I mean in case that sounds a little bit bizarre, if you go to my learned friend's skeleton, at bundle B5 page 115, 344 sub (3) is responding to some of my arguments:

"PLC states a statutory scheme is no answer in circumstances where this is a case of contractual priority."

Stopping there, yes we do say that because it is a case of contractual priority. SLP3 apparently fundamentally disagrees with that. It is something else. It is a case where the two instruments not expressly refer to each other, where 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.

That is why it looks as if they say you go along the way, you find -- you do not really get an answer in the contract, and therefore you find yourself under the statutory scheme. And we say as a matter of -- I accept I have to deal with the contractual argument that I mentioned, I have to deal with that, but I do not have to deal with this argument because there is no halfway house here. You do not give up in contract and say hang on a minute, let's have pari passu. It doesn't work that way. It is an exhaustive scheme. The answer must be in the contract.

As to the way this argument is put, just one thing on this and we can see we submit why the argument is fundamentally flawed. If you are still in the skeleton, my Lord, if you go back to page 9, this is, if I can put it the big cap theory. 13(1), this is where they say they do not need to say anything about it and then the next sentence:

"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."

Well, maybe so if that is all the contracts ever said. If the contracts only say well we are

subordinating to this creditor and the other one said the same, then maybe so because the contract would in fact run out at that point and that is where you get back into the scheme. But that is not these contracts. These contracts provide an exhaustive scheme for their ranking against other creditors and inter se. You never get to the situation where you run out of contract. You have to find the answer in the contract.

I can say also while we are here, and this will come up later, that definition -- the word "same" just before "senior liabilities" is one of the slippery words one has to be rather careful of because what I think my learned friend's submissions amount to is that they have common senior liabilities. I think that is what they mean by "same". But I hope they do not mean the very same, because if it means the very same, you only get there by a contractual interpretation exercise. You do not get there by asserting it.

So I am not denying there is an issue I have to deal with, but I do say that the issue as framed by my learned friend is just the wrong way of looking at the question.

That is all I want to say on that primary issue apart from a few sub-issues which arise in the context of the interpretation exercise. First the scope of

factual matrix evidence. We say it is a limited scope. The sub-debts were standard form so you are not likely to get very much factual matrix there. Sorry, the sub-debts were standard form and the sub-notes were on their face tradeable instruments according to their terms.

We can look at this if need be in due course but every single part of the notes indicates that they are tradeable, they can be transferred, they are bearer instruments and all the rest of it.

We say therefore the relevant audience for the objective construction exercise has to be much wider than just Lehman. Now, in contrast SLP3 say in their skeleton, and I'm always slightly worried if people say this, they want "full factual matrix". But unfortunately, and you can see this going through their document, it involves evidence of subjective intent.

It is weaved into their skeleton from time to time if they think it helps their case, but on the tradeable point it is particularly noticeable because what they say is no no, the court should not treat these as tradeable instruments, because they were not intended to be traded.

We say that is subjective intent. That is the problem with that. You have to look at it on their

face. Objectively on their face they were tradeable. As soon as you start saying we did not intend to trade them, then you are imposing a subjective intent question into the question of how you construct a factual matrix. So we say that doesn't work either.

We will look at some of that stuff I suppose, but we say when you get to the instruments, the only consistent and legally coherent way to approach this construction question is to treat them on their face as tradeable instruments. Who knows what was going to happen to those instruments during their lifetime.

So that is that. The second one, the applicability of commercial --

MR JUSTICE SMITH: Is it a question of subjective intent or is it more a question of not being able to have your cake and eat it? I'm thinking of the sort of Street v Mountford situation, where one has a lease --

MR BELTRAMI: It may be that too.

MR JUSTICE SMITH: -- and one calls a licence. One cannot say that that sort of labelling is a matter of subjective intent, it is a question of an objective label to the document, it is just one that doesn't actually assist. One might say, if one were structuring a transaction as a note, one can either say it is not a note because it is not tradeable, in that case you

take the consequences, or you say it is a note and it is what it is.

MR BELTRAMI: Yes that may be another way of looking at it, I think it amounts to the same thing. Certainly for the objective exercise the court has to do, one cannot get involved in what people intended when they issued the thing, let alone throughout the duration of the note.

So commercial common sense, we have seen a bit of that too, we say that is not a very influential factor, especially when it is clear that the wording of all the instruments expressly allowed for the layering of subordinated debt. So the referential part of both the sub-debt and sub-notes allowed for the layering of subordinated debt and there were instances within Lehman where that very thing happened and we will look at the ECAPS guarantees.

Your Lordship heard this morning there were ECAPS guarantees, claims by the ECAPS holders against PLC on a guarantee which is a debt claim. Under the terms of the ECAPS instruments those were ranked as the equivalent of preference shares. That is why they are subordinated and that is why there is no issue on issue 3 in my application.

So there was a role for layers of subordinated debt, if and insofar as the company needed to do so, as well

as in fact a mechanism for doing that which was to make them equivalent to preference shares. But that is a point I will come on to later.

So we say there is not likely to be much scope for commercial common sense, obviously the court has to be a bit concerned by that generally, especially now when all the detail cannot be recreated and one doesn't really know one way or the other what would or would not have been thought about had the issue arisen.

Your Lordship -- that's a rectification point I'll come to in a minute.

Your Lordship has seen from the structure I showed you that there was a split in May 2007, the ECAPS side on one side and the internal DB stuff on the other side. Whether that makes a commercial reason for it or not I do not know, I am not submitting it is or it is not. I am saying now the court cannot now put itself in the position of the parties then and determine this on a commercial basis. One has to determine it on the scope of the wording.

The third valid point on this issue, the supposed relevance of other drafts and other versions of drafts which Mr Phillips mentioned this morning and is in his written submission, references your Lordship heard to FSA5 and I think various other drafts in the bundle

which say different things and it is said I think that that somehow assists the court. I wrote down what Mr Phillips said this morning. Each of the instruments was based on or related to existing standard form or precedent.

Picking up again another slightly slippery word "related to", there is no evidence that the document we are concerned with was based on anything at all. We do not know what it was based on. So far as I can see, every single draft that is being referred to is different. The wording of FSA5 is different from the wording of the sub-notes. The wording of FSA10 is different to the wording of the sub-notes. The various drafts that have been put in -- there is a bundle of extra drafts -- they are all different too.

So we submit that the court isn't going to get very much assistance from the parade of different drafts saying different things. If the argument is, and it may well be this is what it boils down to, which is that well there was a general regulatory purpose of X and everyone was trying to achieve the same thing so do not worry about what they actually said, just construe them all in the same way, then maybe I invite your Lordship not to write a new chapter on the interpretation of contracts that way.

This isn't going to be relevant. One has to determine these words in this context, not what other things may or may not have said.

A point also in this context, Lord Neuberger -- I won't turn it up -- Waterfall I, made the point, paragraph 50, that even if in principle words mean the same thing in different drafts, it doesn't mean that when put together the solution is going to be the same. And our question is sub-debt versus sub-notes, what is the answer to that conflict? Not what something means in one context and in another context.

The last point on this. Your Lordship will have seen an attempt to introduce what we can call quasi expert evidence into this question, the suggestion in my learned friend's written submission that there was a "general rule" for sub-debts to be pari passu. And that then migrated further in the skeleton to a standard market practice that that should be the answer.

Now, there is a procedural problem with that, that in my learned friend's first position paper that point was made it was said as a standard market practice that all these things ranked pari passu, and our response was we will reserve our position until you get some evidence about it and nothing else went further. You cannot just turn up in court with a couple of articles from the book

and say there you are, that will do instead of expert evidence. Had they wanted to run a case of market practise, then the course would have been to obtain leave to do so and we could have looked at it.

The evidence they actually refer to isn't evidence of what they say it is anyway. Insofar as we can tell I think most of them are American, but insofar as we can tell, what they are saying is that there was no regulatory requirement to rank sub-debt, lower tier 2 and 3 through anything other than a different level. There was a regulatory requirement that tier 1 be ranked below everything else, there was no requirement on the other levels. Insofar as that is what they are saying, fine. Insofar as they are saying "and nobody in the world ever did anything different", well first of all that is not what they are saying; secondly, it would not be consistent with the documents that show that the agreements provide for that possibility and Lehman actually did it in relation to the ECAPS guarantees. So insofar as that is all going to be put forward to assist the court, we say it doesn't.

My Lord, is that a convenient moment for the transcription break?

MR JUSTICE SMITH: Yes, thank you very much. We will rise for five minutes.

(3.13 pm)

(A short break)

(3.20 pm)

MR BELTRAMI: I should show your Lordship, I mentioned before the break the ECAPS issue. Can you go to E tab 10. These are one of the ECAPS and as I said, the ECAPS holders obtained essentially shareholding rights or partnership rights in the partnership because it was a security and they also obtained creditor rights against PLC as guarantor, and if you go to page 154, this is just the summary of it and at the top of the page you will see "Subordinated guarantee", the description of the guarantee, and then underneath the first paragraph in the bullet points it says:

"The subordinated guarantee will rank pari passu with the non-cumulative perpetual preferred securities or preference shares of the guarantor whether or not in issue."

Just to make it clear, if you go back to 152 in the investment considerations, under the heading "No limitation on senior debt", it says:

"The obligations of the guarantor under the subordinated guarantee will rank junior as to payments of all liabilities to creditors of the guarantor including without limitation depositors, general

creditors and subordinated debt holders."

So what you have here is an example within the Lehman funding structure of a ranking of subordinated debt. So you have subordinated debt holders and lower subordinated debt holders and the way they did it here anyway is to equate the lower subordinated debt holders with preference shares. So we'll see that point -- as I mentioned that, I thought I would show your Lordship where it came from.

That is all I wish to say in opening on the first question, i.e. the original notes. We then move on to the amendments and as Mr Phillips I think said, there are three sub-questions there. First is what is the effect of the new subordination wording; second is the new subordination wording engaged in an administration, distributing administration; and our third point, I am not sure if he mentioned it: what is the result if not engaged? Because that also has a little wrinkle attached to it.

On the first question, just to try to flesh out what the issues are, we say the wording places the sub-notes at a level of preference shares. We do not say they are preference shares because plainly they are not, but the wording we say ranks them at a level of preference shares which is above ordinary shares, above certain

other preference shares but below anything at what I would call debt level. That is not below any debts, it is below anything at debt level.

I hesitate to say this but I think it is common ground that a preference share level is below a debt level. So for ranking purposes, however you get there, debt comes above preference share at the level. And as we saw, as I just showed your Lordship from the ECAPS documents, it is a drafting technique to subordinate debt below other debt by putting it at preference share level. We say -- again, surprisingly, a lot of this can boil down to some quite simple points I suppose -- that is what happened here. And you cannot get out of it. It was at a preference share level.

Now, three principal points taken against that: first of all, in writing and orally, it was said that the "Key subordination provisions remained unchanged". Your Lordship may want to go to the amendments, which is E5 at page 73. By the key subordination provisions, it is actually a slightly inconvenient not having the document itself but we can look at that later. They mean the referential bit, the bit about referring to senior creditors and referring to others.

We say when they say the key subordination provisions remain unchanged, they actually mean the

subordination provisions they like remain unchanged. There is nothing to suggest those are the key subordination provisions and we would say, if it matters, and if there is a contest about that as per Lewison LJ the key subordination provisions are the solvency conditions because that is how it is implemented. But we do not have to worry about what is and what isn't the key. What we do have to worry about is what it actually says.

What the amendments do is create two different regimes. Outside of insolvency -- and I use that word generally for the moment -- you have the referential bit about senior creditors. Inside an insolvency you have the preference share route. They are different regimes. They cannot work together because they are mutually exclusive. If it matters, the dominant one is the one inside the insolvency regime first of all because that has the insolvency condition but secondly because subordinated debt is only really relevant in an insolvency. Outside of an insolvency situation you are not concerned about ranking of debt because anyone can get paid off. It only becomes relevant and we can look at Basel I and II. That is what they say; it is only relevant in an insolvency. That is when the thing actually matters.

What this provision does is when it matters, i.e. in an insolvency situation, it puts you on to the preference share level. So it is no good saying: No, no, there is an earlier bit that says something different. There are two regimes under this document as amended, outside an insolvency/inside insolvency. The relevant one, the most relevant one is inside in fact the relevant one for us.

So one cannot get out of the ranking at preference share level by saying there is a different bit that says something else because we are not in that different bit any more. We are in the bit actually that equates to solvency. So we say that is not an answer.

The second point that is taken is, well -- and this was taken at some length also orally -- the definition of notional holder includes a creditor, which is correct. That is what the words say. Now, our understanding is that this is likely to refer to an upper tier 2 creditor. That is an undated subordinated creditor who were generally seen as lower in ranking than others and it looks as if there is an attempt to capture them.

But whatever the attempt is and isn't, we say the argument doesn't go anywhere because, yes, there is such a -- and this category doesn't actually exist in fact --

but, yes, there is in theory an upper tier 2 creditor who could be a notional holder but only if, as you will see in the definition of notional shares, its credit was ranked at preference share level. So it is speculating on an upper tier 2 creditor which is itself put down to preference share level and what the notes are saying is that these notes are above that.

So, yes, it is above that creditor because there is a hierarchy of deeply subordinated debt. Let me put it this way, shares, actual preference shares, these curious notional holders who are actually creditors but they are ranked as preference shares, above ordinary prevent shares, and notes which are ranked as preference shares above the notional holders so you have a gradation of preference share level debt -- sorry, preference share level claims, but that is all that takes you to. It means that these notes would be above that category if it existed, but that tells you nothing about any other creditors because it only applies to creditors --

Your Lordship is looking a little bit puzzled and these things do sometimes require a bit of... But if you go back to the second fact paragraph in 3A, so it is equivalent to preference shares, that is the starting point, clearly not actual preference shares, but ranked

as preference shares in priority to a preferential right so they are above (i) all other class of issued shares. Fine, no doubt about that, and notional holder.

So it is saying you are at the preference share level but you have a special preference share level, you are above ordinary shares and notional holders and notional holders are defined as though they held a notional share and a notional share is a notional share which has a preferential right to retain. So the notional holders are creditors who are themselves equated to preference shares and they are simply saying you are above them. So that is why you have a gradation of preference share level.

MR JUSTICE SMITH: Yes, the reason I am looking a little puzzled -- and it may be the answer is in the notionality of the creditors you are postulating -- but you have been using for the last couple of minutes the language of elevating one class above another.

MR BELTRAMI: Yes.

MR JUSTICE SMITH: And of course it is certainly the essence of Mr Phillips's submissions that you cannot do it that way. You can only push yourself down.

MR BELTRAMI: With agreement.

MR JUSTICE SMITH: With agreement, yes. But, if you are getting agreement of all parties to push someone up you

need the agreement of all.

MR BELTRAMI: Absolutely. If that category existed then there might be a problem. If that category existed --

MR JUSTICE SMITH: So the answer is you are achieving -- what you are doing is you are not actually preferring. What you are doing is you are defining a level and it is really a question of the language you use to define the level at which your debt subsists.

MR BELTRAMI: Yes, I think that would be right. You are defining the level and the question is where you are defining that level.

MR JUSTICE SMITH: If you are simply doing that then, as it were, above or below doesn't matter. It is simply placing it at a level.

MR BELTRAMI: What matters we would say is by defining it a preference share level, you are automatically putting a ceiling on it because as a matter of ordinary approach the preference share level comes below the debt level. So there is a floor and a ceiling to it; that is why your Lordship -- I had not picked up the point. Your Lordship is right that insofar as they are trying to get above debt you have to get agreement for that if it existed.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: Fortunately, maybe sadly for some -- that is

not an issue for me to deal with -- that is not our problem. But what you cannot do which I think Mr Phillips is trying to do is say: Here you are because you are above, you set yourself above this notional creditor, you are therefore pari passu as all other subordinatating creditors. That is the jump that doesn't get justified. We say whether above that notional category or not, with or without permission if it ever existed, the fundamental point is you are setting yourself at that level and that level doesn't encroach into ordinary subordinated debt.

MR JUSTICE SMITH: Yes, I see.

MR BELTRAMI: So that is the second point. And the third point, which I think is pretty much more a conclusion from that, it is said the definition is bottom up and they said look at what they term the conclusory paragraph bottom up. Well, it is not bottom up because a preference share level is not bottom, there is a bottom and top to it, and that is why it was done for the ECAPS. So it is sort of wishful thinking.

On that first issue on the amendments we say one can't get away from what has actually been done. It is notional but it is clear that there is a ceiling placed on the ranking and the ranking is below ordinary subordinated debt.

The second question is: is the wording engaged.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: And your Lordship is aware of the issue because it refers to a winding up. We say it ought to apply or it does apply as a matter of construction to a distributing administration.

This point, I won't take your Lordship to it, it may be I will have to do it in closing, it has essentially been considered and determined by Mr Justice Blair in the case of Coup(?) which is bundle 4, tab 93 A, I think it was under the bank equivalent regulation where there is a very similar clause and the question was ah ha: it says winding up, not administration; he said: they are both the same. It was a contractual case, it is not an authority which is binding as such because it is on a different contract but the principle was exactly the same. These things do exactly the same purpose, a winding up and distribute the administration and to draw a distinction between the two is illogical as well as being --

MR JUSTICE SMITH: I think it is either you or Ms Tolaney who say it in your written submissions that it would be odd for the rights to depend on the vehicle that was used in terms of insolvency to distribute.

MR BELTRAMI: Yes. And in fact let me just show you this

because we are in opening and may not get to it. If you go to bundle F7, 3685.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: It starts on 3682, the LBHI administrator's proposals in 2009. There are various of these documents throughout the bundles, but if you go to 3685.

Your Lordship is of course familiar with the different objectives of administration under the Act and at the bottom of the left-hand column, in 3685:

"The objectives of this administration...(Reading to the words)... administration."

So it is not a save the company administration. It is a distribution administration. Your Lordship can go on 3687. The proposals and the right-hand column (vii):

"The administrators...(Reading to the words)... strategy in order to...to an end."

And A: there could be a creditor's voluntary liquidation, b) there could be a CVA, c) there could be a notice to dissolve and then d) there could be a distribution.

So there is a whole range of options open to administrator, one of which is to go into voluntary liquidation or to distribute as it happened. So you can go from administration to winding up, you can go from winding up to administration of course. And the idea

that everything chops and changes from one to the other, it frankly ought not to take a lot of time in this court. I won't say very much more about that. There are some super technical points about some of the wording of GENPRU on that, but we say the overall point is a simple one. The third aspect of the amendment question, as I mentioned, is what happens if the amendments aren't engaged, the premise being because it is not a winding up, therefore it is not engaged. And there is a rather technical point about what might happen in that eventuality, but I won't deal with that in opening because I will run out of time if I do but that is a point we are going to come back to later.

Let me now move on to the rectification case.

MR JUSTICE SMITH: Yes.

MR BELTRAMI: There is some history to the documents.

Maybe I can show your Lordship just the very outline of what happened. There is no doubt that the trigger for the amendments was the determination within Lehman to enable interest in the notes, that is common ground and that was for a tax benefit.

Mr Grant provided the first draft of the amendments on the 5th June 2008 and that is bundle F5, 2607. This is the e-mail of 5 June 2008. Attached are some resolutions and from 2609, the first draft of the

amendments. And the first draft the principal amendment is at 2612, which is to paragraph 4F. To cut a long story short that is the paragraph that defers interest because you had to make it not an event of default and ensure that the interest accumulated in the meantime and that is the paragraph that achieved that. Shortly after the instructions were given paragraph 4F was put in place to defer interest now.

Now, at the same time, as you will see in the evidence when it is looked at, Mr Grant sent the draft to Mr de Haan his associate in A&O, a tax associate. And Mr de Haan identified a tax problem with the draft arising from the solvency condition we looked at. It was not a problem in the amendments, it was a problem in the original version of the notes and as explained by Mr Grant, and you will see what he says about that, it seems to be that the solvency condition he thought created a tax problem meant that it was equated to the operation of the business in some way and therefore it was beginning to look like equity and therefore the solvency conditions should be removed.

His solution was to remove that condition and that was done by an amendment to that effect in what might be seen as an intermediate draft along the way and that is at bundle F5, page 2733. Easier if you go to 2745, you

can pick out the details. This is what I would call the intermediate draft, which was produced on 11 June, and what this contained, if you go 2748, you still see 4F, but 2747, contains an amendment to 3(a) which, on the face of it, removes the solvency condition other than if an order is made by a competent court of resolution. So the conditions are still there but it doesn't operate in a winding up. And that appears to be Mr de Haan's solution to solve his tax problem as we understand it.

At some stage, and it looks like on 11 June, Mr Grant realised or was told that that created a further problem, which is that if you remove the solvency condition -- whether Lord Justice Lewison was minded, I do not know -- if you remove the insolvency condition you were removing subordination because that was the means to get the solvency condition and this created what he saw as a conflict. If you go to 2896 it is an e-mail of 12 June to his superior and you will see the second sentence, he has talked to Mr Fuller: he has told me he fixed the conflict between tax and the subordination. So tax says remove the solvency condition. Hang on a minute, there is a subordination problem if you do that.

What he then did was redraft clause 3 so as to insert new words of subordination so as to ensure there

was subordination. If you go to 2785, 2786 and 2787 seems to be playing around with different -- I say playing around -- he is testing different versions of how you introduce subordination. Having taken it away, how do you put subordination into the notes all of which are referable to the preference share point. He comes up with a draft and he then sends the revised version, 2839, e-mail of 12 June to Lehman where he says in the second bullet point:

"Showing the comparisons to the changes in the first draft tax sensitivities the amendments are designed to ensure these sensitivities are met."

He identified for Lehman that he has made different changes so as to deal with tax sensitivities in notes and the amendments themselves, 2849, are what then ended up essentially in the final version. So that is how we get to it. Last point on the chronology. In late August there was a further amendment to clause 12, which is F6 3324, which we may have to look at as well, but that was to do with something else, that is how you get the composite version on 12.

Issues for the court on rectification; first, the ambit of the claim because the ambit is to delete essentially all the amendments to clause 3(a). There is one little bit referable to interest I think which

stays, but the claim is to delete everything. So the argument has to be the whole exercise by way of amendment to clause 3(a) was a mistake. Therefore, the parties mutually intended not to make any of those changes at all. Issues are going to arise. First, the nature of the subjective test to support the claim for rectification for mutual mistake. We say it is necessary to show a relevant mistake which means in this context an intention to include something which was excluded or an intention to exclude something which was included. Either way, the test is not satisfied by the absence of an intention. I am not saying the absence of intention cannot be of some evidential value, but it is not the test.

What my learned friend says about that if you go, please, to bundle B, and if you go to paragraph 413, tab 5, this is discussing the Four Seasons case. They say two things in 413 which seems to be we think essential to the argument. It says:

"In reaching the conclusions the Court of Appeal upheld the factual findings of...(Reading to the words)... where first instance he had concluded that they say the absence of a positive intention suffices for the necessary common intention."

We say on that, he certainly did not say that and it

would be wrong in law if he did. It does not suffice for the common intention. There must be -- and the Court of Appeal made this clear as well, we will have to look at this in closing -- there must be a positive intention not to do something as opposed to the absence of intention. The absence of intention may be of evidential value, it does not suffice, he did not say that.

The next thing they say is:

"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."

It is correct he did say something to that effect in his judgment. The trouble is, he was addressing the objective test whereas relevant, you are trying to find from the objective facts the relevant intention and the paragraph they refer to, paragraph 158, is under the heading "The Objective Test." So that isn't going to help us very much now that we know, thanks to the Court of Appeal, the objective test isn't the right test. It is a subjective test. I am not saying the evidential value is not still there but that doesn't help.

So those two what we say are critical supposed

summaries from Mr Justice Henry Carr's judgment are not going to help your Lordship in this case.

So what we are looking for what the court is looking for is a positive intention in this circumstance not to make these changes. We will have to look at the evidence as to whether that is established or not but that is the right target if you like that we are looking for and not anything else. That is the first point.

The second point the court is going to have to identify the relevant individuals whose intention is to be attributed to the parties. Now, on our case we say the relevant individuals are the authorised decision-makers or signatories Mr Rush, Mr Triolo and Ms Upton and, as a matter of law, there is a narrow scope for exceptions. The starting point is always going to be look at the authorised decision-makers. There is a narrow exception to that where the court can find -- and these are sort of interchangeable, we can look at the case, they are sort of interchangeable concepts -- someone else was the actual decision-maker or the actual decision-maker adopted that someone else's thoughts. They seem to be two sides of the same coin in the cases in narrow circumstances. The narrow circumstances are, in effect, if the actual decision-maker acts as a rubber stamp, so he is not

involved in this at all, it is all done for him, a piece of paper is put before him and he stamps it. At that point the actual decision-maker can be one layer down or it can be said the actual decision-maker adopted the intentions of the one-layer down person.

I do not attach from the cases that those two concepts have a different legal analysis. It looks as if they are interchangable consequences of the same factual circumstances. But either way one must get to a situation where the actual decision-maker's own intentions and knowledge and subjective beliefs are sort of discarded and replaced by someone else's and we say there is just no evidence of that here.

There is a case of assertion but what SLP3 have not done is put forward a case which can establish it. One can see from Murray -- we won't look at it now -- the exception is a narrow one. The two different sides of the transaction had kind of similar arrangements, but it was only where the trustee company had nothing at all to do with it that the adoption came through. The other one where the trustee company asked a couple of questions and then signed on the dotted line is different. So it is quite a narrow exception and it has to be established in evidence and we would say the evidence just is not there.

It doesn't help that the evidence is actually contrary to part of their case and you saw it from our written submissions that Ms Dolby's own transcript evidence is that she was not the decision-maker and she left it to others. That is part of my learned friend's case. It is quite -- as this goes in analysis, I do not know. But in any event we have to identify the relevant individuals. We say there is just no evidence the court can act on that. One cannot get beyond the authorised decision-makers in this case and if that is because it is all a long time ago and one can't put together the evidence, and it is too difficult, then so be it. This is rectification, it is not supposed to be easy. So that is the second question.

The third issue for the court if the relevant individuals are the authorised decision-makers and there is no question of adoption, what is the significance of the fact that no-one is giving evidence? And we say the significance is the case must fail at that stage and I am not sure there is a contrary case against me. I am not sure it is being said that if I am right that they are the relevant people, and their minds are the relevant minds or some other route to rectification, I think the case must fail at that point.

So the establishment of the necessary criteria for

decision-makers and adoption is quite central because if they cannot establish it, there is nothing -- the court cannot on this evidence decide that the actual decision-makers were mistaken about anything. So that is the third point.

The fourth point, moving down the gears if you like, if the relevant individuals or the persons whose minds are relevant are Ms Dolby and Ms McMorrow, that is my learned friend's case, what is the significance of their evidence? And clearly we will have to hear from Ms Dolby about that. But we would say this: on the face of what she said in the transcript and on the face of what she says in her witness statements, her intention was to agree the drafting prepared by Allen & Overy. The idea this means she intended to defer interest and no more also runs a danger of the rather imprecise use of language. She may or may not have a subjective wish to do that. Her intention was to agree Allen & Overy's drafting, but that is a matter for evidence no doubt in due course, but that is going to be an issue for the court.

The fifth point to consider is the significance of the fact that it is not alleged -- at least I do not think it is alleged -- that Allen & Overy made a mistake. It is certainly not alleged -- and

Mr Phillips confirmed that -- that any mistake by Allen & Overy was adopted by Lehman, so you cannot start from their mistake and work upwards because there is a break in the chain there. We say that is significant because one can see two different scenarios and we see them sometimes in the cases. If a solicitor does make a mistake and the client adopts that then one can see the mistake is carried through to the client. But that is not their case. If the solicitor did make a mistake -- and he may or may not have done, who knows -- there is a break. What does the client do? The client agrees the drafting provided by the solicitor. Where is the mistake? We say that that break in the chain is likely to be a analytical break that creates a problem but again we have to develop that in due course.

Sixth point, whether there was an outward manifestation of accord. Now, I am sure I am preaching to the converted here. We have some difficulty with this and your Lordship had some difficulty with this. What I do not know is -- one knows from the Court of Appeal that it is required, and that is enough for me, I suppose. Quite what it means is something I am -- I mean, is it an objective test or subjective test at that stage because the purpose of it is apparently to make sure each party knows the other party

shares the same mistake. So it looks a bit subjective in that respect yet it is clearly something with an objective component.

That may work itself out in due course, who knows? But for the moment we know from the Court of Appeal that it must be established. And what does that mean in terms of the two tests? Also a little bit difficult to see, but it may be a highest common factor outcome. You have to have a subjective intention and you have to have an outward manifestation of a sufficient intention and if they both reach a certain level hey ho, you have got rectification. If either falls short, you get nothing. That may be the answer, I do not know.

Some of this clearly will need working out in due course but as we see it at the moment it is an independent requirement. It looks objective, it may have a subjective element to it but if it is not established, even if everything else is established, you cannot get home. What you have here is nothing at all about interest, there is nothing at all about subordination.

We do accept -- and you get this from Four Seasons -- that the outward manifestation of accord can be tacit so it doesn't have to be express. So I am not saying they did not say expressly something about

subordination, therefore they cannot get home on this point. I do accept it may be tacit, but the evidence would have to be quite strong for. Four Seasons your Lordship is no doubt familiar with it the evidence was pretty extraordinary in that case it was commercially absurd to do that which they did so it was not difficult to find a tacit agreement about something that was not said because it was so outrageous that no-one would have said it had they meant it. So again you are setting quite a high bar to establish an outward manifestation of accord by silence. I am not saying it cannot be done, but, gosh, look at the sort of test you need to get there and we will have to look at Four Seasons and see just how extreme that case was. A long way away from this case.

Nothing on the face of the documents to suggest anything about subordination. The evidence from all the witnesses consistently is they never thought about it because it was irrelevant because no-one ever thought Lehman would go under and if it did go under no-one ever talks about subordinated debt, so it is at two stages removed. That is why the issue of ranking, on the face of the evidence, was not something to which they actually addressed their minds ever. So you are in a very different situation. You have to have a tacit

agreement about something which they actually never talked about.

There is an argument to be had there, but we say the test is a high one and on the evidence so far nothing here supports it. But that is -- in any event outward manifestation of accord is the next point, your Lordship.

And finally ultimately the court will have to assess the scale and ambition of the claim. There are two aspects to this. First, the breadth of the rectification case, which are essentially the entirety of the clause 3, so it is not a case where something was omitted or not read as in FSHC. These were amendments specifically included, carefully drafted by Allen & Overy, reviewed within Allen & Overy and were tax changes expressly notified to the client. We say it is ambitious to say the whole thing was a mistake and we will see where the evidence goes on that but it is a high standard they have set themselves.

But the second aspect is the ultimate case theory as I understand it now of my learned friend. If you are still in the skeleton, my Lord, it is paragraph 457. This is essentially after quite a long run up, this is really the culmination of where I think they say that the law of rectification ought to be:

"The common intention can be given effect by removing wording that A&O were never instructed to include ...(Reading to the words)...shared with the Lehman Group."

So this is how they seek to justify the removal of everything. So rectification apparently responds to a solicitor's initiative just because that initiative is not shared expressly with the client.

It is factually incorrect for starters because, as we saw, Mr Grant did expressly highlight the fact that there were changes made to reflect the tax position. So it is not as if he said nothing. But in any event, even if it were factually correct, it would not be we say an adequate basis for rectification. Rectification arises when there is a mistake. The idea that client can instruct a solicitor, the solicitor can do some drafting, and just because the drafting is not directly highlighted to their client he can then change his mind afterwards, is not rectification; that is something entirely different.

And one can test this with the point about the solvency condition. Forget about subordination for the moment. Suppose all the 12 June drafting had not been done, the only extra bit of drafting was the removal of the solvency condition, ie the intermediate draft, and

nothing about the ranking at all, that was pursuant to Mr de Haan's specific tax concern. In my learned friend's case they did not ask him to do that on his case -- wrong -- but on his case they did not tell him they had done that, so on that test they could rectify that too.

So even if it were right, if it were a great point, even if it saved this company millions of dollars in tax, they could turn round a year later, two years later and say no no, we did not instruct you to do that and you did not tell us you had done that, therefore we can rectify the contract.

You cannot possibly have rectification argument on that basis but that is where they have to get to to embrace this broad rectification case that they seek. If the solicitors did something of their own initiative and did not point it out, apparently it is rectification. But that rectification has moved a fair bit in the past few months but it certainly has not moved there.

So this conceals the fact that there is no actual mistake because these parties simply left the drafting to Allen & Overy which happens every day of the year of course when solicitors get on with drafting contracts. The idea the client must know perfectly well every

single clause in an actual contract or amended contract does not respond to the law of rectification.

My Lord, that is all I want to say, I have finished bang on time and I am very pleased about that, and unless you have any further questions those are my submissions.

MR JUSTICE SMITH: No, Mr Beltrami, thank you very much, I am very grateful.

Submissions by MS TOLANEY

MS TOLANEY: My Lord, as your Lordship knows, Deutsche Bank is party to both applications and is now the most substantial holder of the ECAPS. And the ECAPS it should be said are held by other investors as well, both institutional and individual holders.

In summary, our position is on the LBHI2 application in agreement with Mr Beltrami that the LBHI2 sub-debt is senior to the sub-notes. And on the PLC application our primary position is that any claim by LBHI in respect of the sub-debt has been released in its entirety, alternatively in part, and it is only if it's not been released that the question of respective ranking arises and on that issue we are in agreement with Ms Hilliard that the PLC sub-notes are senior to the PLC sub-debt.

I am going to say a little about each of those three issues. Our case on discounting is very well set out in

our submissions in detail and I do not propose to address it further at this stage given the time limits I have.

So, my Lord, turning first to the LBHI2 application. Deutsche Bank agrees with the PLC administrators that it could not be clearer from the express terms of the notes that the notes are junior to the debt for all the reasons you have heard. And it is worth pointing out that the LBHI2 administrators also took that view when the issue was first raised and the reference for that is F7 at page 3686.

So given the clear terms of those contracts there is a straightforward textual construction which has been very well explained to you by Mr Beltrami which we have nothing to add to, except to endorse the point on rectification, that even if your Lordship were not to agree with the original textual construction or the amendment textual construction, the case on rectification is absolutely hopeless for the reasons that have been identified.

The one point my Lord that I wanted to say something about in opening was to answer Mr Phillips' assertion that there was no commercial reason for the competing subordinated debts to rank other than pari passu. And he said this morning, at page 61 approximately of the

[draft] transcript, that essentially there was no reason why the commercial incentives of LBHI are relevant to PLC issued instruments.

My Lord, that is wrong. The dividend stopper was specifically included and did incentivise LBHI to effectively stand behind PLC in order to ensure that the external ECAPS holders were paid and you can see that from a contemporaneous document.

If your Lordship goes to bundle F1 at page 327, I am only going to show you this e-mail my Lord. This is one of a number of examples of contemporaneous documents on the point. At the top of the page what you will see is an e-mail from Paolo Tonucci who was the international treasurer from the Lehman Group, and you see it is sent to Benjamin Katz as well as Erin Callan, amongst others, and you see the date is 7 March 2005. And you see in the third paragraph:

"We could also make clear that the dividend stopper is a mechanism to ensure LBHI support."

This e-mail, just so your Lordship has the context, you can see it from the bottom e-mail, it is in the context of the ratings agencies and, in particular, this e-mail Standard & Poors, who are querying whether they can rate the issue by PLC in this way because they have already rated LBHI and would prefer LBHI therefore to be

giving a guarantee or backing the issue before they gave it the rating that the Lehmans Group were trying to achieve.

What is being said here in the e-mail chain and in a number of e-mails in which ironically, given Mr Phillips' word, the word "incentivise" is actually used, that actually having the dividend stopper is the -- and you can pick this up in the e-mail above the one I just looked at, I looked at the bottom one just now and going up into the last paragraph of the one sent from Benjamin Katz at 2.33, he refers to the "ordinary share dividend stopper" in the middle of the paragraph. "This should be the main driver of how to rate the preference shares."

So my Lord, you see in a contemporaneous document at the time that it was recorded within the Lehman Group that essentially LBHI was going to have skin in the game and that is what the rating agencies could be told, that instead of providing a guarantee they would be bound by the terms of the dividend stopper.

While we are in this bundle, can I just show you at page 503 the terms of that dividend stopper and what your Lordship will see at page 473 is where the agreement begins and this is the Limited Partnership Agreement. On the first page you see the parties to the

agreement including LBHI at paragraph number 5, and you see that the General Partner is agreeing to become the partner and to deal with the matters including acquiring the notes and so on.

But you see that LBHI although not a party is bound by it, and in particular clause 18, and if your Lordship goes over to then page 503, that is clause 18 which is the dividend stopper:

"LBHI undertakes that, in the event that any Distribution is not paid in full, it will not:

"(a) declare or pay any dividend on its shares of common stock; or

"(b) repurchase or redeem any of its non-cumulative preferred stock or common stock at its option,

"until such time as Distributions on the Preferred Securities have been paid in full for one year."

The distribution clause is at clause 12. You see that on page 496, 12.3. So what you see clearly recorded in the contractual agreements. And I will come on to develop this further, but also in the contemporaneous documents within the Lehman Group is that the dividend stopper was quite a stick to beat LBHI with, considered to be akin to a guarantee from LBHI itself to ensure the commercial commitment and incentive to ensure that PLC met its obligations to the external

ECAP holders.

And that answers the point that was made this morning.

In that context, my Lord, can I make four points about the commercial context and the dividend stopper. First of all, as I have just shown your Lordship, it is indisputable and is clearly recorded in the contemporaneous documents, and there is a whole series of them, that LBHI was highly incentivised to ensure that PLC was in a position to make payments under the PLC sub-debt in order to fund payments to the ECAPS holders. And that is because of the dividend stopper.

Second and crucially, as Mr Beltrami has outlined, nothing was payable in this case under the PLC notes unless PLC met the contractual solvency test. And that essentially required PLC to be in a position to pay all of its senior liabilities before it could make any individual payment on the notes.

Third, PLC would only be contractually solvent if its available assets exceeded its senior liabilities and since the LBHI2 sub-debt was a very significant asset of PLC, PLC's ability to satisfy the contractual solvency test in the PLC sub-notes was in turn affected by LBHI2's ability to satisfy the similar contractual solvency test in the LBHI2 sub-debt. If it could not

then nothing would be payable to PLC and that would reduce PLC's available asset and jeopardise PLC's solvency.

Your Lordship saw from the charts that Mr Beltrami showed you that the structure as shown on those charts supported entirely that point because two points emerged from the charts that you were shown; first, the only external funding came from the ECAPS holders, the rest was all movement within the Lehmans Group; and second, in the 2007 restructuring the amount funded by the ECAPS was not restructured in the same way as the internal debt. It was treated differently.

We say that there was good reason for that given that dividend stopper and the potential catastrophic ramifications, which is the reason why LBHI was incentivised in the first place. And that is the reason why we say, and this is my fourth and final point, that commercial and common sense required that the LBHI2 sub-debt and the PLC sub-notes ranked in priority to the other subordinated desk of LBHI2 and PLC. Those were purely internal debts which had no equivalent market ramifications if they were not paid.

We are supported in that analysis by the division we say between the 6-odd billion and the 1 billion restructuring, because it is obvious that you would not

want the two to compete but rather prioritise the smaller 1 billion which then doesn't trigger the consequences I have outlined.

That is why we say, and you see this from our skeleton, it would be bizarre for intra-group book debts to compete with the funding chain for external debts in those circumstances.

My Lord, just standing back, we submit that those commercial considerations are entirely consistent with and support the textual construction that Mr Beltrami had clearly outlined. We raise the point to answer a point that has been taken against us that there was no commercial purpose, therefore it is obviously pari passu and indeed the case of Wood v Capita was referred to your Lordship this morning and if your Lordship is going to go down the Wood v Capita route with the iterative construction that is being suggested, what we say is the commercial considerations at LBHI2 level would assist your Lordship in that regard but it would be quite wrong for your Lordship to be persuaded that there were no commercial considerations, not least because the documents clearly record that there were. The commercial considerations obviously we submit may come into play more clearly at PLC level depending on your Lordship's approach to the textual construction and

I will develop that when I come on to address the PLC application.

My Lord, your Lordship has the point from Mr Beltrami's submissions that the solvency conditions are key to this whole analysis and indeed were not really engaged with by Mr Phillips, and Mr Beltrami showed you I think the solvency conditions in relation to the LBHI2 debt. Just so that your Lordship has it, perhaps we can just have a look at the solvency conditions at PLC level.

MR JUSTICE SMITH: Yes.

MS TOLANEY: So it is E tab 9 we need to look at and these are the notes, and the relevant solvency conditions at page 129.

MR JUSTICE SMITH: Yes.

MS TOLANEY: And your Lordship will see that in (3)(a) where the heading is "Status and subordination", the rights of the noteholders are subordinated to the senior liabilities and accordingly payment of any amount -- it is the "any amount" that is important here -- in respect of the notes is conditional upon the first one, which is not relevant at the moment but it is a cumulative requirement; and 2, the issuer being solvent as set out there, and your Lordship again will see then clause (3)(b) which defines contractual solvency and

liabilities for these purposes, for the reasons we have explained in our skeleton, are essentially the senior liabilities. And that is at paragraph 177 of our skeleton argument. The bundle reference, my Lord, is bundle B, tab 3 at page 65.

MR JUSTICE SMITH: Thank you.

MS TOLANEY: The essential point which your Lordship has is that it is much more rational and easier for PLC to put itself in a position to satisfy the solvency condition I have just shown you if the sub-debt of a large amount is an excluded liability. Otherwise, it has to pay all of its liabilities including the debt in order to legally make any payment, and of course the three PLC sub-debt facilities were very large, 3 billion and 12.5 billion by way of example. And you can see that from the agreed statement of facts, bundle C, tab 23 at page 303.

So we say that once you look at the structure of the documents and the solvency conditions which are absolutely key, and you put it together with the dividend stopper being required in order to make LBHI ensure that PLC could pay its external holders, it becomes obvious as to how the notes and debt should rank at each level. And we rely equally on the solvency condition at the LBHI2 level that Mr Beltrami referred

your Lordship to because obviously one must flow from the other. You saw the funding chain and the core flow.

So, my Lord, that is the point that we rely on and as I say it is evidenced both in the agreements and in the documents and it supports the construction that has been advanced on the words, and we say for all of those reasons there is a perfectly rational reason for this to be drafted as it was.

My Lord, can I then move on to just say something briefly about LBHI's factual evidence. Mr Beltrami has touched on this.

Until this morning, insofar as we were concerned three witnesses were being tendered on the ranking issues: Ms Hutcherson, Mr O'Grady and until this morning Mr O'Meara. I just flag up now because I anticipate that your Lordship may either now or during cross-examination intervene in the sense that the evidence of all of these three witnesses, and one has been withdrawn, is largely irrelevant and often inadmissible.

Take Ms Hutcherson for example. Her personal views and expectations as to how she might have expected things to rank but did not know and wasn't privy to any discussion about is absolutely hopelessly inadmissible and by way of example, paragraphs 32 and 52. Similarly

Mr O'Grady, and we are not surprised at all that Mr O'Meara's statement has been withdrawn. Their evidence is completely irrelevant. They spend a long time explaining to the court in great detail how payments were made on a practical level, but without any engagement on any of the points that I have just made to your Lordship. And in Mr O'Meara's case, the arguments that were given this morning for the withdrawal of his statement really did not withstand analysis. Mr Katz had always made it plain -- I think I am being interrupted already.

MR PHILLIPS: It was just a small point --

MS TOLANEY: Can I finish my sentence before you interrupt?

MR PHILLIPS: You may finish your paragraph.

MS TOLANEY: Thank you very much.

Mr Katz had always said, and Deutsche Bank always made it plain, that the dividend stopper point was one which applied in a solvent situation. It was not suggested that it had a material impact on an insolvent situation but the question of priority was not to be judged purely on an insolvent basis. So to suggest that it is only now from the third witness statement that that suddenly has been revealed is quite surprising.

Similarly Mr Katz did not make the concession that Mr Phillips suggested about Miss Callan, purely the time

period was corrected. It is of course entirely up to Mr Phillips as to whether he withdraws his evidence but I thought I should just correct some of the inaccuracies of the statements made this morning.

MR PHILLIPS: My Lord, perhaps while we are on inaccuracies.

MR JUSTICE SMITH: Let us deal with that point first.

MR PHILLIPS: What, the reason why Mr O'Meara has not been called? He has not been called because Mr Katz put in and basically said yes, okay, I agree, I was not reporting to Mr O'Meara and the insolvency point has gone.

The point I actually just wanted to deal with was the O'Grady point because what my learned friend seems to have forgotten is that on 19 September 2018 her instructing solicitor asked for a statement of all interest payments and cash flows of each of the instruments throughout the whole piece and they identified Mr O'Grady as someone with knowledge who they would like to hear from. We put in a witness statement. So it is a bit much to say that it is irrelevant when it came from their request.

MS TOLANEY: My Lord, as I understand it by way of tit-for-tat, I think Mr Phillips chose not to adduce expert evidence on alleged market practice as Mr Beltrami has adhered to so it was perfectly within

the realms to make a decision not to produce completely irrelevant evidence if it was obviously so. It doesn't help, my Lord, just simply because he is still being tendered for cross-examination, and so your Lordship may have your own views as to how useful or not putting lengthy cross-examination to those witnesses will be, but of course we will all take our steer at the time.

MR PHILLIPS: My Lord, how I am supposed to withdraw something that my learned friend asked for is tricky. But if she is saying she now doesn't want it we will consider that.

MR JUSTICE SMITH: Let me make an indication now. We have got a very sophisticated trial timetable which I am delighted to see everyone has complied with so far. I am not inclined to engage, in the course of the witnesses giving evidence, in whether something is or is not admissible, still less on questions of relevance. I intend to leave those for maturer consideration after the event. The fact is that to take rectification rather than construction, the law is sufficiently difficult for me to be disinclined to take a firm view about what questions may or may not be asked.

So my inclination within reason is to allow the parties to put the points they wish to put, not to entertain as I say within reason objections on the

grounds of admissibility but to leave it to the parties to make their submissions when they make their closing submissions about what I should and what I should not have regard to. And I will then take my view and exclude from my mind that which is inadmissible and take full account of that which is. So I hope that helps in terms of how the parties approach their cross-examination.

MS TOLANEY: That is very helpful my Lord.

MR JUSTICE SMITH: I am more than happy for you to take shots about which witnesses should or should not have been called, but after they have given their evidence rather than before.

MS TOLANEY: Indeed my Lord, that is very helpful to know. Very grateful.

My Lord I am going to move to release. Speaking of timetables, I was allocated 15 minutes, which I have had.

MR JUSTICE SMITH: And more tomorrow, though.

MS TOLANEY: Indeed. I am very happy to continue now and have more than my 15 minutes now, or to start release tomorrow. I am in your Lordship's hands.

MR JUSTICE SMITH: I am grateful. I have a few things to raise I am afraid on a rather mundane housekeeping level so it may be if that is a convenient moment Ms

Tolaney --

MS TOLANEY: It is my Lord.

MR JUSTICE SMITH: I can raise those with the parties.

Housekeeping

The first point was looking at the timetable, quite rightly the parties have allocated Day 8 as a day for taking stock and preparing their closing submissions. That seems eminently sensible because obviously you will have had several days of evidence before then. It does seem to me, though, that the note at the top of Day 9, "Any written closings to be filed in advance", is a touch optimistic. I am more than happy for the parties to submit whatever speaking notes they wish for me to read as and when but I just do not see how you can produce anything sensible for me to pre-read and for me to pre-read that material in the course of that time.

So it seems to me I should make it clear that I see this as a day for the parties to pull together their thoughts with a view to presenting it over the course of the next four days. As I say, if you want to put speaking notes to assist your advocacy by all means do so, just do not expect me to have read them. I will try to but no guarantees.

That means we effectively are running this case on oral closings. Obviously it is being transcribed, I do

not have a problem with that. What I am going to float though is: is there any mileage in having as it were a single document which all of the parties contribute to which really sets out against agreed headings where they disagree, where they disagree violently and where dare I say they agree? Really referencing back to their opening submissions and to any points that arise out of the evidence or out of clarification in terms of the other parties' cases. That would almost certainly be material that would be produced after the case is finished.

Now, I raise that and it may be the parties want to consider just how bad an idea this is before they come back to it but I am raising it to be of assistance.

MR BELTRAMI: My Lord, if I can speak for our side, we will consider that overnight if we can and come back to you.

On the anterior question about what -- what we are looking for is what your Lordship would find most helpful and clearly the Day 9 observation is a non-starter. I just do not know, and again we can all think about it, whether your Lordship would prefer to have some form of -- you have very long, let's be neutral about that, opening submissions. I hope you won't get very long closing submissions. There may be something to be said for a condensed version of

a written document from each party which focuses on the true issues and whether that can be done for example by lunchtime on Day 8, whether that would be helpful I do not know, I am just throwing that out as a possibility if your Lordship might find that helpful, because if so we can maybe work towards that or talk about it.

MR JUSTICE SMITH: Yes. I mean, my concern is that you are in danger of riding two horses and so doing neither well. The fact is there is an awful lot of material and it seems to me that I ought to steer the parties in the direction of ensuring that in the four days they have for closings they are in a position to utilise that time best. Whether after the event each party puts in a very short distillation of where they stand having heard everything, then I am more than happy to receive that.

MR BELTRAMI: It may be that is a solution. We do not want to get consequential and consequential, it would go on forever, but it may well be in a case such as this, for example, and maybe we can talk about it tomorrow morning, if your Lordship directed with a page limit distillation of points after the event on an exchange basis maybe, maybe that might be a solution. We can maybe take that away and think about it.

MR JUSTICE SMITH: I do not think we should make any decision now. Mr Phillips I do not know if you have

anything to add?

MR PHILLIPS: My Lord I do. It will not have been lost on your Lordship that we are the only party that needs to deal with absolutely every issue. Of course we will think about it further. One proposal that I had seen floating around earlier was that the parties would amend their skeletons to reflect what has come up through other parties' skeletons and the evidence. I am not convinced that that is the best way of doing it. But what your Lordship might find of most assistance is there are some issues that are purely of law and those lend themselves better, perhaps, to written documents and now quite when we can produce them is obviously something we will have to keep an eye on but obviously in relation to the issues to which oral evidence goes, your Lordship is absolutely right, it is going to be a real push, certainly for us, to produce a lot of written material in the three days that we -- that we have got after -- so on discounting and partial release it is a near racing certainty that we will produce something in writing. One does prepare as much as one can before starting the Tribunal so that is a near racing certainty. We will see what we can do with the other points.

One thing that I was going to do with your Lordship

at the end of Friday, and your Lordship may or may not be able to do this, is to ask your Lordship if there were particular points, particular areas where you would be more assisted in relation to others and it is obvious there are so many different points and they interlock in so many different ways, if your Lordship is not going to be assisted in relation to one or two points there is no need for the parties to spend too much time actually addressing them but we can only really do that on Friday.

MR JUSTICE SMITH: Yes, I will bear that in mind and think about that point very carefully. The danger of providing any sort of indication as to what is important and what is not is that almost certainly I will be proved wrong by the time I come to write my judgment.

MR PHILLIPS: Absolutely.

MR JUSTICE SMITH: But what I would say is that again I will think about this and the parties should think about this. I am not particularly attracted by page limits. I am going to put down a marker though, that it seems to me I have got quite a lot to read and digest and I have been through these written openings a couple of times now. But an awful lot has been said and what I think is going to be of assistance is, first of all, an obviously proper treatment of material that is new, about which

I mean the witness evidence; and then, secondly, a boiling down of where the actual disagreements in fact lie and that I think might well be served in some form of post-hearing written submissions.

I think Mr Beltrami's point about them all coming at the same time is a point perhaps well made. But perhaps I can leave it like that. It just seemed to me that I ought to raise it simply because it seemed to me what was being suggested in the timetable was unworkable. I notice no-one is pushing back on that but what is actually workable is something I am more than willing to hear the parties on. I do not know if anyone else has anything to add to Mr Phillips or Mr Beltrami? No.

MR PHILLIPS: My Lord.

MR JUSTICE SMITH: We will leave it at that.

MR PHILLIPS: Did your Lordship have other housekeeping issues at this point?

MR JUSTICE SMITH: I have a couple. The others are more straightforward.

We have got a very helpful diagram which Mr Arden handed up, a more fleshed out version. I wonder if you could provide me with a copy of the diagram at the agreed facts, C tab 23 page 307, in Word, so I could play with that.

MR PHILLIPS: I will hand that one over immediately to

Mr Arden who is nodding furiously.

MR ARDEN: My Lord I do not know where we got it but we have one in Word which is how we managed to edit the thing I handed up today.

MR JUSTICE SMITH: That would be very helpful, thank you. One thing I know is that after this trial I am going off to Cardiff for two weeks. That I think means I am not going to be able to take the bundles with me. I do not want to put any party to additional expense but to the extent there is material available electronically, I would take that with me. It will not be as useful as the marked up versions that I have, but it would certainly enable me to do some work, if the parties can assist in providing something.

MR BELTRAMI: My understanding is it is available electronically but I shall come back to you tomorrow morning on that.

MR JUSTICE SMITH: I am grateful to you, Mr Beltrami. Subject to that, the only other question is I notice that my files jump from H to J. Is there any reason for the absence of file I? I am not missing --

MR PHILLIPS: Transcripts my Lord.

MR JUSTICE SMITH: Transcripts are going to go in there. I think that will be helpful because I do not want to anticipate but there may well be reference to the

transcripts when the witnesses are being dealt with or for other reason, but it is usually helpful to have a run of material so that one can have a common reference, otherwise we are all looking madly for where we put the transcripts.

But those were I am afraid my rather mundane points at the end of a very interesting day.

MR PHILLIPS: My Lord, may I raise just one other point?

MR JUSTICE SMITH: Yes, indeed.

MR PHILLIPS: Which relates to the timing of cross-examination. Of course as your Lordship knows and has seen, we have produced a timetable.

MR JUSTICE SMITH: Yes.

MR PHILLIPS: Your Lordship should be aware that we produced this timetable with two parameters very much in mind. The first was our US experts should give evidence on the Friday. For obvious logistical reasons that had to be a fixed day and they needed to know exactly where they were going to be. And the corollary of that is that when we identified the length of time for each of the witnesses, we fit them in -- what we did was fit them into the available time.

I am just going to put this down by way of a marker really at this stage, which is that that timetable included 45 minutes for Mr Sutton -- it doesn't appear

on your Lordship's timetable because he was withdrawn -- and 45 minutes for Mr O'Meara, which gives us another one hour and 30 minutes and the position at the moment, and your Lordship has already probably identified this, Ms Dolby and Mr Katz are probably the two most significant witnesses and at the moment Ms Dolby is down for an hour and Mr Katz for an hour and 15. And it is likely that we are going to need or I am going to need a bit more time with each of them. I cannot tell you precisely what, your Lordship will appreciate the length of cross-examination is quite difficult to predict in advance, but there is a strong possibility that I am going to need at least another half an hour of that one and a half hours for those two, but we will see.

Your Lordship should also of course be aware that Mr O'Grady at the moment is down with an hour and 15 minutes and it did not sound as though there was a huge amount of enthusiasm for how important his detailed analysis -- and I say this having actually attempted to read these schedules of how Lehmans operated its cash flow mechanisms -- it doesn't sound as though there is a huge amount of enthusiasm for really digging into that so it may be there is some more time that can be freed up for more productive cross-examination. I just put that down as a marker.

MR JUSTICE SMITH: Well, it is the case when one has guillotines and trial timetables that there is a degree of stress, but what I do not want to happen is either for a cross-examination to be so rushed that the witness is not given a fair crack of the whip and the one thing I will be patrolling quite carefully is that however quickly counsel belts out their questions, the witness will have ample time to answer.

We do not know or I do not know at least what these witnesses will be like in the witness box. So can I simply say this: within the confines of the timetable, I am quite prepared to stretch the court day and seek to accommodate the demands that you are yourself, but it goes for others, quite rightly articulating.

The only fixed point that cannot be moved is we will have to finish at 4.15 on Wednesday. I will have to be out of court by then. But I am quite happy to start earlier and run later on other days subject always to the shorthand writers having enough time to gather their wits during the course of the day by way of rest periods.

Can I leave it at that? If you have a problem in terms of an argument about whose pressing need to cross-examine has priority over the others, then raise it with me tomorrow and we can deal with it then. But

is that sufficient indicator from me?

MR PHILLIPS: Certainly for my purposes, my Lord, and I am very grateful to your Lordship that you might extend the sitting hours if we do find that we need a bit more time. Looking at it, we are not talking about -- it is very unlikely I think anyone is going to say I need another two hours with this witness or anything like that.

MR JUSTICE SMITH: No.

MR PHILLIPS: It is --

MR JUSTICE SMITH: I do not think the timetable will bear that.

MR PHILLIPS: No.

MR JUSTICE SMITH: It is more a half hour or so there and, as I say, that I am certainly at the moment prepared to seek to accommodate that for anyone who raises it. We will see how we go. If we find large numbers of inadmissible questions then my views may well change but that we will come to when we come to it.

Thank you all very much. Is there any reason not to start at 10.30 tomorrow? No.

MR PHILLIPS: No my Lord.

MR JUSTICE SMITH: Very well. 10.30 tomorrow morning.

(4. 40 pm)

(The hearing was adjourned until

Tuesday, 12 November 2019 at 10.30 am)

1

2

3

4

5

6