Tuesday, 19 November 2019

(10.00 am)

MR PHILLIPS: Good morning, my Lord.

MR JUSTICE MARCUS SMITH: Good morning, Mr Phillips.

Closing submissions by MR PHILLIPS

MR PHILLIPS: My Lord, your Lordship has now had an opportunity to listen to and see the evidence and having done so we would invite your Lordship to conclude that on the ranking issue, the pari passu construction is on any view the correct answer to the priority dispute at both a PLC level and an LBHI2 level.

Your Lordship heard a key piece of evidence from Mr Miller in his cross-examination. Mr Miller, a senior capital markets partner at Allen & Overy during the entire period material to the case, was asked by Ms Hilliard about the Allen & Overy November 2008 presentation, which for your Lordship's note is at K1. When asked by your Lordship, he confirmed that the default position in relation to lower tier 2 and tier 3 debt was that it would rank pari passu inter se, absent a clear provision to the contrary in the relevant instruments. Mr Miller said that this reflected a market practice or understanding as to how lower tier 2/tier 3 debt ranked relative to each other. For your Lordship's note again, that was Day 3, page 21,

line 14 to 22:11.

This is consistent with how we put the point in our opening skeleton at 102 to 107 and is fully supported by the Basel materials.

Mr Miller's evidence is evidence of market practice, but as your Lordship will have appreciated from the authorities, it is consistent with and flows out of the pari passu principle itself and the case law and both Golden Key and Lehman Client Monies case, Golden Key being at authorities 3, tab 83 and Client Monies being at authorities 4, tab 91, show that the maxim is the starting point, albeit it can yield to clear contrary intention. My Lord, I'm just going to read from Lady Justice Arden. I was interested to see that Mr Zacaroli, Mr Crow, Mr Dicker and others, far more significant than me -- I was the other one -- were involved and Lady Justice Arden said:

"The concept of pari passu distribution may also be a factor which makes one interpretation more plausible than another."

That's paragraph 6, which your Lordship might like too look at a convenient moment.

Similarly, the strong default position is that lower tier 2 and tier 3 will rank pari passu inter se unless there is something clear and unequivocal to the

contrary. This means that the pari passu principle is the correct analytical starting point for considering both ranking issues.

At PLC level it is common ground between LBHI on the one hand and GP1 Deutsche Bank on the other the PLC subdebt and the PLC subnotes are all lower tier debt, or tier 3, and it has been conceded by Deutsche Bank -- this is at paragraph 180 of their skeleton -- and by GP1 at 47 of their skeleton that the PLC subdebts rank pari passu inter se.

At LBHI2 level it is common ground between SLP3 and PLC that: 1, before the execution of the LBHI2 subnotes there were three tranches of LBHI2 subdebt and that those three subtranches all ranked pari passu. PLC quite rightly make that concession in its skeleton at paragraph 66; 2, the LBHI2 subdebt was substantially but not entirely refinanced in May 2007 by the LBHI2 subnotes; and 3, the LBHI subdebt was lower tier 2/tier 3 and this was agreed by PLC in the PLC position paper at 51.4 and the LBHI2 subnotes that refinanced it was lower tier 2.

What that means, my Lord, is that at both PLC level and LBHI2 level, the default position was that all the instruments ranked pari passu and it is in this context, and with this default position in mind, that

your Lordship has to ask whether as a matter of construction there are sufficient materials to show an express contrary intention to the pari passu principle and whether the reasonable reader would conclude that the default position had been disapplied.

At PLC level, GP1 and Deutsche Bank need to show that there is sufficient language in the PLC subnotes to make them senior to the PLC subdebt. That results in the juniority construction as we have called it and we say they do not even come close.

First, the only express language that GP1 and Deutsche Bank can point to is what we can only call pari passu language in the extended definition of subordinated liabilities, which your Lordship is familiar with --

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: -- in the PLC subnotes. And the pari passu language and the absurd, with respect, premise that the subdebts cannot rank pari passu with anything, is the high-water mark of their linguistic case.

We will have to deal with it of course, but we submit that's quite a straightforward point.

Second, for commercial common sense to even be engaged, GP1 and Deutsche Bank need to at least show that the construction of the relevant instruments

presents an ambiguity or uncertainty which means the court can compare and contrast which construction is more consistent with business common sense. We address the law on this in paragraph 117 of our skeleton. As we will see, GP1 and Deutsche Bank do not again get out of the starting blocks.

But even if the court does need to consider commercial considerations as part of the PLC ranking issue, the major stumbling block is Mr Katz's evidence and the less compelling dividend stopper argument.

At LBHI2 level -- and to rebut the default position -- PLC need to show that there was an alteration in ranking as between the refinanced LBHI2 subdebt and the LBHI2 subnotes that refinance them. To do this, PLC need to identify clear express provisions in the LBHI2 subnotes that would leave the reasonable reader with the impression that there had been a ranking alteration and that Mr Miller's market default had been disapplied. Again, there is no clear and unequivocal language that shows any such objective intention to effect a ranking alteration, either at part 1 of the analysis, or at part 2 of the analysis, which is the pre and post 2008 amendments.

In that respect we note at the outset PLC's change of case in oral open submissions. PLC now leans very

heavily on the solvency condition, a point so important that it did not even feature in their position paper, and places much less weight on the subordinated senior creditor provision, "subordinated other than" in the definition of "Senior Creditors" in the LBHI2 subnotes.

At LBHI2 level, PLC have quite rightly disavowed any reliance on Deutsche Bank's commercial arguments and that is because, as we put it to Mr Katz, they are a convenient fiction. In any event, Mr Katz agreed that he was not even involved in the 2007 restructuring. There is no evidence at all of the dividend stopper argument applying at LBHI2 level.

It is in that context that we will be inviting you, my Lord, on both applications, to direct that the pari passu construction is the correct answer.

This will allow the surplus at LBHI2 to be shared rateably between SLP3 and through SLP3 the very considerable volume of external LBHI creditors, and PLC where unsecured creditors have been paid 100 pence in the pound and where there have already been significant distributions in relation to statutory interest as well.

To the extent that there is a surplus for subordinated creditors at PLC, it will result in a rateable distribution between LBHI and its external creditors on the one hand, and GP1 and its creditors,

the largest being Deutsche Bank, on the other.

The outcome will have the twin attractions of being legally correct and commercially fair and in that regard I would remind your Lordship that SLP3 LBHI do not merely represent the interests of internal Lehman entities. LBHI was the US parent of the Lehman Group. The approximately US$220 billion of LBHI's creditors are largely external and have received on average 36 cents on the dollar through the Chapter 11 plan. Recoveries on the LBHI2 subnotes and the PLC subdebt ultimately go to these external creditors.

Your Lordship is also asked to make directions in relation to the release issue and the discounting issue to cover the eventuality that there is a surplus for subordinated creditors at PLC. In relation to the release issue, we submit that it is very clear, having seen the New York law evidence, that section 802 of the settlement agreement did not release the PLC subdebt. First, it is clear on the face of the recitals that it was not part of the scope and purpose of the settlement agreement to address after-acquired claims of this nature and, second, it is also clear in the broad terms of the release, which extends to claims that are unmatured, unforeseeable and so on, that it does not cover after-acquired claims because unlike, for example,

prospective and future claims, these are not claims that the parties can release because they are not claims that are the parties' to release.

The partial release issue is a pure matter of law. We will address it. It is a totally new point. Deutsche Bank have dropped all the points in their position paper and now advance new arguments based on what is described as an absolutely "fundamental principle of guarantee law", so fundamental that it is based on one sole landlord and tenant case from the 1990s and which does not address insolvency and which is in fact a case about a primary debtor.

Finally, there is the discounting issue. Deutsche Bank provided 45 pages on this topic in their skeleton argument. On analysis there is in fact very little serious argument in those 45 pages. The frequent invocation of implied terms and the rule in ex parte James which the PLC administrators themselves disagree with, confirms that this is not a good point. It's a very technical area of insolvency law but thankfully, my Lord, the analysis is actually quite simple.

So we've got quite a lot of material to get through.

MR JUSTICE MARCUS SMITH: Yes indeed.

MR PHILLIPS: Starting with the PLC ranking issue.

Your Lordship has our opening written submissions. They are at 140 to 261. The materials before your Lordship show that the pari passu construction is the only possible answer to the PLC ranking issue. 1, the operative provisions under the PLC subdebt and the PLC subnotes are materially the same. 2, this is because they are either drawn up or based on FSA Standard Form 10. 3, the purpose of the standard forms was to implement the relevant EU directives, the requirement of which was for regulatory loan capital to be subordinated to the claims of all other creditors. 4, the drafting of both sets of instruments envisaged subordination to all of PLC's senior liabilities. 5, the senior liabilities are the same for the purposes of both sets of instruments. 6, they rank pari passu.

As we explained in our opening, when you boil it right down, the GP 1 and Deutsche Bank textual analysis, if we can call it that, is based on the same fundamentally flawed premise, that the PLC subdebt cannot rank pari passu with any other debt. Now we have heard the evidence, nowhere is that fundamental flaw more apparent than what we heard from Mr Miller.

As we have already shown your Lordship, his evidence was that it was market practice for lower tier 2 and tier 3 subordinated debt instruments to rank pari passu.

We would invite your Lordship to accept his evidence. He was a partner in the Allen & Overy capital markets team. Moreover, it is consistent with other materials before the court which are to the same effect, including the Basel working papers.

The next question is how can it seriously be argued that FSA Standard Form 10, the industry bedrock, at least before GENPRU, does not allow other subordinated debts to rank pari passu.

Then, my Lord, these two propositions, the alleged inability to rank pari passu on the one hand, which has to be where they go, and the default lower tier 2/tier 3 ranking being pari passu, are very obviously mutually inconsistent. We fail to understand how a case can be seriously argued against us. The juniority construction is basically unarguable.

Now, anticipating that problem, there has already been a climb-down by both Deutsche Bank at paragraph 180 of its skeleton, and GP 1 at paragraph 47 of its skeleton, where they appear to have conceded, albeit via different routes, that the three different tranches of the PLC subdebts can rank pari passu inter se. Now, that concession is in effect the end of GP 1 and DB's case. It is a floodgates type concession. Once it has been conceded that the three PLC subdebts can rank

pari passu inter se, it necessarily follows that the PLC subdebts can rank pari passu with other subordinated debts.

In the face of these very serious problems, Deutsche Bank confidently told your Lordship in their opening that the LBHI construction -- and I'm quoting -- "does not fly", because it takes no account of the express terms of the contract and because it cannot be true where the parties have agreed that they do not rank pari passu. And she said that on Day 2, at page 16, lines 21 to 22.

The only express term that GP Deutsche Bank and GP1 can point to to get their juniority construction is in fact a pari passu provision. It's what is found in the extended definition of the term of subordinated liabilities in the PLC subnotes, which we say is a very powerful indicator of itself.

Finally, my Lord, then there is the dividend stopper argument. We will have to deal with it, assuming, my Lord, that you need to be addressed on it, not least because it was the only reason that Deutsche Bank was ordered by Mr Justice Mann in July 2018 to be joined to the LBHI2 application at all and for your Lordship's note, you might like to see at authorities bundle 6/145 is the joinder decision and you will see that

Deutsche Bank only just scraped in by the skin of their teeth and only to argue that point. You will perhaps not be surprised to hear that we will be asking you to reject Mr Katz's evidence.

All of this leads to one result, the pari passu construction, and there should be nothing surprising about that outcome.

Your Lordship has heard that the ECAPS were a means of raising capital and that they were the equivalent of the tier 1 preference shares in LBHI. Your Lordship heard that from Mr Katz and your Lordship can see it in a number of the emails. They were intended to be the equivalent of tier 1 capital in LBHI, that's how they were rated by the rating agencies. That is what the ECAPS holders invested in. There is no prospect of any LBHI shareholders receiving any distributions in LBHI. Deutsche Bank is an external investor which acquired ECAPS interest post insolvency in the secondary debt markets. It would be an odd result commercially if an investment sold and rated at LBHI tier 1 capital level received distributions before the unsecured creditors of LBHI had been paid out. My Lord, that is dealing with nothing commercially surprising about this.

Can I then move on to deal with the other parties' evolving cases. I just want to make a few quick points

about how the case against us evolved. Can I just ask you, my Lord, to pick up divider A and I just want to look at A8, which is Deutsche Bank's position paper and, my Lord, in 34 through to 52, they dealt with the relative ranking and in 38 to 41-- does your Lordship see the subheading "The PLC subdebt cannot rank pari passu with the PLC subnotes"?

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: And they said their terms preclude pari passu ranking with any other debt. They say that in paragraph 41, your Lordship will see:

"The effect of the different definition of subordinated liabilities in the PLC subdebt is that the PLC subdebt cannot rank pari passu with the PLC subnotes as LBHI contends because its terms preclude pari passu ranking with any other debt."

And, my Lord, that led to -- and your Lordship sees it in their position paper -- the so-called circularity whereby each of the PLC subdebts and the PLC subnotes are senior liabilities vis-à-vis each other and, as we move on to 47, the circularity should be broken. First of all, there was giving effect to what the parties would objectively have intended, and alternatively implying a term.

They then moved on to deal with the timing and

chronology of the PLC subdebt and that's over at 51 and this timing argument we deal with, for your Lordship's note, in the reply position paper which your Lordship has got at A10, 190, 30.5, paragraph 52. This was what was said to be supported by the tax and commercial objectives and your Lordship sees:

"As regards tax and commercial objectives ..."

And they supported all of this by the tax and commercial objectives.

Now, for your Lordship's note, in Deutsche Bank's skeleton argument at B3, on the construction points at 159 to 197 they dropped the timing argument; that's the first point. On the commercial incentives between 28 to 66 they dropped the tax argument. In their oral opening they described their argument as commercial and GP1's argument as textual and it is in fact not clear whether Deutsche Bank still advance a free-standing textual argument at all, or whether they only now advance the dividend stopper argument.

We will seek to address the points as advanced in their written opening, but your Lordship should appreciate we are firing at a moving target and it is actually a theme that I'm going to be taking your Lordship through with all of this.

Can I then just look at GP1's position paper, which

is in A9. That is in A9 and I just wanted to turn up 59 to 72. The argument in 59 to 72 was that the PLC subdebts cannot rank pari passu with anything, they just go to the bottom of the pile. This was the bottom of the pile argument and then at 23 to 26, they deal with the point that was explored by Ms Hilliard in cross-examination, which is that the first two long-term facilities contained -- and to quote them -- significant amendments to the standard form. We will come back to that, but it is not clear where that's supposed to go.

Then, my Lord, for your Lordship's note, GP1's skeleton, which is at B4, at 25 to 27, that dealt with deviations from the standard form and said:

"Whatever the reasons for these departures from the relevant standard form, it serves to demonstrate that it is wrong to place too great a weight on them."

Of course, GP1 didn't open their case, so we will have to see where we go.

Can I then go to the textual analysis.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: Can I just invite your Lordship -- although I anticipate, my Lord, that you have looked at these several times so I'm not going to read through them every time, can I ask your Lordship to go to E6, E7 and E8, but we're going to do this by reference to E6.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: This is the PLC subdebt and we go to clause 5.1 which deals with subordination and, my Lord, it starts -- I pick it up after the reference to paragraph 4:

"The rights of the lender in respect of the subordinated liabilities are subordinated to the senior liabilities."

I'm going to make some submissions shortly. Then it goes on to say:

"Accordingly, payment of any amount of the subordinated liabilities is conditional upon ..."

What you see from that is that the solvency condition is a mechanism for implementing the core subordination provision. The core subordination provision is the very simple contractual statement that the rights of the lender in respect of the subordinated liabilities are subordinated to the senior liabilities and it goes on to say, conditional upon that:

"The payment condition in 5.1(b) must be satisfied, whether or not a solvency has begun and the payment of in at the amount is conditional upon PLC 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 that the borrower could make such payment and still be solvent."

And we then get to 5.2 which deals with solvency:

"For the purposes of 1(b) above, the borrower shall be solvent if it is able to pay its liabilities other than the subordinated liabilities, in full, disregarding ..."

There are then the critical definitions, the important definitions: senior liabilities, subordinated liabilities and extended liabilities. The senior liabilities are all liabilities other than the subordinated liabilities and the excluded liabilities and that includes unsubordinated liabilities of course, but it also includes subordinated senior liabilities, in other words subordinated liabilities other than the subordinated liabilities or the excluded liabilities, in other words the tier of ranking in the senior liabilities that may itself be subordinated to other senior liabilities. It is a point we will be coming back to.

And of course on the LBHI2 application, PLC has conceded that such a category exists in the LBHI2 subordinated debt.

The starting point is that the PLC subdebts rank pari passu inter se. GP1's skeleton describes this as

not an unattractive starting point at paragraph 47 and that's a point we do agree with and Deutsche Bank's skeleton I mentioned at paragraph 180, and that is not surprising, first of all given the evidence that lower tier 2 and tier 3 subdebt rank pari passu, secondly the fact that PLC subdebts were all drawn up on Standard Form 10, or something very close to it -- I will come back to that -- that use exactly the same subordination language as FSA Standard Form 10. Two debts on the same form intended to be subordinated to all liabilities and all other creditors, which comes from the EU directives, prove in the same place.

Now, everyone is agreed that the PLC subdebts rank pari passu, the question is what technical solution should be adopted to that problem. Now, we set out the building blocks in 212 to 224 of our skeleton and I'm giving you that for your Lordship's note, I don't want to turn it up. But point 1: the literalist starting point that each is subordinated on a literal interpretation to liabilities which include the other PLC subdebts, is obviously incorrect.

MR JUSTICE MARCUS SMITH: Though it is, you would accept, the literal meaning of the words?

MR PHILLIPS: It could be read like that, yes. They could and that starting point is obviously incorrect.

MR JUSTICE MARCUS SMITH: Yes. No, I understand that, but I think we ought to recognise the starting point is that the words "this agreement in subordinated liabilities" and the fact that senior liabilities is effectively a catch-all means that if one is being literalist, we have that as a starting point.

MR PHILLIPS: Absolutely, my Lord, and that's why the literalist approach must give way, must give some way to a contextualist approach in relation to these agreements.

The next point is that the PLC subdebt must be construed against the regulatory background in which they were created and in footnote 194 we referred to an Australian case of Phoenix Commercial, which for your Lordship's note is in 492 of the authorities bundle, and Lewison on the Interpretation of Contracts and your Lordship has heard what Mr Miller confirmed in his oral evidence about the purpose of regulatory subdebt, which was to support non-regulatory debt, including non-regulatory subordinated debt, which obviously militates against one regulatory subdebt being a senior liability for the other regulatory subdebt because the other regulatory subdebt then on that analysis is supporting other regulatory subdebt.

And for your Lordship's note, Day 3, page 16:1 to 9

he confirmed it was no part of the capital adequacy provisions to protect subordinated creditors or regulated capital creditors and Day 3, page 43:10 to 44:2, he confirmed the purpose of the FSA was to make sure that non-regulatory capital creditors, senior liabilities, get paid first in an insolvency. That is clear and one can see it from Basel, one can see it through the directive, it's absolutely clear.

The next point is that the law does not require judges to attribute to the parties an intention they plainly could not have had. We get that from Investors Compensation Scheme which is at A/49, at page 917, and parties using the FSA 10 form cannot have intended to subordinate one tranche of regulatory subordinated debt to another tranche of regulatory subordinated debt using the same forms.

So we then come to the mechanism which we respectfully submit is the preferred mechanism which achieves the right outcome, which is the implication of a term into FSA Standard Form 10 and we address this at 219 to 220 and your Lordship will have seen that we also refer to other ways of getting to the same place and we know because of what we know about what the market understood was happening, and it works the following way -- I'm sorry, my Lord, did you want to --

MR JUSTICE MARCUS SMITH: I'm just turning up 219 to 220 so I can see them.

MR PHILLIPS: Yes. The words "all other liabilities of the lender which rank or are expressed to rank pari passu with the liabilities of the lender under this agreement" would be included on our implied term within the definition of subordinated liabilities.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: So we pick up "expressed to rank or rank" and that implied term reflects the words that the parties to the PLC subnotes included when the definition was extended. When they applied for and obtained waivers, they included a reference to subordinated debt that ranks or is expressed to rank. And that would work. And we do say that the fact that the industry -- yes, and I'm reminded Day 3, page 33:21 to 34:23, Mr Miller said that this had been done because "What people were grappling with is how do they", multiple agreements, "interact with each other". He said that was a point of discussion around the capital markets at the time.

My Lord, the fact that the industry -- if I can call them that -- felt it needed to extend the definition of subordinated liabilities to other pari passu subordinated liabilities plainly in our submission satisfies the test of obviousness and necessity in

Marks & Spencer v Paribas and in our submission it shouldn't be controversial because, 1, all the parties agree that FSA Standard Form 10 is defective on this point. 2, on a strict reading it only envisages -- and I think this is a point Mr Miller alluded to -- on a strict reading form 10 only envisages there being one tranche of subordinated liability, which is obviously shortsighted, it ignores the bigger picture. A borrower could have numerous subordinated loan agreements to which it was a party and it would make no sense, where that was the case, for the second in time to automatically be promoted to a senior liability vis-à-vis the first and the first to be a senior liability vis-à-vis the second and that was the circularity that everyone has grappled with and, as we explained in our opening, your Lordship has seen that there are various solutions to this problem, but the right solution I respectfully submit is the implied term to imply into that standard form to mirror what was done on the forms that were amended and approved on waiver applications, in circumstances where your Lordship has seen that the waiver applications were all made and approved on the basis that it left the subordination the same.

Can I then just tell your Lordship that PLC, at

66.2, which is in B2/19 of their skeleton, they posit an implied term and the implied term that PLC posit is where the agreements are on the same form and on the same day and they say that you can imply a term that they rank pari passu inter se.

Then Deutsche Bank -- I'm sorry, would your Lordship like to see that?

MR JUSTICE MARCUS SMITH: No, I have the point. So there would be a difference then between the first and second agreements and the third, because the third is October 2005?

MR PHILLIPS: Yes, absolutely. And that's one of the criticisms that I was about to come on to, my Lord.

And Deutsche Bank, at 180.3 which is at B3/69, posit a broader construction of the definition of subordinated liabilities to include loans and advances made under other tranches of the PLC debt between the same parties for the same purpose and on materially the same terms, and I'm going to come on to why that's too narrow as well.

But of course those are not insignificant concessions by my learned friends. It's not concessions, it's agreements as to the way forward.

MR JUSTICE MARCUS SMITH: Well, so what you're saying is that -- to take the analysis in stages -- everyone

agrees that the literal reading is a bad outcome and everyone agrees, in your submission, that the way out is by way of an implication of term --

MR PHILLIPS: Yes.

MR JUSTICE MARCUS SMITH: -- rather than some other route.

MR PHILLIPS: Yes, my Lord. And a number of other routes have been canvassed and debated. It's not as though everyone has gone straight for this as the solution. We can all see there's a problem, we can all see there needs to be a solution and everyone has tried to identify what the solution should be and this one, we would respectfully suggest, is the right one, and it also mirrors what was being done when the subnotes were then drafted and the waivers went through.

We say that the solutions advocated by Deutsche Bank and PLC are unduly restrictive. So your Lordship has got the point about the same day and also, respectfully, it's not clear to us why they need to be created on exactly the same form, because that might create problems where you've got a particular agreement that's created pursuant to a waiver application where the terms might be almost but not entirely identical. And, thirdly, it is not clear to us why they need to be with the same party because, in particular in the regulatory capital context, it is entirely possible that there

could be different tranches of subordinated regulatory capital that are obtained from different parties and so if one takes the example where borrower A enters into a first, an FSA Standard Form 10 agreement with lender B, several years later perhaps enters into a second bespoke subordinated loan agreement with a different lender, C, which second instrument expresses itself pari passu because it is bespoke so they have the amended wording, there's no sensible reason why the second instrument should not rank pari passu with the first and yet that narrow construction would lead to that result.

So for these reasons we submit the implied term that we have advanced is commercially workable and it does not suffer from these strictures and we invite the court to read that term into the definition of subordinated liabilities, which of course, as your Lordship has seen and as I have already said, is very similar, if not identical, to the sorts of terms that were going through on the waivers. So one thing we do know is it does not infringe, certainly as far as the market or the FSA are concerned it did not infringe, the underlying requirements of this sort of regulatory capital.

Can I then move to the subnotes very briefly, take your Lordship briefly to the subnotes again, and what

I would like to remind your Lordship of is first of all the subordination which is in E9 and I want to turn up 129 first of all, if I may, which is clause 3(a), "Status and subordination", and, my Lord, your Lordship sees the second sentence:

"The rights of the noteholders in respect of the notes are subordinated to the senior liabilities."

And I will come back to the "and accordingly" language. And your Lordship has seen the definition of subordinated liabilities at 128 and the definition is it includes:

"... all liabilities of noteholders in respect of the notes and all other liabilities which rank or are expressed to rank pari passu with the notes."

And of course one has got the definition of solvent, just to remind your Lordship, in 3(b). I'm going to come back to it.

But your Lordship heard evidence from Mr Miller in relation to the background to the subnotes, on Day 3, 33-38, which confirmed what we put in our skeleton at 164-179 and in summary, the PLC subnotes were based on a precedent. They were based on the Collins Stewart notes and that is explicit in the waiver applications themselves. Collins Stewart had already had to grapple with the problem of -- and I'm quoting -- "What happens

if there is a second one, where does it rank amongst each other?" and that was Day 3, page 35, lines 1 to 4.

The Collins Stewart solution was to adopt the definition of subordinated liabilities used in the PLC subnotes. This was an issue that the capital markets have been aware of for some time and the Collins Stewart solution subsequently appears to have been adopted by others in the market and for your Lordship's note, you can find the Collins Stewart notes at F1, 101.1 to 101.25 and the relevant definition is at 101.5. I'm not going to turn it up, I'm just going to show you it says the same thing.

Other than the structural differences -- because Collins Stewart used the trust structure for subordination -- the material provisions in relation to subordination were identical.

So, my Lord, moving on to the submissions and the argument, our argument is simple. Same senior liabilities in every note, same subordination provisions; all of them are lower tier 2/tier 3 debt. There is no contrary expression provision to disturb pari passu and that, we submit, leads to the pari passu construction and we deal with that core analysis at 232 to 241 of our skeleton argument and just to remind your Lordship, the steps are the PLC subdebt all ranked

pari passu, the PLC subdebts admitted the possibility of ranking pari passu with other subordinated debts, that was expressed on the face of the PLC subnotes, because they have a definition that says "ranked or expressed to rank pari passu". The PLC subnotes were intended to rank at the same level as the subdebt, that was clarified in the waiver direction. We anticipate, in view of the cross-examination, an argument against us along the following lines, which is that all the waiver direction does is to confirm ranking below the unsubordinated creditors because that is all IPRU required; IPRU and GENPRU did not make any stipulations as to how lower tier 2, LT3 subordinated debt ranked inter se. That we anticipate.

Now, that may or may not be correct in terms of what IPRU required. It's not in fact what the waiver direction says, but where, we ask, is the indication of an intention to rank anything other than pari passu? There isn't one.

So turning to some Deutsche Bank arguments, we address their points starting at 159 in our skeleton and there are two factors that are fatal to Deutsche Bank's argument: 1 is the evidence about the market practice or understanding; 2, their concession that the PLC subdebts rank pari passu inter se.

On the second point, at 182 of their skeleton they submit that the same reasoning in relation to the PLC subdebts inter se does not apply as between the subdebt and the subnotes. So what they say is "Yes, that all ranks pari passu, but when you turn to the subnotes, the same logic doesn't apply".

And it's said that the floodgates point doesn't follow because the definition of subordinated liabilities in the subdebt does not include the subnotes, the subnotes are tradeable listed notes rather than loans issued between -- they are issued between different parties and on materially different terms, by which they mean the definition of the subordinated liabilities.

We say this is wrong, because once your Lordship has accepted our implied term, it is plain that the PLC subdebts can rank pari passu with other subordinated debt because the question one would be asking is the same question: does it rank or is it expressed to rank? And of course to state the obvious, there's a difference between "expressed to rank", which means that the an agreement says "This debt ranks pari passu with that debt", and then there is ranks, which is of course a state of facts, in other words: if you come behind the same senior creditors, you will rank pari passu because

that is the legal construct within which we are operating.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: As far as the point about tradeability is concerned, well, that's just a non sequitur. Just because it is tradeable doesn't mean it is issued on different terms.

So not only is Deutsche Bank's restrictive analysis wrong, it has the added problem that it triggers a repeat of the same circularity problem that they sought to break at paragraph 180 of their skeleton argument.

However, to then break this second circularity problem they resort to an implied term which does not, unlike the implied term we are suggesting, even attempt to engage with the obviousness and necessity test, so if I can ask your Lordship to look at B3 in relation to this, to Deutsche Bank's core analysis, B3. Starting at paragraph 190 on page 70 they've got a heading "Resolving relative ranking" and if I can pick it up at 192:

"Although there were strong commercial reasons ..."

Now, we're going to come back to the strong commercial reasons, but it is not right to say that the consequences DB referred to could not be expressly

provided for. The applicable capital advocacy rules did not prescribe standard forms without more because of the waiver application, so as Deutsche Bank argue, the rules were silent about ranking inter se, there was no restriction as Ms Hutcherson told us, so if PLC had wished to record the difference in ranking of the subnotes, given that there was a waiver application, it could have sought permission to do so. So in other words, if they had wanted the subnotes to rank senior they could have just asked for that in the waiver application.

193, the premise that the position is analogous to the position in Aberdeen City Council, which was where there was an event that occurred subsequently that was not contemplated, is wrong and if I can just show, just to remind you, in authorities bundle 5, at tab 120 and I just want to remind your Lordship of paragraph 22, just so your Lordship can see what the point is, this is 22:

"In some cases an event subsequently occurs which was plainly not intended or contemplated by the parties judging by the language of their contract."

And then:

"In such a case, if it is clear what the parties would have intended, the court will give effect to that

intention."

And the existence of other subordinated -- there are two reasons why the principle doesn't apply here. First of all, the issuance of other FSA subordinated debt on standard form 10 was not a completely unforeseeable event. In fact, as your Lordship has heard, it was standard in the market, and the suggested solution, the juniority construction, is not clearly what the parties would have intended. In fact in our submission it is obviously wrong.

Then at 196 your Lordship will see the implied term that is suggested and we don't really need to bother your Lordship with that because a term is not obvious and necessary merely because it suits one party's commercial objectives and they don't even try to explain how that test is met. So that's it. There is no more currently at least to Deutsche Bank's case than that, on construction. The rest has been dropped, or does not appear to be advanced.

There are some criticisms in 178 to 184 of LBHI's case, but can I boil it down, my Lord. The criticisms are twofold. First, they argue that our approach assumes the premise it seeks to prove, namely that the subdebt and the subnotes are subordinated to the same liabilities and I think your Lordship knows why we make

that point. And, secondly, that our approach fails to take account that the reason for the similarity in language is that the sole purpose of Standard Form 10 was to protect unsubordinated creditors and not address relative ranking.

Those are the two points and they are easily answered. 1, the use of form 10 reflected the fact that lower tier 2/tier 3 subdebt ranked, as a general rule, pari passu unless there was a clear express provision to the contrary. 2, in the absence of such provision lower tier 2/tier 3, they rank behind the same senior liabilities, which of course is critical to all of this.

And there is very obviously no express contrary intention to all of these contracts ranking behind the same senior liabilities and the only indication of ranking that one finds that is expressly provided in the PLC subnotes is that there are other debts that rank pari passu and that's the only indication that you actually get, and of course junior in the excluded.

That takes me to GP1 and the arguments that GP1 run are based on the same false premise, which is that the PLC subdebts do not recognise the possibility of them ranking pari passu to any other liability and Mr Miller's answer that these were all drawn up on the same standard forms, and what your Lordship can see from

there is a total answer. And even if GP1 can argue that the first two PLC subdebts did not need to be issued on Standard Form 10, the problem GP1 faces is that they were, and that the third PLC subdebt did need to use FSA form 10 language and it did. And your Lordship has seen the first two, they took out clauses 4.2 and 4.3. Well, that doesn't impact on the relevant clauses that we're looking at here, which are 5. So as far as is material, they were on the same form, whether they needed to be or not.

So the implied term and the presumption against absurdity, we submit the obvious analytical answers to the --

MR JUSTICE MARCUS SMITH: Just in terms of departure from the Standard Form 10, we had evidence on this and I think it was put that this wasn't a case of, as it were, an unauthorised departure from the standard term, but it was simply the case that the standard term could be departed from because the rules did not apply to the particular entity that was entering into this transaction.

Do you say that there's any difference between the consequences of those two scenarios: error or non-obligation to follow the standard form?

MR PHILLIPS: No, my Lord, no.

MR JUSTICE MARCUS SMITH: So from your point of view it doesn't matter why?

MR PHILLIPS: Absolutely. What matters for present purposes is the subordination provision and the subordination provision is the same. So this is a jolly interesting examination of whether or not somebody picked up a form that had been in place when the SFA was the relevant body as opposed to the FSA form which came along later. And your Lordship I think saw that there was a reference to 1998 in the bottom left-hand corner which may explain that -- that is the SFA form, which of course would also explain why the FSA isn't referred to in clauses 4.2 and 4.3, but whether or not that's a complete answer, it really doesn't matter.

MR JUSTICE MARCUS SMITH: No. It's really the evidence of Ms Hutcherson that I'm thinking of --

MR PHILLIPS: Absolutely.

MR JUSTICE MARCUS SMITH: -- because -- and to be entirely fair to her she was very clear that she was only speculating -- her thesis at the beginning was that the wrong form had simply been used, but she was I think quite amenable to the suggestion that actually there was no need to infer a mistake because it could be that the obligation to use the form did not extend to this particular case.

MR PHILLIPS: At that time.
MR JUSTICE MARCUS SMITH: At that time.
MR PHILLIPS: One of the things your Lordship will be very, very familiar with is that the development of -- and I don't want to spend too long on this, but your Lordship will be very familiar with the fact that what we see happening in Basel and what we see happening through the directives is something that developed through the 1990s and into the mid-2000s following the collapse of BCCI, which of course had been very much about the failure of consolidated supervision and that was really one of the things they were all grappling with, but anyway that's just a historic aside.

My Lord, can I then move on to commercial incentives, and subject to your Lordship, I was minded to stop at around 11.30 for the transcript writers if that --

MR JUSTICE MARCUS SMITH: Yes, that would be an appropriate time.
MR PHILLIPS: My Lord, on commercial incentives, your Lordship has our opening submissions on these points. For your Lordship's note it is 252 to 256 in relation to PLC and 350 to 355 in relation to LBHI2.

We put to Mr Katz at the end of his cross-examination that the dividend stopper argument is

a convenient fiction and that remains our position. In oral opening we heard from Deutsche Bank, Day 2, 160-167, that 1, there are a whole series of contemporaneous documents that show that LBHI was highly incentivised to ensure that PLC was in a position to make payments under the PLC subnotes in order to fund payments under the ECAPS; and 2, the essential point 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 PLC subdebt of a large amount is an excluded liability.

Two initial observations.

One, we have still no the seen any of those documents that evidence the dividend stopper giving an incentive to make the subnotes senior to the subdebt. They were not referred to or exhibited in Mr Katz's three witness statements, they were not referred to in Deutsche bank's position paper, they were not referred to in Deutsche Bank's skeleton argument and we have not seen them in evidence at trial;

Two, the argument as we understand it requires the PLC subdebt to be an excluded liability for the solvency condition to be satisfied, which totally misreads the solvency condition. The solvency condition does not take into account excluded liabilities or subordinated

liabilities, so on Deutsche Bank's case the solvency condition would be satisfied if the PLC subdebt was a subordinated liability and of course on our case they are a subordinated liability.

The dividend stopper point is unarguable. There is not a shred of evidence relating to these commercial incentives. There is not one document in all of the thousands disclosed. There is the evidence of one witness, Mr Katz, but we will be inviting your Lordship to approach that with extreme caution, not least because Mr Katz could not cite a single document that evidences the commercial incentives. The only evidence we saw pointed the other way. As your Lordship saw, the early term sheets of the PLC subnotes express themselves to be junior to not senior to the PLC subdebt.

So taken together the dividend stopper argument is nothing more than assertion. There's no substance to it at all. And that is clear, we would submit, from Deutsche Bank's skeleton. "The relevant parties would have intended that the PLC subnotes to rank senior", that's paragraph 30. And Mr Katz' witness statement, "LBHI would have been incentivised". "I recall the PLC note would have been prioritised". That language is woolly. It's the language of hope and expectation not certainty, and it bears an uncanny resemblance to

Arnold v Britton and I'm quoting paragraph 22:

"If it is clear what the parties would have intended, the court will give effect to that intention."

And Mr Katz insisted to your Lordship that he had written -- because I asked him expressly -- this part of that witness statement himself. That, with respect, is one of several aspects of his witness evidence that was unsatisfactory.

Finally, my Lord, your Lordship has seen Deutsche Bank also advanced numerous tax based arguments in its position paper. They were rightly dropped before trial. And the right thing to do would have been to drop the dividend stopper point as well.

My Lord, I'm not going to take your Lordship back over the mechanics of how the dividend stopper work, but if I can just say a few words about Mr Katz.

Mr Katz was not a impressive witness. He was badly prepared. He did not appear to have re-read any of the contemporaneous documents and he appeared to be very distant from the facts and matters he was supposed to be assisting the court with. By his own admission, his recollection was poor. He was not even in the Lehman Group finance department and we discovered that he had never before seen key documents referred to in his evidence, such as the PLC subdebt. And worse than

that, his evidence was evasive and often incredible and I'm just going to give your Lordship two examples, if I may.

Despite being asked the same question several times, Mr Katz was not prepared to agree that the interest payments on the PLC subnotes and the PLC subdebt did not coincide and were not in direct competition. He was shown the different due dates, the former annually, the latter monthly, but insisted that all obligations are competing in some way -- and that was Day4/30:5-12 -- even if they did not fall contractually due at the same time.

Mr Katz refused to consider the facts as they were at the time. His constant refrain, your Lordship will recall, was that these were perpetual securities so the situation in 2005 to 2008 was not relevant and for your Lordship's note, Day4/32:11-21.

And the other example -- I've got a number but I'm just going to give you two. Mr Katz was shown three drafts of the PLC subnotes that had passed between members of his team and been passed to Allen & Overy as approved and copied to him as being final. Those drafts provided that the PLC subnotes would be subordinated to all the existing tier 2 and tier 3 subdebt of PLC. His initial response was to say that he had never seen the

term sheet, that's Day4/55:3-6. However, he admitted to your Lordship very soon afterwards that his usual practice was to read emails and attachments sent to him, Day4/56:5-9. He lay responsibility for the drafts at the feet of his junior, and I'm quoting, Mr Tomala, Day4/56:17-23. He accepted your Lordship's understanding that these documents would be looked at quite carefully by someone in his team moving forwards, Day4/59:18-24. And after all his evidence was, as your Lordship will remember, that his team would consider how the subnotes would perform in an insolvency. The same team members continued to accept the juniority drafting and they went to Allen & Overy.

I will just mention a third. He would not accept, despite being asked the same question repeatedly, that these emails evidenced his team discussing or considering subordination and that was Day4/68:4-8. And your Lordship quite rightly explained to him that when these drafts were circulating, they were circulating for a purpose, which is 4, 69:23-24, and Mr Katz did not appear to accept this.

Turning to the arguments, my Lord, initial thoughts. At the outset, Deutsche Bank has conceded that the dividend stopper argument does not apply in

an insolvency. That's an important starting point because LBHI would not be paying dividends in any event; if LBHI was insolvent it would not be paying dividends to its shareholders. So the dividends stopper in that event would be a non-issue and that's at 33.2 of their skeleton, which was in effect accepting the evidence that would have been given by Mr O'Meara. LBHI wouldn't have been able to pay the shareholders anyway.

That limited and that limits PLC's argument to the solvent situation, which it describes as the situation where PLC is unable to satisfy the solvency condition so that (a) PLC cannot make interest payments on the subnotes, and (b) the partnerships cannot make coupon payments to the ECAPS holders. So we call that a solvent insolvency.

Pausing there, it is very curious that in a case about the priorities of payment of principle in an insolvency, Deutsche Bank's entire case now rests on what it says would have happened in relation to interest payments outside of an insolvency process. However, as we saw in Mr Katz's evidence, there is a strong air of unreality about this new case. It is based on the entirely false premise that the issue would ever arise and we saw in his evidence that 1, the annual interest payments dates of the three sets of ECAPS were

different, the PLC subdebt was paid monthly, there was no coincidence or alignment of due dates, there was never in fact a moment in time when this direct competition of interest rate payments would have arisen. Secondly, PLC's balance sheet. In the 41 months between the ECAPS and 15 September 2008 there were 12 infusions of equity of over 2.35 billion. Your Lordship saw the footings, they were about 2 billion. And we saw that the ECAPS coupon, which is paid annually, was about, collectively, 40 million euros. And, as your Lordship saw, not all paid in one go, three different lots.

So the notion that PLC would be unable, from a balance sheet solvency perspective, to pay the coupon on those PLC subnotes in full is quite frankly fanciful, and Mr Katz's refrain that these are perpetual securities, he was thinking far into the future, did not ring true at all.

So the argument is explained in 41 to 43 of Deutsche Bank's skeleton which is at B3/15 and basically what they argue is that to satisfy the solvency condition on the subnotes, PLC needed to pay its senior liabilities in full, which was all its liabilities, including subordinated liabilities and excluded liabilities, so that was the starting point, and if PLC could not satisfy the solvency test, no payments would

be made under the subnote and it wouldn't be possible to make distributions to the ECAPS holders and as a result it was -- and I'm quoting -- obvious that the PLC subdebt needed to be an excluded liability because otherwise PLC's ability to pay the subnotes would be competing with its very substantial liabilities on the subdebt. And this was not made out at all.

The evidence showed: 1, in reality the direct competition never occurred; 2, there were several alternatives that LBHI could and did consider, situations where there would have been a non-payment, for example it was described as administrative error, and Mr Katz accepted all of the following -- this is Day4/92:20-25 -- 1, it was open to LBHI to fund any shortfalls through an injection of equity; 2, it was open to LBHI to fund PLC on a subordinated basis; 3, it was open to LBHI, and indeed the correspondence shows that LBHI did consider this, to provide funding directly to the relevant partnership, in other words cut PLC out the loop, make sure the partnership is funded so it could meet the ECAPS.

As a result of Mr Katz's evidence that these alternatives were possible and indeed were considered, which is evident from the contemporaneous documentation, your Lordship does not need to give any weight to

Mr Katz's evidence in Katz 2, paragraphs 9 to 23, when he was at great pains to explain that any funding from LBHI UK to PLC would result in a further breach of the insolvency condition. Your Lordship will recollect that the thesis was if LBHI UK had advanced the money, or if the money had been advanced, that would have been a debt, it would have counted to the insolvency condition and then they couldn't have paid.

So as a result of this Deutsche Bank's entire case at paragraphs 40 to 43, 59 to 63 in relation to the problem of competing interest payments and the potential hazards of breaching the solvency condition through the provision of liquidity to PLC cannot proceed.

The only other point that Deutsche Bank appear to be making is that the PLC subdebt had to be an excluded liability for PLC to be able to satisfy the solvency condition under the PLC subnotes and pay its subordinated liabilities, ie the PLC subnotes. And they rely on this to reinforce their conclusion that the PLC subdebt was junior or excluded and that's at 43 and 65, and this argument makes no sense whatsoever. This is because, first of all, the PLC subdebt does not have to be excluded liabilities for PLC to be able to satisfy the solvency condition. It would also be the case if the PLC subdebt was subordinated liabilities because

then it doesn't count towards the solvency condition. And of course your Lordship knows our case is that it was subordinated liabilities and it is not our case that the subdebt was a senior liability. The subdebt could be a subordinated liability for the purposes of the subnotes and the solvency condition would still be satisfied.

We note in passing that Deutsche Bank rely on two tables, and it is at pages 21 and 22 of their skeleton in their submissions, to explain this quandary and we can see pages 21 ... does your Lordship see the --

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: I like a good table. Actually the tables are a little bit further on. It is 23 and 24. I gave you a bad reference there, I do apologise.

In both of these tables they appear to treat the PLC subdebt as a senior liability and if PLC can only pay PLC's subnotes, then the subdebts must be senior. I'm not sure that was a very good way of putting it.

Does your Lordship see that the liabilities are treated as senior? And what they don't do is they don't deal with it on the basis that it might be subordinated or excluded, which is the point.

(Pause).

The final point is that Deutsche Bank seek to extend

the dividend stopper argument, which your Lordship sees is hopeless at PLC level, they try and extend it into LBHI 2 level and at PLC, as your Lordship has seen, there is simply no evidence that the argument may come into play at all. Mr Katz confirmed the evidence given by Ms Dolby that he played no part in the 2007 instruction and there is simply no evidence before the court that you can extend this into LBHI2.

Now, my Lord, I said 11.30. I have in fact got to the LBHI2 ranking part 1, so if that would be convenient for the shorthand writers ...

MR JUSTICE MARCUS SMITH: Yes, of course. We will rise for five minutes.

MR PHILLIPS: Thank you.

(11.20 am)

(Short Break)

(11.30 am)

MR PHILLIPS: My Lord, can we return to page 24 of my learned friend's skeleton. I think I had demonstrated why you should never let Phillips loose on any sort of schedule or table.

It was actually a very simple point. My Lord, these balance sheets are supposed to show the solvency test and the point is on the left-hand side, which is before the advance, they include the subdebt principle in the

solvency debt and of course it wouldn't be, and then on the right-hand side what they do is they increase that by 1,000, or it is a million, and they include that subdebt principle as a liability as well and of course, as your Lordship knows, neither count as liabilities.

So it is a completely false analysis. It is a surprisingly simple point, my Lord.

MR JUSTICE MARCUS SMITH: Why aren't they liabilities?

MR PHILLIPS: Under the solvency test, because it excludes subordinated liabilities.

So it is a surprisingly simple proposition. What they do is they increase something that doesn't count towards a test anyway.

My Lord, that takes me to part 1, which is pre-amendment. We're in LBHI2. And your Lordship has our written submissions at 262 to 357 and we are addressing PLC's argument in as much as we can at this stage and we say that because despite taking various potshots at our analysis in this his opening, Mr Beltrami told us very little about his own construction case and it may well be -- and this is not an invitation -- that there will be a host of new arguments which we will have to address at some stage, but let's wait and see.

Before turning to the legal framework and to our

argument, your Lordship should be mindful of three recent developments in PLC's case. The first two are these.

First, it is now accepted by PLC that the LBHI2 subdebts rank pari passu inter se. Like us, PLC have posited an implied term to square the circle and that is their skeleton at paragraph 66, which is at B2/18.

Second, it is now accepted that the LBHI2 subdebts permitted a potential category of subordinated senior debt and this was accepted in opening for the first time. In view of this common ground, we cannot see how, as a matter of substance, PLC can argue that there is a difference in the subordination categories envisaged under the notes as compared with the debts. My Lord, they are plainly the same.

The linguistic differences that PLC relies on so heavily in its position paper and skeleton are severely undermined by those two points, which perhaps explains the third recent development in PLC's case. The solvency condition argument is now front and centre. Indeed, my learned friend Mr Beltrami said that one should look at that before the referential senior creditors wording, which was the core point in both his position paper, and that was at paragraphs 40 to 45, and his skeleton argument, at paragraphs 73 to 80. His

argument on the solvency condition is plainly wrong as a matter of construction, but it is telling that PLC have felt the need to rely on an argument that was in fact first raised by Deutsche Bank in its position paper and which only featured as a brief aside in paragraph 80 of PLC's own skeleton argument.

Turning to the legal framework. On contract law, save for differences on the extent of the factual matrix, and Mr Beltrami's emphasis on a textual construction, there is actually not a great deal of difference between the parties. There does appear to be a difference of approach on the law of subordination and how it operates in this context and we want to deal with that first.

My learned friend Mr Beltrami made three points in opening on the law of subordination and we say, with the greatest of respect, that he was incorrect on all three points.

First, he reiterated his reliance on Lord Justice Lewison's analysis on how subordinatation works, as set out in the Court of Appeal in Waterfall I, which he takes as his starting point for the significance of the solvency condition.

Given the amount of emphasis Mr Beltrami now seeks to put on the solvency condition, we will take

your Lordship -- we have to take your Lordship through this area of the law, so can I ask you, my Lord, to pick up authorities bundle 5 at divider 123, and, my Lord, this is the report of Mr Justice David Richards' decision in Waterfall I at first instance. And as your Lordship knows, the issue concerned the relative rankings of three tranches of form 10 debt, statutory interest and non-proveable liabilities. Those were the issues in the case and I would like to take your Lordship to paragraph 69, if I may, which is on page 29 of the report.

In this section Mr Justice David Richards discusses the issues on subordinated debt agreements and what he says in paragraph 69 is that:

"The answer to this point lies in my judgment, as Mr Trower for the administrators of LBIE submits, in the provisions of clause 70E. I have earlier quoted equated these provisions. The expression 'the debts proved' means all of those debts admitted to proof by the administrator, because it is only those debts which will be paid out of the available assets. In my judgment, the logic of a proof in respect of the subordinated loan debts, coupled with an attempt to require the administrator to admit the proof would be both an attempt to obtain repayment of subordinated

liabilities otherwise than than in accordance with the terms of the agreement within the meaning of 7D and the taking of action whereby the subordination of those liabilities to the senior liabilities might be impaired or adversely affected within the meaning of 7E."

Now, if I can ask your Lordship to pick up authorities bundle 8, tab 180 and I just want to show you as the starting point -- this is the order that was made by Mr Justice David Richards and it is (i) and what he declared in (i) is:

"The claims of LBHI2 under its subordinated loan agreements with LBIE are subordinated to proveable debts, statutory interest and non-proveable liabilities, all of which, other than the claims of LBHI2 under its subordinated loan agreements and the statutory interest thereon, if any, must ..."

So your Lordship sees what he carves out as it were:

"... must be paid in full before (a) LBHI2 is entitled to prove and require the LBIE administrators to admit such proof in respect of its claims under its subordinated loan agreements with LBIE and (b) such claims are available for insolvency set-off resulting from the giving of notice."

I don't need to trouble you with the set-off provision but your Lordship sees that what

Mr Justice David Richards declared is that the senior liabilities had to be paid before LBHI2 could prove, in the LBIE insolvency, and of course it won't be lost on your Lordship this is on FSA Standard Form 10, so it is obviously helpful from that point of view.

That, my Lord, followed Mr Justice Vinelott's decision in MCC and let me just explain what I mean about that. If you could take up authorities 2 and it is divider 42, and I think I have said to your Lordship that MCC was something of a watershed because until the MCC decision there was a real debate about whether or not in light of the pari passu rule and in light of British Eagle it was possible contractually to subordinate debt and it was one of the reasons why there were other mechanisms which were being used.

Now, MCC is in divider 42 and I first want to show your Lordship the subordination provision which is at 1405 at letter H.

Just to explain to your Lordship, the question in MCC was whether the holders of subordinated debt could be excluded from a scheme of arrangement and the broad nub is if someone has no economic interest, you can exclude them. So that was the question, if the subordination provision was effective they would be excluded and if not, then they could not be excluded.

So the subordination provision is at H and it is under the guarantee:

"MCC undertook to pay on first demand. In summary ..."

And so on:

"... provided that the guarantee of payment of the nominal value or in the case of event of default only the paid up value on interest with regard to the bonds and to the paid up value of the preference shares under this guarantee constitutes an unsecured and subordinated obligation of the guarantor."

Now, just pausing there, your Lordship can see the language is used because it then goes on to say in that:

"... in any case of any distribution of assets by the guarantor ..."

And you can skip down past the language of:

"... whether in cash or otherwise in liquidation or bankruptcy of the guarantor during a period in which suspension of payment is granted by the guarantor or in case the guarantor negotiates with all its creditors with a view to general settlement."

So skip down to there, so it is:

"In any case in any distribution of assets by the guarantor creditors of unsubordinated indebtedness of the guarantor shall be entitled to be paid in full

before any payment shall be made on account of payments under the bonds or the preference shares, but the payments to bonders and coupon holders and preference shareholders shall be made before any payment shall be made in such cases to the holder of any class of stock in the guarantor."

Now, I should just explain, my Lord, one of the reasons why this was a contractual subordination provision, one of the reasons why it was so important was there was no trust law in Switzerland and in a previous decision of British and Commonwealth when we dealt with the scheme, trust law was available so the question whether or not a contractual right to subordinate was effective just didn't arise.

Now, Mr Justice Vinelott considered all of the authorities on the pari passu principle and I'm not going to take you through the debate, but I want to go forward to page 1411G which is page 1411, and picking up at G, and I just want to pick up at the question:

"The question is whether this underlying consideration of public policy should similarly invalidate an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to the claims of other unsecured creditors and preclude the waiver or subordination of the creditor's claim after

the commencement of the bankruptcy or winding up."

So your Lordship sees he goes through all the cases, he says "Does this rule of public policy mean that you cannot enter into a contract to subordinate?"

"I do not think that it does. It seems to me to be plain that after the commencement of a bankruptcy or winding up a creditor must be entitled to waive his debt, just as he is entitled to decline to submit a proof."

And that was critical reasoning, absolutely critical reasoning in Mr Justice Vinelott's judgment:

"There might in any given case be a question whether a waiver was binding on him, but that is irrelevant for this purpose. If the creditor can waive his right altogether I can see no reason why he should not waive his right to prove save to the extent of any assets remaining after the debts of other unsecured creditors have been paid in full, or if he is a preferential creditor to agree that his debt will rank equally with the unsecured non-preferential debts. So also the earlier a creditor can waive his right to prove or agree the postponement of his debt after the commencement of the bankruptcy or winding up, I can see no reason why he should not agree with the debtor that his debt will not be payable, or will be postponed or subordinated in the

event of a bankruptcy or winding up. The reason for giving effect to an agreement in these terms seems to me to be, if anything, stronger than that for allowing the creditor to waive or postpone or subordinate his debt after the commencement of the bankruptcy or winding up for other creditors might have given credit on the assumption that the agreement would be binding."

That was the decision in MCC and it is 1993 and that was a real watershed.

So if I can then go back to bundle A5. What your Lordship can see there is the reasoning of Mr Justice David Richards was absolutely in line with that reasoning so I want to go back in bundle 5 to 129, which is the Court of Appeal and I want to pick it up at paragraph 38, where Lord Justice Lewison says:

"There are a number of different ways in which subordination agreements can be drawn. Three are relevant for present purposes. The first is an agreement that if the subordinated creditor receives any payment in part satisfaction of its subordinated debt it will hold the receipt on trust for senior creditors. This form of agreement ..."

So that's the trust mechanism and that's what was used, for example, in British and Commonwealth.

"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 arises under clause 4 subject to clause 5."

Now, the second category is that the debt that the contract, as properly construed, makes the debt a contingent debt. Contingent is the operative word and as your Lordship is aware, that is a term of art in an insolvency. So he then looks at clause 5, he says:

"Clause 5 imposes conditions on the right to repayment. If no insolvency process has begun, then the condition in clause 5.1(a) must be satisfied. Whether or not an insolvency process has begun, the condition in 5.1(b) must also be satisfied. In my judgment clause 5.1 means that the right to repayment of the subordinated debt is a contingent right, contingent on the satisfaction of 5.1(b) and if appropriate, 5.1(a) as well."

What Lord Justice Lewison was holding was that the solvency condition made payment of the debt contingent on satisfying the solvency condition and he is looking at our forms. And then he goes on to say this:

"The third method of subordinating loans of which the clause in SSSL Realisations is an example, contains a contractual provision precluding the subordinated

creditor from proving in the insolvency of the debtor until all other creditors have been paid."

And he goes on to say that it was described by Professor Goode as:

"... the most controversial formulation of subordination agreement, although a clause of this kind has been held not to infringe the pari passu principle and hence is legally valid."

My Lord, just by way of comment, it is absolutely right that the academic commentary at the time was that pure contractual subordination was the most controversial because the question remained as to whether or not it satisfied the pari passu principle. Now, we can have a debate about whether or not Professor Goode was slightly behind the times on that, but that was why it was described as controversial.

So if I can then go to paragraph 62 and 63, because what Lord Justice Lewison held was that the subordinated debt was contingent debt and should be valued and, my Lord, just so your Lordship knows how this works, if you've got a contingent debt, you prove and then the administrator or liquidator puts a value on that debt, so he estimates how much that debt might receive in due course. So what he says in 62:

"I conclude therefore that the subordinated debt is

repayable on contingencies ..."

That is his finding:

"... that include (a) payment of statutory interest, and (b) payment of any non-proveable liabilities. Any valuation of the contingent debt must take account of both contingencies. In that way the lodging of a proof will not adversely affect the subordination. For these reasons I have dismissed the appeal against paragraph A of the judge's order."

Now, he dismissed part, but not the timing part.

Does your Lordship have a bundle called "Supplemental authorities bundle"? Do you have this? No. Right, sorry, can I just hand this up. I realised yesterday afternoon that you don't actually have the Court of Appeal order in the bundles, so it is just that.

MR JUSTICE MARCUS SMITH: Thank you. (Handed).

MR PHILLIPS: And it is in divider 10. Because I think that to understand exactly what was going on, my Lord, you need to see the order.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: And it is the declaration -- does your Lordship see number 2 of the Court of Appeal's order?

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: "Declaration 1 of the order ..."

That's the declaration we looked at, my Lord:

"... is varied to declare that the claims of LBHI2 under its subordinated loan agreements to LBIE are proveable in the administration or liquidation but are subordinated to proveable debt, statutory interest and non-proveable liabilities and are repayable only on contingencies including payment of all claims."

So your Lordship sees a material difference between the order made by Mr Justice David Richards and the order made by the Court of Appeal and the differences are the Court of Appeal said you can prove as a contingent creditor and Mr Justice David Richards held that you cannot prove until the senior creditors have been paid.

MR JUSTICE MARCUS SMITH: Yes, I see. So what Mr Justice David Richards had was that there were two-stages of proof.

MR PHILLIPS: Yes.

MR JUSTICE MARCUS SMITH: Whereas Lord Justice Lewison's -- or the Court of Appeal's order envisages one stage of proving but subject to the contingencies articulated in paragraph 2.

MR PHILLIPS: Absolutely, my Lord, and of course once the proof goes in, you put a value on the claim subject to

those contingencies; that's how the system works.

So if I can then take you to authorities bundle 6 and I want to go to divider 146 because I want to go to the Supreme Court's judgment and I want to go, if I may, to paragraph 68 of Lord Neuberger's judgment. My Lord, Lord Neuberger says:

"The LBIE administrators contend that it would not be open to LBHI2 to lodge a proof in LBIE's administration for the subordinated debt until all senior creditors have been paid in full.

David Richards MJ accepted that contention on the ground that clause 7D and/or E had the effect of precluding the right of lodging proof. The Court of Appeal disagreed and considered that LBHI2 could prove the subordinated debt at any time. However, they said that until the senior liabilities had been paid in full the subordinated debt would be a contingent debt and because of the terms of the loan the correct value to subscribe to such a proof before the senior liabilities have been paid in full would be nil as nothing could be paid on the proof. If and when the senior liabilities were met in full the Court of Appeal said that the proof in respect of the subordinated debt would be revalued."

So your Lordship sees that Lord Neuberger is addressing that difference between the two judgments:

"In my judgment David Richards MJ's view on this point is to be preferred. The Court of Appeal's view appears to me to raise a logical problem. If at the time such a proof was lodged, there was a chance that the senior liabilities would be paid in full, then as with any other debt which rests on a contingency that may occur, the valuation of that proof would not be nil, it would have to be a figure which discounted the sum due in order to allow for the contingency not occurring."

So that's the valuation point, my Lord:

"However, if the proof is ascribed a valuation greater than nil, it would have to be paid out on any distribution made prior to the satisfaction in full of any proved claims."

Unless there was one payment of 100%. So your Lordship sees the point: the senior creditors prove, the contingent creditor proves, a value is put on that and then distributions are made. Well, they might be 30 pence in the pound and it goes to everybody:

"As David Richards MJ said, that would appear to fall foul of clause 7. Further, any dividend would be paid out before any statutory interest and non-proveable liabilities had been paid, which would be inconsistent with the conclusions I have just expressed. It

1 therefore follows that in my view it would not be open
2 to LBHI2 to lodge a proof in respect of the subordinated
3 debt until the non-proveable liabilities have been paid
4 in full, or at least until that is clear after meeting
5 that proof in full and paying statutory interest due on
6 it. The non-proveable liabilities would be met in
7 full ... as soon as that happened there would, subject
8 to what I say in the next paragraph, be nothing to stop
9 LBHI2 lodging a late proof."
10 Then 72:
11 "Accordingly I would restore paragraph 1 of the
12 order made by David Richards MJ because although I agree
13 with the Court of Appeal that he was right as to ranking
14 of the subordinated debt, I disagree with the
15 Court of Appeal and agree with the judge as to when the
16 subordinated creditors can prove for the subordinated
17 debt."
18 So, my Lord, this, per the Supreme Court, is not
19 a category 2 case. This is a straightforward
20 contractual subordination case, it is not a contingent
21 debt case and so, with respect to my learned friend
22 Mr Beltrami, we suggest it is wrong to suggest that
23 Lord Justice Lewison's analysis that the mechanism that
24 gives effect to the subordinated debt is a contingent
25 claim mechanism. That did not survive the

Supreme Court.

The mechanism is that creditors have agreed to defer their proofs. What my learned friend Mr Beltrami is trying to do is to move as far away as he can from the statutory scheme and to submit to your Lordship "It's all in the contract nothing can be paid until ...", that's the contingent debt analysis; it's wrong.

And, my Lord, your Lordship will have picked up from Lord Neuberger in paragraph 70 that he described there is nothing to stop lodging of a late proof, because Lord Neuberger absolutely understood that is what would happen.

That ties in to the second point my learned friend Mr Beltrami made. He said 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 and he said that at Day1/114:11-16.

So my learned friend Mr Beltrami's suggestion is that once you are subordinated, that's it, and the pari passu rule is gone, and that is not right. You are never disapplying the pari passu rule under rule 14.12, you are simply disapplying or deferring your contractual right to prove. And, my Lord, that was the nub of the problem that Lord Neuberger identified in Waterfall I

and your Lordship I think has the point that once you allow someone to prove, you then have to value and then distributions will be made and it is why Lord Justice Lewison's analysis does not work.

The correct analysis is that the subordinating creditor is deferring his right to prove until after the senior creditors, such that the proved debt does not have to be paid pari passu in competition with the senior creditors.

And it is not insignificant that that debate, that difference about how this mechanism works, was a debate about these forms. It's a debate about how these forms work that has taken place all the way up to the Supreme Court. It's not insignificant.

My Lord, I'm just going to give you a couple of references for your Lordship's note about rules. First of all, rule 14.30, which is the rule that provides that where an administrator is going to declare a dividend he has to give notice of that which of course specifies the date for proof, so it's an ongoing process, and rule 14.40, which is important in this context because a creditor is not entitled to disturb payment of a dividend because he did not prove before the declaration of the dividend.

What happens is dividends that have been paid, have

been paid, they cannot be disturbed and it may be you can get a catch-up dividend later. So the mechanism that the Supreme Court envisaged and indeed that Mr Justice David Richards envisaged is that what happened is that administrators will declare intention to declare a dividend, the seniors can prove at that point, they continue to prove and receive dividends until they are paid 100% and then you get to the point where if there is further money, that the administrators can declare they're going to make another payment and the subordinated creditors will then prove and receive dividends.

And of course your Lordship knows the answer to the question, but what happens at any stage during the proving process when there is not enough money to pay 100%? They abate pari passu -- they abate, equally they rank pari passu and that can be at the point of seniors proving but it can also critically be at the point when subordinated are proving and the significance of that underlying concept is what is behind cases like Golden Key and the Lehman's Client Money because everybody knows that the backdrop of all of these contracts, all of these provisions, is that whenever you prove you will abate equally with anyone else who can prove at the same point: you will rank pari passu.

Of course from a statutory perspective that's the situation we're in. Two interim distributions were made to LBHI2 to unsubordinated creditors satisfying their principle claims and statutory interest claims in full and that's in the progress report at F, volume 10, 5735. So the subordinated creditors are not entitled to disturb previous distributions and if there are to be further distributions, they will prove and they will abate equally.

The third point Mr Beltrami made was a more general criticism of our case. He said that the answer must be in the contract and you do not give up on the contract and say "Hang on a minute, let's have pari passu", and he said that on Day1/122:5-12. That is really not what we are saying. The contracts provide for disjunctive pari passu categories which are not senior liabilities. The first consists of subordinated debts which express themselves to be pari passu, so if A states in terms it ranks pari passu with B and B says in terms it ranks pari passu with A, they express themselves to rank pari passu and they rank pari passu because they will prove at the same time.

The second category is subordinated debts that do rank pari passu and your Lordship will appreciate that on the language of these contracts, these two categories

appear, either expressed to rank pari passu or rank pari passu. This is where my learned friend Mr Beltrami gets into some difficulty because your Lordship may have picked up that PLC's position paper omitted that category altogether from the descriptions table and that was a key point that we relied on in our reply position paper, paragraphs 8 to 10, which is A10/178, and we have still not heard from PLC what they say those words mean.

The category is important because it is common ground that it is engaged on the LBHI2 ranking issue. The form 10 debts are all silent as to how they rank. They do not express themselves to rank pari passu with anything else. But PLC now concedes they do rank pari passu. What the mechanism is, we have discussed. They concede that they do rank pari passu, so they rank pari passu. So one has to ask, well, how and why do those debts rank pari passu? How and why do they carry a pari passu ranking inter se on PLC's case? Is it because Mr Beltrami says that it is just because the words used are identical? Well, that can't be right. It cannot be that their case on the meaning of this category is that to fall within it you have to use exactly the same words. We say the answer is the "rank pari passu" words envisage a situation where exactly the same categories of senior liabilities sit above the

subordinated debts in question and the rest of it all follows from the statutory scheme and we're not saying you go to the statutory scheme because you're filling a hole, we say that's the context for all of this, that is the context in which subordinated debt operates.

So whether or not identical words are used is irrelevant. The key, as we will turn to later on, is a question of substance. It is concerned with categories of debts identified as ranking above me, or above the creditor and the contracts and if the categories are the same as those of another debt, they will be pari passu. The ranks pari passu category -- this is important -- it is likely to be engaged in the context of complex capital structures with lots of subordinated debts issued at different times which do not necessarily refer to each other in express terms in any way. And it is particularly when they are on the same form. There is no express reference in the standard form of LT2, T3 debt that it ranks pari passu with another, but it is plain to the reasonable reader, standing back, that these dated regulatory debts rank at the same point in the waterfall, the market practice which your Lordship has heard about, the general understanding and there is no contrary indication.

So we say that these contracts recognise the

environment in which they operate. Far from SLP3 running out of contract, what we have sought to do is explain a specific definitional category in the instruments, ie the concept of what it means for two debts to rank pari passu.

Can I then move on to contract law and make three short points. First, if we could pick up volume 6 of the authorities, but this will be quick, tab 132, which is Wood v Capita and it is just two points to pick up on paragraph 13. Your Lordship sees this is in the judgment of Lord Hodge. He starts with:

"Textualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation."

And that's an important point. But if I can then move down to letter D, where he says:

"Negotiators of complex formal contracts may often not achieve logical and coherent text because of for example the conflicting aims of parties, failures of communication, different drafting practices, deadlines, which require the parties to compromise in order to reach agreement. There may often therefore be provisions in a detailed, professionally drawn contract which lack clarity and the lawyer or judge in interpreting such provisions may be particularly helped

by considering the factual matrix and purpose of similar provisions in contracts of a similar type."

And so they talk about purpose of similar provisions, contract of similar type, and of course your Lordship sees we've got standard forms, it is subordinated debt, it operates within the insolvency regime. And that is the context and there's a reference going on to Sigma and the iterative process.

The second point relates to commercial consequences. My learned friend Mr Beltrami said "Commercial common sense is not a very influential factor", Day1/126:9. He said something about it being too long, too difficult and we say the evidence before your Lordship is very clear on what the 2007 restructuring was supposed to achieve and if we can just look quickly at Sigma, which is in authorities 4, at tab 90, and I just wanted to look at paragraph 12 which is on 582.

My Lord, would your Lordship just cast your eye over it. I really want to pick it up just above E:

"Lord Neuberger was right to observe that the resolution of an issue of interpretation in a case like the present is an iterative process involving checking each of the rival meanings against the other provisions of the document and investigating its commercial consequences."

So it isn't that the text completely excludes the matrix, or that the matrix will permit the court to ignore the text; it is an iterative process in which you look at the text, you test it in the context of its matrix and the weight that you put on to each is a matter of judgment, but this is a case in which the commercial consequences need to be looked at, the commercial context needs to be looked at, because PLC's case yields the result that two dated regulatory subordinated debts would be subordinated to each other in the absence of any regulatory, commercial or any other reason and it takes no account of the context, either of the regulatory context by which this regulatory subdebt is created in order to support the more senior debt, nor does it take any account of the context in an insolvency which is that where you get two debts ranking at the same point, they rank pari passu."

And in those subnotes you've got the language "Ranks pari passu".

Your Lordship has the point.

Your Lordship heard Ms Dolby's evidence on the 2007 restructuring. You will recall her congratulatory email -- F, volume 4, 227A -- where she is referring to the ongoing benefit. In her evidence she accepted the purpose of the transaction was to create an efficient

tax funding structure and that's Day3/65:1-12 and Day3/72-75 and we say this is clear: it is significant and it is plain that that was the purpose of all of this; it was not to alter what would otherwise be the ranking.

The third point is the factual matrix which I'm going to take quite shortly because you have had various types of factual matrix. My learned friend Ms Tolaney has the dividend stopper, Mr Katz's recollections of priority and so on. Mr Beltrami has the ECAPS guarantee to construe the subnotes. We've got the standard forms and the regulatory context, although we do say that's not simply factual matrix, it's actually the regulatory requirements flowing from the EU directives. But where we differ from Mr Beltrami in principle is on his approach to tradeable instruments.

So if we understand his submission in opening he was saying if the instrument is theoretically tradeable, that's the end of the matter and this can be a very narrow factual matrix only because anyone can come along and theoretically acquire an interest. We say the law on this point is not quite so mechanical as to say "tradeable/not tradeable equals no matrix on the one hand but matrix on the other" and we address this at 136 to 139 of our skeleton, but just if we could pick up

volume 4 again, I just wanted to look at the LB refinancing number 3, which is at tab 98, just to make this point.

My Lord, if you look at paragraph 1 you will see that it's a Lehmans case. It concerned a securitisation trust deed which issued various notes.

MR JUSTICE MARCUS SMITH: Sorry, you said tab 98?

MR PHILLIPS: I'm so sorry, tab 98, divider 98.

MR JUSTICE MARCUS SMITH: Yes thank you.

MR PHILLIPS: Does your Lordship have a decision of Mr Justice Briggs and it is --

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: And I was just looking at paragraph 1 and going to move quickly on to paragraph 6 where:

"LB3 was the initial purchaser of the notes issued by Excalibur ...(Reading to the words)... took possession of the notes."

So what you've got is you've got notes acquired initially by Lehman entities and then LBB pledges it as security to DBB which is an external entity, which is the Deutsche Bundesbank, and then in paragraph 9 Mr Justice Briggs identifies objectively the purpose of the transaction, that:

"It is not an exercise in identifying the subjective intention of the party, it is the objective purpose of

the transaction, which included a pledge to an external party."

So he says this in 9:

"Viewed in the round therefore the Excalibur securitisation was a structure devised and put into place initially entirely within the Lehman Group, save for the inclusion of ... for the purpose of enabling the group to use the class A notes as security for its euro borrowing. The first arm's length transaction in relation to the securitisation occurred on the pledge of the bulk of the class A notes by LBB to DBB as I have described."

And then if we can flick forward to paragraph 42, which is on page 9 of the report and I just want to pick up four lines down:

"Although devised and initially put in place internally within the Lehmans Group its function is to constitute and define the term of the notes. Class A notes in particular were intended to be used by way of sale or, more likely, security for borrowing such that the relevant audience for the present purpose must be taken to include entities considering buying or lending upon the security of the class A notes."

So pausing there, Mr Justice Briggs didn't ask himself the question "Is this tradeable? If it is

tradeable, that's the end of the question, I've got to look at this particular audience", he actually looked at the question whether or not it was or would be tradeable and he goes on in 43 to say:

"Identification of the relevant audience is important because it serves to identify the range of background facts relevant to interpretation. Although the principle is that the matrix of fact includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man, it is subject to the controlling requirement that it should have been reasonably available to the parties and to the exclusion of an examination of the parties' previous negotiations."

So Mr Justice Briggs is looking at what was intended. He is not looking at subjective intention, but he is looking at the purpose of the issuance and he identifies who it might go to as a matter of reality. Not the possibility because it is a tradeable instrument, or that security might be taken on it; it has to be more than that, you have to identify the audience. And my learned friend Mr Beltrami's case is much more rigid. For him the word "identification" there just would not play any part, it would be surplus

to requirements. He would simply say these are potentially, theoretically tradeable because they were quoted on the CISX, and that's it, full stop, you must therefore look at anyone who might be able to buy these through the CISX, as opposed to the correct answer which is this was only put on the CISX for tax purposes and the real audience are the individuals internally at Lehmans.

So in our submission you need to identify the relevant audience. We say it was an internal transaction for the benefit of the Lehman Group. There's a reference to Ms Dolby's evidence at Day3/81:10-16 and of course if we were wrong on that and tradeability means that you don't just look at the Lehmans individuals, well, we say the audience is a sophisticated institutional investor.

Can I then move on to the symmetry argument. We set out the symmetry argument in our skeleton for the LBHI2 ranking issue at paragraphs 324 to 331. And if I could just ask, my Lord, if you could turn up our skeleton argument because I just want to go to appendix B, which I think has the privilege of being in a separate tab in bundle B. It is in tab 7. Now, what our comparative table does, in relation to both ranking issues, is it sets out a comparative table of the different language

used in the subdebt and the subnotes and when, my Lord, you look at the language across the various pieces, you see a symmetry between the various different notes and debts.

The argument really proceeds as follows. First of all, the subordination categories envisaged by the notes and debts are entirely symmetrical and what we mean by that is that you look in substance at where the debts put themselves in the waterfall. So you start off by considering who the senior creditors are not, so if we're looking at the LBHI2 ranking issue on page 3, the senior liabilities means:

"... all liabilities except the subordinated liabilities and the excluded liabilities."

And on the notes pre-amendment it means:

"Creditors ... are the unsubordinated creditors of the issuer ..."

Which of course were included in subordinated liabilities:

"... or (ii), who are subordinated of the issuer, other than the claims of noteholders that are expressed to rank pari passu and those whose claims rank or are expressed to rank pari passu with or junior to ..."

And, my Lord, just to explain why pari passu expressed to rank comes up twice, the first time is

expressed to rank pari passu in the notes themselves and the second time will be rank or expressed to rank in the other contractual documents, so that's why you get that.

So it is common ground -- so first of all you consider who they are not. It is common ground for the purposes of both the debts and the notes that the excluded liabilities that are expressed to or do rank junior to them are not senior liabilities or senior creditors. So expressed to or do rank junior, the excludes, they are not senior.

Next, the senior creditors or liabilities do not include subordinated debts which rank or are expressed to rank pari passu with the LBHI2 subdebt and subnotes and we say that that follows from the concession we were discussing earlier in relation to PLC and we note that if it was otherwise, GP1's bottom-of-the-pile thesis would kick in and the LBHI2 subdebt really did go to the bottom of the pile.

Second, you have to look at what the senior creditors are. So we've got rid of what they aren't and now we're looking at what they are. It is common ground that for the purposes of both the LBHI2 subdebt and the subnotes, the unsubordinated creditors, the statutory interest and the non-proveable liabilities are senior liabilities and senior creditors and of course we've got

the Supreme Court as well which tells us that that is right. As regulatory capital, the LBHI2 subdebt and subnotes are -- after all, they are serving the primary purpose of supporting non-regulatory debt, so that's not at all surprising and it is part of the reasoning in Waterfall I.

We also found out in PLC's opening that it was conceded for the first time that the LBHI subdebts are also potentially subordinated to other subordinated debts. Mr Beltrami said:

"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."

That was Day1/120:3-8. And he is right about that because not all senior debt is going to be unsubordinated in the loose sense. Just because something is subordinated, it doesn't make it regulatory subordinated, regulatory capital.

The existence of the possible subordinated senior debt category under the LBHI2 subdebts is plain, given the breadth of the definition of the senior liabilities and the definition "all liabilities except", so it says "all liabilities except".

So we say the reasonable reader looking at these

instruments would conclude that the notes and the debt are in exactly the same place in the waterfall and what we mean by that is that one cannot identify a category, either above or below, that is present in one but not the other and that's what we mean by symmetry. There is complete symmetry as to where each of them fall in the waterfall.

Therefore, when answering -- and that's what that table helpfully identifies. When answering the key question of which creditors the subordinated debts are entitled to prove after, the answer is the debt and the notes are entitled to prove after the same creditors and not after each other. And that is entirely in keeping with what the market would expect and with basic common sense.

Now, this analysis leaves PLC with a problem. Its case on part 1 as set out in its position paper, and its skeleton, focused on a difference of language which it described as -- and I'm quoting -- the "principal determinant of priority". However, it now accepts that there is no difference in substance because the LBHI2 subdebt also potentially permits what we refer to as subordinated senior debt and the notes merely spell out what the debt also permits, namely senior debt that might be subordinated. So they then have a circularity

problem and if I can just go to their position paper -- sorry, we can put our skeleton away -- which is in bundle A, page 106 and it is paragraph 43.

Your Lordship will see that PLC had argued that the "subordinated creditors other than" wording under the note was a qualified express statement of juniority, an expression of juniority to all subordinated debt save for carve-outs, which it of course misdescribed because your Lordship sees that what they said is that they were:

"... subordinated senior creditors who comprised (a) all subordinated creditors and (b) subordinated creditors save for those expressed to rank pari passu or junior."

Your Lordship sees that. They missed out ranks. But they have now accepted that the subdebts are also potentially subordinated to other subordinated debt, subject to carve-outs, and then you can run into another circularity problem.

So, my Lord, the pattern that your Lordship might detect across both ranking issues is an attempt to identify fundamental categorical distinctions from very small linguistic differences. That's really what's happening here and in our submission these attempts don't stack up. So in the PLC ranking issue, we had

been told that the extension of the definition of subordinated liabilities in the subdebts to expressed rank pari passu wording was a categorical point of distinction with the subdebts because the subdebts cannot rank pari passu with everything. Now, that's unsustainable as we know, but again in the LBHI2 ranking issue we were told that the express language "subordinated creditors other than", that wording under the notes was again a categorical point of distinction with the subdebts because the subdebts were not potentially subordinated to other subordinated debts and that now is unsustainable because of PLC's latest concession.

So against a backdrop of categorical symmetry, in other words symmetry amongst the categories, what is it that the reasonable reader would identify as having altered the pre-existing ranking of the LBHI subdebt and what Mr Miller has told us was the default market expectation in respect of dated regulatory subordinated debts, in other words a pari passu ranking? If PLC's only answer is just the "subordinated other than" wording then that is an absolute triumph of form over substance and particularly so given how broad the "other than" wording is. The "other than" exception is in many ways the dominant limb, so it is "other than" and then

it identifies a number of things.

An analogy would be a very broad exception -- take an exculpation clause. So you start off and you think "this exculpation clause is really all-encompassing" and then you read an equally broad carve-out for negligence, wilful default, so again the "other than" exception is very broad.

Mr Beltrami opened his case by saying that:

"The wording we would submit is where the real meat of it is found."

Day1/121:2-4. In our submission the real meat of it is in a categorical analysis: what categories does the instrument provide are above, in other words: after whom do I rank? And if there is symmetry between those categories, the reasonable reader necessarily cannot conclude that one is an excluded category vis-à-vis the other, nor that they are subordinated senior liabilities for each other's purposes. Rather the conclusion the reader would draw is that the LBHI2 subdebt and the LBHI subnotes are subordinated at the same level, consistently with the market expectation for dated subordinated debt.

We wait to see how PLC deal with this argument, given that they have not answered it in either their position paper, their skeleton or their opening.

Can I move on to the solvency condition argument. We thought it had been common ground with PLC that the key question was "After whom are you entitled to prove?", but in my learned friend's opening, a point that took on new prominence was what we will call the solvency condition argument. This tried to frame the question rather differently. The argument was in fact a hand-me-down, as your Lordship has seen from Deutsche Bank, which we addressed in our reply paper at 42.2, and in more detail in a section called "Deutsche Bank's further argument" at 345 to 347 of our skeleton.

PLC alluded to it only briefly in a single paragraph, single short paragraph of their skeleton, at paragraph 80. However, in his oral opening this alternative argument appears to have been upgraded to PLC's central argument on construction. Mr Beltrami said there was a referential aspect and a solvency aspect "and it may not matter very much but the solvency condition is probably the right starting point" and he then referred again to Lord Justice Lewison's analysis and that was Day1/116:23-25. We disagree.

Can we just remind your Lordship of condition 3, which is in bundle E, tab 4, at page 55. Clause 3, "Status and subordination". My learned friend

Mr Beltrami says that the solvency condition in 3(b) of the LBHI2 subnotes is "probably the right starting point", that's what he said. That is certainly an odd starting point given that it is preceded by 3(a). So let's look at 3(a). So it starts by saying:

"The notes constitute direct, unsecured and subordinated obligations of the issuer and the rights and claims of the noteholders against the issuer rank pari passu without preference amongst themselves."

So that just deals with the internal pari passu ranking:

"The rights of the noteholders against the issuer in respect of the notes are subordinated in right to payment to the senior creditors as defined below ..."

And then you see:

"... and accordingly ..."

Which is a key word:

"... payment of principal in respect of the notes is conditional upon the issue of being solvent at the time of and immediately after the payment."

Now, I just want to pause there and make three points. The first point is that the priority language, the language that tells you to whom you are subordinated, refers to the rights of the noteholders being subordinated in right of payment to the senior

creditors. They are defined below. It is telling you what you are subordinating and to whom, so you have subordinated the right of payment to the senior creditors.

In this case the noteholders' rights are subordinated to the senior creditors and your Lordship heard from Mr Grant the significance of the first part of condition 3(a).

The solvency condition then gives effect to this priority language, which your Lordship will recollect mirrors what we saw in MCC, so the solvency condition gives effect to the priority language and that is made plain by the use of the word "accordingly". And it is:

"... accordingly it is conditional upon being solvent before and after ..."

Now, it is only then that you can go to 3(b), because 3(b) says:

"For the purposes of 3(a) above, the issuer shall be solvent if (i) it is able to pay its debts as they fall due, and (ii) its assets exceed its liabilities (each as defined below), other than liabilities to persons who are not senior creditors."

The assets your Lordship sees defined there. It is the unconsolidated gross assets of the issuer and the liabilities is the:

"... unconsolidated gross liabilities of the issuer or as shown in the latest public audited accounts of the issuer but adjusted for contingencies and subsequent events in all such manner ..."

And so on.

The argument is simple. Mr Beltrami takes us to 3(b) first, without any context and apparently that is because of what Lord Justice Lewison said in Waterfall I, and he does that because the next step of his argument is to say that debts -- which was in (i) -- really means "all debts" and if it is drawn that broadly then it includes the LBHI2 subdebt as well. And he referred to section 123 of the Insolvency Act and he said that the debts must include other subordinated debts, so accordingly the LBHI2 subnotes rank after the LBHI2 subdebt because unless and until the subdebt is paid in full then no sums are payable under the subnotes.

So what he does is he says the right to payment under the subnotes is contingent on the subdebt being paid in full because of the reference to debt in (i). That's where he gets to. And in oral opening we were told that the effect of this is an express subordination in the notes because you are subordinated to all other debts because you cannot get a look in until you are

paid: Day1/119:3-6. That is wrong for the reasons we explain in our skeleton at 347 and the point is simple: the debts in 3(a) means the debts of the senior creditors and there are numerous reasons for this.

First, conditions 3(a) and 3(b) should be construed together. 3(a) identifies to whom the debtor has agreed to subordinate its rights. SLP3 has agreed only to subordinate its rights to the senior creditors "as defined below". SLP3 has not agreed to be subordinated to all debts, other than the senior creditors.

The subordination is to the senior creditors as defined. The subordination cannot be to both the senior creditors, subject to carve-outs, but also to all the creditors without exception, which is what my learned friend's construction would mean. The PLC construction ignores that key inconsistency at its heart and fails for that reason alone.

Second, the payment condition follows from the use of the word "accordingly" which makes it very clear that the solvency condition in 3(b) is merely a mechanism or means for implementing the subordination to the senior creditors. It's not doing something different, or introducing a new and further subordination provision.

Third, the first six words up to the comma of condition 3(b), "for the purposes of condition 3(a)

above", refer back to condition 3(a). They make it plain that the solvency condition that follows is intended to give effect to the subordination provision in 3(a).

Fourth, debts with a small d is undefined. It's not used elsewhere in the notes, but it can only mean senior creditors against the backdrop of condition 3(a).

Fifth, the words in parentheses "(other than its liabilities to persons who are not senior creditors)" at the end of the first sentence of 3(b) make it clear that 3(b) is dealing with liabilities other than to persons who are not senior creditors.

Sixth, this is consistent with the meaning of debts in 123(e) of the Insolvency Act, which means debts that are in fact due or due in the near future, which your Lordship would get from Cheney Finance. That's in the supplemental authorities bundle at tab 6, if your Lordship wanted to see it, but the point is that debts are debts which are in fact due or due in the near future and there's a very interesting debate about how near in the future it needs to be.

Going back to 3(b), seventh, this construction renders 3(b)(i), ie the cashflow, and condition 3(b)(ii), ie the balance sheet test, consistent so that neither takes into account liabilities or debts that are

not senior creditors, so that "able to pay its debts as it falls due", so you see which of the senior creditors debts are able to be paid and also you have a balance sheet test.

Otherwise, the two aspects of the solvency condition will be inconsistent. LBHI2 would need to show that it could pay all of its debts on the cashflow basis, including all senior and non-senior liabilities to be solvent under 3(b)(i), but it would only need to show that on the balance sheet test the issuer assets exceeded the non-senior liabilities to be solvent for 3(b)(ii). So you could satisfy 3(b)(ii), but then if you failed on 3(b)(i) in relation to debts that were not the senior liabilities, you wouldn't meet the test. So one has to have a unitary construction of this clause.

Eighth and by no means least, if "debts" includes both senior and non-senior liabilities then the solvency condition would be unworkable, not least because even if a debt was expressed to rank junior to the LBHI2 subnotes, it would need to be paid before the LBHI2 subnotes became available. That's extraordinary. On my learned friend's construction you could have something that is expressed to be junior in this agreement and yet it would have to be paid before the LBHI2 subnotes become payable and so it would alter the

identity of the debts to which the subnotes are functionally subordinated and we say that is a very powerful indicator that PLC's is the wrong construction and it makes the subordination scheme taken as a whole inconsistent and unworkable.

So stepping back and just reminding ourselves, PLC's construction amounts to an argument that the condition subordinates the subnotes to all debts, or all liabilities and the subnotes are not payable because this is a contingency until all debts are paid and PLC's premise of starting from the solvency condition and then working backwards to condition 3(a) to identify the senior creditors, which is effectively what they are doing, puts the cart before the horse. You start with 3(a) because the key question is the identity of the creditors the subordinated creditor is entitled to prove after, and then the solvency condition implements the subordination of the debt to the senior creditors.

And, my Lord, just stepping back again, subordinated debt only works if the debtor has agreed to subordinate itself to other debts. On this basis anyone could pile in and they would become senior to the subordinated creditor and so what this amounts to is an agreement that you will be subordinated to absolutely everyone and that's a very surprising result.

But then my learned friend's solution, his condition argument, is wholly dependent upon where he starts. It just depends where you start. He starts with the subnotes. But taking the same approach, but starting with the subdebt, you reach, by parity of reasoning, the similarly false conclusion that the subnotes are senior to the subdebt, which is why one has to be especially careful when construing two agreements alongside each other that are structured symmetrically because what can happen is you start going round and round in circles. And just to show your Lordship, if your Lordship goes to tab 1, and if we could go on to the subordination provision in 5, the starting point is that we have the same operative subordination language:

"The rights of the lender in respect of the subordinated liabilities are subordinated to the senior liabilities."

You have the same "accordingly" language:

"Accordingly payment of any amount of the subordinated liabilities is conditional upon ..."

And, as we have explained, this is the mechanism that implements the core subordination provision, it's the priority language.

However, Mr Beltrami would jump to 5.1(b):

"The borrower being solvent at the time of and

immediately after the payment by the borrower and accordingly no such amount that would otherwise fall due for payment shall be payable except to the extent that the borrower could make such payments and still be solvent."

And you would then look at 5.2 which provides that:

"For the purposes of 5.1(b), the borrower shall be solvent if he is able to pay its liabilities other than the subordinated liabilities in full, disregarding the excluded liabilities."

And also (a). So the liabilities, which your Lordship knows, means "liabilities payable or owing by the borrower", so on the face of the language it would include the liabilities under the subnotes, so the question then becomes whether or not the subnotes are carved out of the solvency test and that would happen, we are told, if either 1, the subnotes are subordinated liabilities, but on Mr Beltrami's case this is limited by the definition to the subdebt arising under this agreement so they cannot be subnotes; or they are not payable or capable of being established in the solvency of the borrowing -- I don't understand Mr Beltrami to be arguing subnotes fall within this exclusion -- which leaves the subnotes are excluded liabilities.

So we turn to the definition that requires the

subnotes to be expressed to be and do rank junior to the subdebt, to fall within that carve-out. So it requires an expression in the subnotes that they rank junior to the subdebt and there's no such expression and the reference to "debt" in the solvency condition is not an expression of juniority -- there is one impression of what they are junior to, which is the senior liabilities -- which means that the LBHI2 subnotes are not carved out of the solvency test in the LBHI2 subdebts and accordingly, following Mr Beltrami's reasoning, the LBHI2 subdebts rank after the LBHI2 subnotes because unless and until the LBHI2 subnotes are paid in full, no sums are due and payable under the LBHI2 subdebts.

The argument is as bad when the starting point is the solvency condition in the subdebt as it is when the starting point is the solvency condition in the subnotes.

It also confirms that the payment condition can only apply to the senior liabilities or the senior creditors, or the entire structure falls down.

These are the same circularity issues that prevail at every level of the analysis. For every assumption or inference there is a counter assumption or counter inference and it makes no sense to rely on one solvency

condition to the exclusion of the other, to make one instrument senior to the other. If anything, this is proof and reemphasises the default position described by Mr Miller and it is certainly not a clear indication of a contrary intention to deeply subordinate one set of lower tier 2/tier 3 debt, in other words the LBHI2 subnotes, to another, the LBHI2 subdebt, which is why they are pari passu.

My Lord, moving on to the linguistic argument, once the solvency condition is gone, PLC has to go back to the words and it appears to be reluctant to do so because the linguistic argument is simple. For the purposes of the LBHI2 subnotes, the LBHI2 subdebt are subordinated creditors and fall within the broad carve-out language of "other than those with claims expressed to rank and those with claims that rank pari passu". They rank pari passu.

For the purposes of the subdebt the LBHI2 subnotes fall within the extended definition of subordinated liabilities that we have discussed, the LBHI2 subdebt, which is extended by way of the implied term that we discussed.

Now, Mr Beltrami said in opening that SLP3 had not advanced a case in relation to this point of language. However, in PLC's position paper at 39, PLC had already

acknowledged that this was our case, when they said:

"Its case would seem to be that at the LBHI2 subnotes constitute subordinated liabilities within the definition of the LBHI2 subdebt agreements."

And SLP3 acknowledged in its reply paper, footnote 6, that to the extent it is necessary to imply a term, it would be the inclusion of the words "and all other liabilities of the issuer ranked or expressed to rank".

So the linguistic argument is really straightforward. It flows from the symmetry argument. One has got the symmetry argument, one's got the linguistic argument and given that the subordinated categories in the instrument are symmetrical, the reasonable reader would consider that they rank pari passu, ie the notes are subordinated liabilities under the debts, the debts fall into the other than category under the notes; there's nothing more to it.

Now, we address PLC's linguistic arguments in 339 to 344 of our skeleton. These are the different wording argument and the timing argument and we explain in our skeleton, 341-342, the different wording argument as put against us in the PLC position paper relied on two points: 1, the assertion that the LBHI2 subdebt could not rank pari passu with anything; and 2, the assertion

that the LBHI2 subdebt does not provide for subordinated senior debt. As we understand it, neither of those points can or are being pursued any more, which leaves PLC's suggestion that the words "subordinated other than" must, by reasonable inference, or natural inference, refer to the LBHI2 subdebt and they make that point in 81.3 and 81.4 of their skeleton.

Your Lordship will have picked up that this is, according to PLC's skeleton, the principal determinant which resolves the priority issue and the answer turns on the difference of wording between the two instruments. You see that in 73 and you see it in 81. It is oversimplistic and we submit it is wrong.

The reference to "subordinated other than" is not of necessity a reference to all existing subordinated debt. A couple of points. 1, the carve-out is broad, it is if anything the dominant limb of the provision and catches many other varieties of subordinated debt. 2, it is accepted that the subdebt also permits subordinated senior debt. 3, we have seen from other Lehman precedents, for example the one Mr Katz's team used for the draft term sheets of the PLC subnotes, that when the Lehman Group wished to refer to subordination to existing subordinated debt, that is the exact word that they used and your Lordship will recall the rights of

holders in respect of the subordinated notes are subordinated to the senior liabilities and the existing tier 2 and tier 3 subordinated debt of the issuer. That was F1/247. It was one of the term sheets I put to Mr Katz.

So we have seen that when the Lehman Group wanted to impose juniority on a subordinated instrument, it would use express wording of juniority and we see that in the PLC guarantee, "junior to all liabilities of the guarantor, including subordinated liabilities", is the language they use. That's in E10/176 which I'm going to come back to and the point is it says "junior" expressly.

So to use PLC's own words, PLC's linguistic analysis assumes the conclusion it seeks to prove.

My Lord, I can see it is 2 minutes to. I was about to move on to future proofing.

MR JUSTICE MARCUS SMITH: Well, that I think would be a convenient moment.

MR PHILLIPS: Yes, it would, my Lord.

MR JUSTICE MARCUS SMITH: We will resume at 2 o'clock, Mr Phillips.

MR PHILLIPS: Thank you very much.

(1.00 pm)

(The luncheon adjournment)

(2.00 pm)

MR JUSTICE MARCUS SMITH: Mr Phillips, before you begin, the gentleman to my right is Mr Robin Vos who has recently been appointed as one of our section 9.4 judges. He is sitting in to see how you do.

MR PHILLIPS: Well, I hope I get marks for technical merit and artistic impression.

Right, may I move on then to deal with what I might call evolving capital structures. It is clearly a feature of all of the instruments in this case that they set out potential categories and layers of subordinated debt which may be created in the future, even if they were not in existence at the time of the relevant instrument's creation. There would be multiple layers, some would be full, some would be empty because the relevant category was not activated at that moment in time, but of course it could be filled at a later time and your Lordship will remember that Mr Grant told your Lordship that there were potential categories that might have been filled in the future and that was Day 2/137.

Mr Grant's evidence referred to the inclusion of particular language and to be faithful, to quote, "Where these securities ranked on a capital structure of a bank as it may have evolved potentially in the future". That

was Day2/131:23-25.

The important point is that these instruments were drafted with a view to catering for a bank or firm's capital structure evolving over a potentially lengthy period of time, in the face of a changing commercial environment, as well as of course developing regulatory requirements, and we thought it would be helpful just to offer some examples to try and explain what sorts of debts this potential category might have been catering for.

First, there's what we would call non-regulatory subordinated debt and we saw an example of that in the Maxwell decision. That was not regulatory, but it was subordinated debt and so you might have subordinated debt that is not part of an institution's regulatory capital.

Second, we referred in our skeleton to the possibility of other forms of regulatory subordinated debt which might qualify and one such example was a non-preferred senior debt that now must rank ahead of regulatory capital, if I can call it that, and in paragraph 108 and following, which we call post-GENPRU and belong(?), we refer to the total loss-absorbing capital or TLAC, and I'm not going to take your Lordship to it now, but in J2 we've got the TLAC regulations and

we've got, in authorities bundle 7 at 172 we've got the Banks and Building Societies (Priorities On Insolvency) Order. The point is that there was another layer that could come in and that might be -- J2/19.

MR JUSTICE MARCUS SMITH: Should I turn that up, or is that just for my note?

MR PHILLIPS: No, no, that was just for your Lordship's note, I'm sorry.

All of that is consistent with Mr Miller's witness statement and he said that there was no regulatory requirement for subordinated debt that would rank ahead of lower tier 2 debt such as the LBHI2 subnotes. Instead the references to subordinated senior debt in the definition of senior creditors in the LBHI2 subnotes reflected what he described as a general preference within the Lehman regulatory team for flexibility. And against that backdrop, PLC also accepts in its position paper at 47.2 that the "subordinated creditors other than" wording might be directed towards the future.

The question then is why on PLC's case the senior subordinated category under the note must have been -- must have been directed to and engaged the unrefinanced LBHI2 subdebt, in other words the subdebt that existed that was not refinanced, when it was issued. And the question becomes even more difficult to answer bearing

in mind that at one point in time of course PLC held both of them, there was a scintilla in time when PLC held both the unrefinanced debt and the subnotes as the initial noteholder and we say that the reasonable reader would find it a curious thing that two dated regulated subordinated debts held by the same borrower, albeit for a scintilla temporis, should at that time have ranked differently. That's quite an odd result.

Your Lordship heard that PLC was the initial holder from Ms Dolby on Day3/83:19-21 and it is plain from the face of the offering circular itself at E4/67.

Can I then move on to forms and precedents. Your Lordship saw the FSA Standard Form 10 and the FSA standard form 5 in opening and we explained to your Lordship that these two forms were intended to and indeed had to achieve the same subordination outcome and they were required to do that of course because of the EU directives.

Now, my learned friend Mr Beltrami was dismissive of the forms in opening, describing them as a parade, each of which said different things and we were inviting your Lordship to construe all sorts of different forms in the same way, but with respect, we're not asking your Lordship to do that, we're quite happy to accept that standard form 5 was not the exact precedent that

Mr Miller used for the definition of senior creditors in the LBHI2 subnotes and we have never said otherwise and it's not what he said in his witness statement.

We point to the standard forms to respond to what was until recently understood to be Mr Beltrami's main point on part 1, which was that the separation of unsubordinated creditors and subordinated creditors other than was the principal determinant of priority and we showed your Lordship Standard Form 10 and Standard Form 5 in opening because taken side by side they illustrate that the "senior creditors" wording and the "subordinated creditors other than" wording is not dispositive of the ranking question in the manner that we understood was being suggested, which may or may not be a part of why that particular argument has gone down the pecking order.

The standard forms cast doubt on this argument and in our submission a definition in standard forms, out in the market for some 20 years is unlikely to have the sort of determinative support that PLC seeks to give it and it doesn't serve as a general indication of juniority, which is how my learned friend put his case.

The bifurcated definition of senior creditors, familiar as it was in the market from a dated regulatory context, would not convey to the reasonable reader that

notes were an excluded liability. It's quite the opposite.

Mr Miller was asked about this in his evidence and we just want to note the following. First, his evidence was the drafting of the note's subordination provision was not a one-off and that there were several contemporaneous transactions which used this formula for a dated lower tier 2 issuance. Your Lordship will remember he said that, that was Day2/158:6-15. He agreed that Standard Form 5 was not the precedent he used. He actually said that. He said:

"Answer: I am sure I would have recollected if we had looked at an actual regulatory form, although it is perfectly possible that the model had some shared provenance with those forms."

He said that Day3/6:1-4 and that's plainly correct, plainly possible.

The definition of senior creditors in the LBHI2 subnotes is very similar to that in FSA Standard Form 5 and specifically has an express acknowledgment of subordinated creditors subject to the "other than" carve-out for pari passu and junior creditors.

Mr Miller also spoke of how market norms and expectations were established in the mid-1980s only to be carried over to the present day. That was on

Day3/20:1-9 and these are the IMRO forms, which for your Lordship's note -- I'm not going to ask you to turn up more forms but for your Lordship's note it is J2/16/905. They were in force from 1996 to 2001 and are the direct precursor of chapter 5 of IPRU and the definition of senior creditors was the same formulation as we find in IPRU chapter 5 and again that's page 907.

So against the backdrop of these forms we say it is clear that the only linguistic feature that PLC can point to as expressing juniority in 2007 is a definitional characteristic that had been in the market, the standard form regulatory debts, since the mid-1990s and that only serves to underscore that there's nothing to suggest a departure from the default position that you heard Mr Miller describe.

There are other examples and they are in the K bundle, which we did refer to briefly. K2 at page -- and I do just want to show your Lordship this. K2 is an Anglo Irish Asset Finance fixed variable rate subordinated note and I just wanted to show your Lordship page 4 over to page 5. Your Lordship sees page 4 is "Status and subordination" and over to page 5, I just want to pick up "For the purposes of this condition ...", does your Lordship see that after the break there?

MR JUSTICE MARCUS SMITH: Yes, I've got it.

MR PHILLIPS: "For the purposes of this condition ...(Reading to the words)... to the claims of the holders of the notes."

So there is an example. I have made it crystal clear that we're not saying that was the example Mr Miller used, we simply do not know, but your Lordship sees the language, and for your Lordship's note you get the same in relation to Standard Bank Plc subordinated notes 2008 but there there was a trust provision, but for present purposes if I can just show you K3, at page 18, I just want to show your Lordship the definition of senior creditors:

"Senior creditors means all creditors of the issuer ...(Reading to the words)... or junior to the claims of the noteholders."

It was suggested by my learned friend, Mr Beltrami, that those bore no semblance to the senior creditors in the LBHI2 subnotes. That is not the case. They were using a concept established in the marketplace that defines senior creditors both by reference to unsubordinated creditors as well as subordinated creditors and the key point is that your Lordship can see that structure that we find in the definitions, that we see in the subnotes, was as Mr Miller indicated. It

was something that was relatively common in the marketplace, it's consistent with form 5 and your Lordship can see that you've got those various examples and for that to be the basis for an argument that it makes the notes junior is really putting far too much weight into a linguistic difference that is not that significant.

Finally purpose. We say this is a case in which the court can step back and having looked at the aims and genesis of the transaction determine that there was no intention to alter the subdebt, the level of the subdebt that was being refinanced when prior to the LBHI2 subnotes the subdebt had ranked pari passu with the unrefinanced LBHI2 subdebt. So it was subdebt, it was all subdebt and everyone is agreed that all ranked pari passu. Some of it was being, as it were, hived out into the subnotes and we're being told that that then made the subnotes junior. Well, there's no evidence of any purpose or intention behind that. It was a straight refinancing of the substantial part of the LBHI2 subdebt and the core commercial purpose was tax driven, did not address subordination at all.

Ms Dolby's evidence was very clear. She agreed that the entire purpose of the LBHI2 subnotes was to create a tax efficient funding structure, Day3/65:1-7. It was

to create a tax benefit, Day3/71:18-19. This was very clear from the correspondence also with the FSA and HMRC in March 2005. We are thinking in particular of the clearance application which your Lordship saw with Ms Dolby. We put it to Ms Dolby -- F4/1897 -- and there was no intention to subordinate the subnotes to the subdebt.

Ms Dolby also agreed that the subnotes would be made on the same terms and conditions, and she said that Day3/78:19-24, the same amount, the same coupon as the subdebt.

So drawing all of the threads together -- at the moment we're dealing with the pre-amendment position -- our position is the correct answer at the LBHI2 ranking part 1 is the pari passu construction. We say this is clear when one looks at the substance of the subordination provisions in question. PLC's approach priorities form over substance, pointing to the odd linguistic difference; there's no real difference in substance in the definition of senior creditors. That explains the heavy reliance now on clause 3(b) and Lord Justice Lewison's contingent debt analysis and the solvency condition which for reasons we have explained is untenable.

Finally, as a final point, if GP1 is right on its

bottom-of-the-pile construction thesis and the LBHI2 subdebt cannot rank pari passu with anything else because we're in an inescapable rush to the bottom, then your Lordship would have to conclude that the LBHI2 subdebt ranks junior to the LBHI2 subnotes. That would follow.

May I then move on to part 2, post amendment.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: On a proper construction of the 2008 amendments, the reasonable reader would not conclude that condition 3(a) as amended altered the existing pari passu ranking of the LBHI2 subnotes and the subdebt.

When one considers the mechanism, it becomes clear as a matter of ordinary language that the amended LBHI2 subnotes ranked below the same senior creditors. They ranked above another class of creditors, the so-called notional holders, and they were not intended to rank pari passu with the actual preference shares in LBHI2 at the so-called preference share level, as my learned friend Mr Beltrami puts it.

When construing the amendment you are entitled to have regard to the following: 1, the very limited deferral of interest purposes that is set out on the face of both the LBHI2 board minutes and the Delaware

consent; 2, the Allen & Overy confirmatory letter that confirmed the continuing LT2 status, which is entirely consistent with the confirmatory note at the end of condition 3(a) itself ...

MR JUSTICE MARCUS SMITH: Mr Phillips, apparently an alarm, silent alarm has gone off and I am asked whether we can rise for five minutes to deal with that. I apologise for interrupting your flow.

MR PHILLIPS: Of course, my Lord.

MR JUSTICE MARCUS SMITH: We will rise for five minutes, I'm sorry about that.

(2.20 pm)

(Short Break)

(2.22 pm)

MR PHILLIPS: My Lord, may I go back to -- I was just saying when construing the amendment your Lordship is entitled to have regard to a number of things and I had mentioned the very limited deferral of interest purposes that is set out on the face of both the board minutes and the Delaware consent, the Allen & Overy confirmatory letter which is entirely consistent with the confirmatory note at the end of 3(a) and then the crucial differences between the payability mechanism in this case, which was obviously bespoke, and what was a well-established drafting technique ordinarily applied in relation to

more subordinated debts forming part of lower tiers of capital.

Can we go to condition 3(a) as amended, which is in bundle E, divider 5. My Lord, it is just helpful to look at this now, having seen some documents and heard the evidence, to then go back and see what we really have.

The first point is that the main subordination provision, which PLC from time to time call the referential part, is completely unchanged and what I mean by that is the language "the rights of the noteholders against the issuer in respect of the notes are subordinated in right of payment to the senior creditors", that is unchanged and that, we submit, is the subordination provision. And in answering the key question "After whom is the noteholder entitled to prove?", we say that answer is the same pre and post amendment.

So the part of the condition that we say is the dominant part which defines the ranking behind the senior creditors as defined below is completely untouched. Crucially, the definition of senior creditors also remains entirely untouched. The amendments to the mechanism below do not convey an intention for the notes to rank behind different

senior creditors and if you want to alter who you rank behind, you simply amend the definition of senior creditors, so that's important.

The changes then relate solely to the mechanisms which we say flow from the subordination language and a further mechanism is interested but the substantive subordination must be the same.

Pausing there, if PLC is right that one should start, as my learned friend says, from the solvency condition in part 1 that we have looked at, then a real curiosity arises in part 2 if we are correct at part 1. If we are correct that the effect of the unamended 3(a) and the solvency condition was for the debts notes and debts to rank pari passu, then post amendment PLC must presumably accept that outside of a winding up they continue to rank pari passu. So PLC are saying that this mechanism which applied only in a winding up -- and I'm not distinguishing winding up and administration for the purposes of this part of the argument -- which is of course in insolvency where subordination really matters, there has been an alteration to ranking and we pointed out that oddity in 49 of our reply position paper, A10/200.

So that's another point that a reasonable reader would have in mind: why would there be a ranking

difference within a winding up and outside of a winding up and the more reasonable inference of course is that the two mechanisms, the solvency condition and the payability condition, are just two means of ensuring the same priority outcome, which is you are subordinated behind the senior creditors.

My Lord, then if we can turn to what we call the payability condition. Your Lordship knows that the amendments start with "The conditionality referred to above shall not apply" and it there identifies the resolutions and the winding up, but the payability condition one picks up with the words "If at any time".

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: So:

"If at any time an order is made by a competent court or resolution passed for the winding up or dissolution of the issuer ..."

Then there are the brackets which take out reconstruction, amalgamation, reorganisation, merger, consolidation and so on:

"... there shall be payable, by the issuer, in respect of each note ..."

So that is why we call it a payability condition, it says "There shall be payable in respect of each note" and then in brackets "(in lieu of any other payment to

the issuer)", so that takes that out:

"... such amount, if any, as would have been payable to the noteholder if on the day prior to the commencement of the winding up and thereafter such noteholder were the holder of one of a class of preference shares in the capital of the issuer having a preferential right to a return of assets in the winding up of the issuer over ..."

Now, there are a few points on the language. First of all, as I have indicated, it is a payability condition, it identifies what the noteholder is going to be paid. It is not saying the noteholder becomes a preference shareholder, it is defining the amount that is payable by a number of reference points.

Second, we are dealing with a hypothetical preference share construct, so they have called it a preference share and they construct what is payable by reference to that hypothetical and that's plain from the language used.

So the notes were dated debt pre-amendment and they remained dated debt post amendment, indeed they remained LT2 debt at all times. So the hypothetical nature of the concept is made clear by the use of the subjunctive mood, so "if the noteholder were", so it is "as if the noteholder were" and that's the first hint that we are

not dealing with what I would describe as real or actual preference shares.

Third, the preference share has a right to a return of assets over specified categories. It is what the hypothetical share has rights over -- and we will see it's debt -- that confirms the use of the hypothetical share as a fictional construct, because shares can't have returns over debt.

The right to return is over -- and we see it here -- the holders of all other classes of issued shares in the case for the time being, being in the capital of the issuer. So the first thing that they are to be paid over is all shares, that's the first thing, and the second is the notional holders. So it's another construct. And I'm going to come back to -- your Lordship sees the "on assumption" language there; I'm going to skip over that and I will come back to it.

It then says:

"For the purposes of the above provisions, the notional holder is any creditor ..."

Obviously very important:

"... 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 another notional, hypothetical construct,

but it is a creditor and the notes rank above a certain type of creditor and that is the notional holder and the notional holder holds a notional share and the notional share means:

"... any notional unissued shares in the capital of the issuer which have a preferential right to a return of assets in the winding up of the issuer over the holders of all other classes of issued shares for the time being in the capital of the issuer but not further or otherwise."

So the linguistic points on the wording that are the rights to return are stated to be above the issued share capital of LBHI2. That necessarily excludes the preference shares.

In addition, the noteholder has rights over a notional holder and the notional holder is any creditor whose claim is quantified as though they held a notional share and a notional share is any notional unissued shares which have a referential right to return over -- which means in priority to -- the holders of all other classes of issued shares.

Now, what one has got is one has got all of the shares and above that one has got the notional shares and they are described as a notional share but it is a form of debt because it is a creditor who is holding

a notional share, so it is the layer of debt above all of the shares and the noteholders have a right of payment in the layer above that layer of debt that is immediately above the shares.

One of the things to always bear in mind when one is talking about -- everyone calls these case the waterfall cases -- is that is precisely what the courts have been grappling with right the way through this process and you can go from the secured creditors and you have the unsecured creditors and so on, all the way down, and what we have here, because we're now in the subordinated creditors, is we've got the LT2 creditors, if I can label them that, and then you've got creditors who are above the shareholders, which is the notional holders, that's the UT2, then underneath that you have the shares and of course between the different categories of shareholder there will be different layering and we know. So the amended subnotes have a right to return over the notional holders, who in turn have a right of return above the rights of the preference shares.

On no view would an actual preference share ever have a right of return over a creditor in a winding up. I won't take your Lordship to it, but there are statutory provisions in section 107, section 143 of the Insolvency Act and paragraph 65.2 of schedule B1 and for

the postponement of a members' debt there is section 74.2(f), but this is an absolute break, if you like, that shareholders cannot rank above creditors.

So going back to the language I skipped over, "on the assumption", so:

"On the assumption that a preference share was entitled to receive on the return of assets on such winding up an amount equal to the principal amount of such note together with arrears of interest if any and any accrued interest."

What that is dealing with is making sure that the amount payable is the principal and accrued interest. That's what that assumption is dealing with and that is the language that deals with the tax concern. It addresses the concern that payment should not appear to be results dependent. Your Lordship may remember that from Day2/106:11-14. Because the tax concern was that if the payments were results dependent then they would be treated as equity and not debt and that was a problem, or thought to be a problem.

So what we have is we've got a double fiction. There is a double fiction introduced by this hypothetical preference share. First, when considering what is payable on the preference share you have to consider that its rights are above those of the notional

holders who, as I have indicated to your Lordship, are creditors and this implements the subordination aspect of the construct from the bottom-up perspective. I'm going to come back to that. And second, you operate on the further assumption that the preference share is actually entitled to receive 100% of principal and interest.

Now, we're not aware of any preference share that both ranks above creditors and which is automatically assumed to receive 100%. So all of this would put beyond doubt to the reasonable reader that this is not looking to put the notes at the so-called preference share level. Whatever the mechanism is doing, it is not putting these notes in at what one might describe as a preference share level. As we have described, or as your Lordship knows, they are clearly at a creditor level.

And then we get to the confirmatory note and when your Lordship comes to consider intention behind these amendments, this note was part of the draft that of course is attached to the resolution and it says:

"The notes are intended to have a right to a return of assets ...(Reading to the words)... respective meanings given to that term in GENPRU."

And what that is telling you is that what is

intended is that it ranks above the tier 1 and the upper tier 2 and that is a very strong indicator of the objective purpose of the amendments to condition 3(a).

MR JUSTICE MARCUS SMITH: What am I to make of this note?

MR PHILLIPS: Sorry, my Lord?

MR JUSTICE MARCUS SMITH: What am I to make of this confirmatory note? I mean what exactly is its status? It is obviously a part of the terms and conditions of the notes, but it's not actually a term and condition.

MR PHILLIPS: It's a statement of what is intended by the language which is used in the notes and to that extent it is unusual because when your Lordship is asking yourself: what can I ascertain to have been the intention of these amendments as regards subordination, you know, assuming that you think that there is and we would say it is an objective statement of the purpose, insofar as it relates to -- it's an objective statement of the purpose and you get the two parts out of it that it makes the notes payable in full and it does not alter the ranking -- I'm going to come on to this because this is looking at it bottom-up and we have still got the top-down.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: So I would respectfully submit that is an objective statement of what was intended and because it

is part of the draft amendment -- it's part of the amendment and it goes with all the resolutions and it is completely consistent with everything you have heard from the evidence -- and I'm going to come on to the role of Ms Dolby and the role of Mr Rush and what they were all intending and all the rest of it, we will come on to all of that. You've got there a statement of the objective purpose of the notes.

Critically, what you do not see in that statement of what was intended by these amendments is "The notes are intended to be subordinated to the subdebt", or indeed any other debt. It doesn't actually say what it is subordinated to, it says what it is senior to.

So, my Lord, in summary, three points: the LBHI2 subnotes are stated as being intended to have a right of return in the assets in priority, the rights of holders of any securities which qualify as upper tier 2 and tier 1; it confirms that the amended LBHI2 subnotes rank above upper tier 2 subordinated creditors, as well as the equity, the actual preference shareholders, the actual ordinary shareholders, and this is consistent with the confirmatory opinion which confirms LT2 status and the drafting of the notional holder concept.

That's how the condition works. It is not the most straightforward mechanism. Mr Grant's evidence was it

was a bespoke solution. He took concepts from elsewhere. It's not something he had drafted before, he has not seen it drafted in relation to LT2 security, nor was it something he had drafted since and he said that in his evidence, Grant 1/49 at C5/13 and he confirmed it in cross-examination.

The use of the label "preference share" on one view wasn't necessary, or the use of perhaps some of the language wasn't necessary, but it does work, it does work and it does what it says in the confirmatory opinion that it was intended to do.

Now, before we tie all this together I want to deal with my learned friend Mr Beltrami's reliance on the PLC guarantee. He referred to it in opening and put it to various witnesses without actually ever showing them the terms of the subordination under it. We assume, on my learned friend's case, it is admissible for the construction of the LBHI2 subnotes, though it is not quite clear how that stacks up with his factual matrix case.

Two points. The first is that if the Lehman Group wanted something to be ultra subordinated, it would leave the reader in no doubt about this. Second, the comparison between the 2008 amendments and the ECAPS really just serves to highlight how different the

subordination provisions really are.

Now, on the first point, my Lord, could you just turn to divider 10, which is one of the ECAPS prospectuses and if we could go to 154, "The subordinated guarantee", your Lordship sees:

"The guarantor will provide a subordinated guarantee to be executed by the guarantor and the subordinated guarantee will rank pari passu with the non-cumulative perpetual preferred securities or preference shares of the guarantor."

So that leaves the reader in no doubt that the guarantee will rank pari passu with the non-cumulative perpetual preferred securities, or preference shares of the guarantor.

There are also the ratings agency presentations and I just give your Lordship the reference -- F6/182 at 195 -- which says that the ultimate objective as stated was to confer rights on the ECAPS holders in PLC that were functionally equivalent of those of a perpetual non-cumulative preference share issued directly by LBHI which was actually tier 1 shares in the parent, a point that I made to your Lordship before.

The second point is how different the drafting technique in the PLC guarantee and the 2008 amendments are and my learned friend took you to the summary but he

didn't take you to the clause, so can we go to 174 -- actually I should start at 176. So on 174 you have got the terms of the subordinated guarantee.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: And on 176 I want to show you clause 2.9 and clause 2.9 says:

"The guarantor agrees that its obligations here under constitute unsecured obligations of the guarantor subordinated in right of payment to senior creditors and will at all times rank ..."

And then it sets out its ranking:

"... (a) junior to all liabilities of the guarantor, including subordinated liabilities (in each case other than any liability of the guarantor) which constitutes or would, but for any limitation, constitute tier 1 capital, or which is referred to in (b) or (c) below and any other liability expressed to rank pari passu with or junior to this subordinated guarantee."

Well, that's the guarantee -- that's the terms of the guarantee on the subordinated creditors and:

"... (b) is pari passu with parity securities."

And they are defined at 160 as preference shares:

"... and senior to the junior share capital of the guarantor."

And just so that your Lordship can see, on 174 the

parity securities are there defined.

So your Lordship sees 2.9 and your Lordship can see how the subordination is being done and what the dominant wording is. The condition tells us the PLC agrees that its obligations are subordinated in right to payment to the senior creditors, which it defines below, so it's the usual structure, and your Lordship will note there is no solvency condition at all and no payability provision, so it's very similar to the sort of subordination provision one saw in Maxwell.

What is doing the work are the definitions, the referential part. So we look at who the senior creditors are and we see that they are all liabilities except the tier 1. So it says:

"All liabilities ... other than any liability which constitutes tier 1 capital or referred to in (b) and (c)."

And then we are told that it ranks pari passu with parity securities, which your Lordship has seen. So this isn't a condition to payment at all, it is defining who your senior creditors are and who is not a senior creditor, and, as I have said to your Lordship, so you rank pari passu with non-cumulative preference shares and of course whether issued then or in the future.

Now, my learned friend Mr Beltrami doubtless will

seek to say that the amended notes use a preferential share mechanism drawn from the guarantee, but that is not what we see at all. We see a very careful and deliberate definition of which creditors with PLC guarantee liabilities are subordinated to and which creditors rank pari passu with it and who ranks below it and, as Mr Miller confirmed in his cross-examination, this sort of mechanism was used at innovative tier 1 level. It is what he called ultra subordination and that was Day2/144:23-24 for your Lordship's note.

So the suggestion that something is being done in the ECAPS guarantee that is analogous to the 2008 amendments is misconceived, my Lord, that does not work. The mechanism used in the ECAPS guarantee which refers to ranking pari passu with actual preference shares, innovative tier 1 as described, is different to that used in the 2008 amendments which refer to having a right of return over a notional preference share and of course your Lordship will appreciate that is two levels higher than the level of the PLC guarantee.

What my learned friend's case really boils down to is to say that the word "preference share" is used in the guarantee and the word "preference share" is also used in the 2008 amendments, but there is no comparable drafting technique. The 2008 amendments alter

a mechanism implementing the subordination, they do not alter to whom you are subordinated.

So moving on to some submissions arising out of that. The first point is that the dominant subordination wording in 3(a) is unchanged and, my Lord, that is a very significant point. Your Lordship heard Mr Grant refer to it as well, but I don't need him to show your Lordship that 3(a) does not alter that dominant subordination wording.

SLP3's rights to payment are still subordinated behind the same senior creditors, which do not include PLC as borrower on the LBHI2 subdebt.

The conditionalities both just flow from 3(a) and 3(a) is the same in that critical respect, and my learned friend's change of tack to focus on the solvency condition in part 1 and the payability condition in part 2, ignores that those conditions. Both of them are simply implementing the subordination to the senior creditors.

Next, my Lord, if the intention had been to subordinate the debt to the preference share level, that would have involved an amendment to the referential language in 3(a) and the relevant subordination definition. That's the technique used in the PLC guarantee, it is not what we see in the notes.

My learned friend made two points in response to this. First, he said in opening that condition 3(a) was not the key bit but that really the focus is on the solvency condition as per Lord Justice Lewison. He said that at Day1/134 to 139 and for the reasons I have given to your Lordship that's misplaced.

Second, he says these are two separate regimes and the senior creditors' bit has nothing to do with the new payability mechanism. That of course raises an obvious problem. Is my learned friend saying that in a winding up the noteholders' rights are not subordinated to the senior creditors? It appears to be what he was saying, he said they're separate and that's just not right. The condition only ever implements the subordination provision. I think your Lordship has that point.

The second major point is that the preference share by which the amount payable is referable is a hypothetical share. It's not an actual share. You get that from the language. You would get it from the category of a class of preference shares, not an actual issued preference share, supported by the "If such a noteholder were the holder", never holds an actual preference share, and there's an assumption that this odd class of preference share is entitled to receive in a winding up 100% of principal and accrued interest and

again, as I have said to your Lordship, we know of no such preference share.

So the reasonable reader would be left in no doubt that something else is going on here by the reference to the hypothetical preference share and all of these oddities would overwhelmingly point away from the conclusion that the noteholders' claims were being put at a preference share level and if you wanted to put it at a preference share level, that's easy enough. You just modify the referential part of the clause and say you rank with actual preference shares as they did in the guarantee.

The third point is the hypothetical preference share ranks above other creditors. No actual preference share does so. It's another very strong indication of the legal fiction. It's not intending the noteholder to rank alongside an actual preference share. First, the noteholders are expressly described as ranking above creditors. Your Lordship has the point. Those creditors are the notional holders; the fact that they are expressly described as creditors is crucial to the analysis and not a point PLC has offered any cogent response to.

Mr Grant explained in his evidence that he was expressly referring to another layer as he counted up

from the bottom. Your Lordship will remember that. He described how he was counting up from the bottom and he described the notional holders as the layer that he put in. That upper tier 2 layer sat above the preference shares and in turn of course the notes were recognised as falling within an existing layer which is the lower tier 2 level which is above the upper tier 2 level and that was consistent both with the confirmatory note and Allen & Overy's confirmatory opinion regarding the note's continuing LT2 status.

In short, the LBHI2 noteholders rank above the notional holders, while the upper tier 2 creditors rank above all the issued share capital, which includes actual preferenced shares.

The refrain we heard from my learned friend Mr Beltrami's opening was "the wording places the subnotes at a level of preference shares" and he said that on Day1/132:20-22. He also said that the effect of condition 3(a) was "they ranked as preference shares", that was Day1/136:25 to 137:1.

We say it cannot possibly do that because it expressly envisages ranking above other creditors and creditors always rank above equity.

Fourth, the confirmatory note or opinion. Unusually, the draftsman has left a note in italics

clarifying the intention behind the amendments at the bottom of the page which your Lordship has seen and that is a very strong indicator of the objective purpose of the amendments to 3(a).

In summary, the LBHI2 subnotes are stated as being intended to have a right of return of assets in a winding up in priority to the rights of the holders of any securities of the issuer which qualify as upper tier 2 capital or tier 1 capital within the meaning of GENPRU and that confirms that the amended LBHI2 subnotes rank above upper tier 2 subordinated creditors as well as the equity. This means the ranking is described from the bottom-up. The LBHI2 subnotes rank above the upper tier 2 and the tier 1 and they continue to rank below the senior creditors. So you've got it from the bottom and the top and, my Lord, it won't have been lost on your Lordship when you heard Mr Grant, he described it, using his fingers, as reaching the same point.

Fifth, this is important, our reading permits a unitary reading of the contract. The payability mechanism implements the condition 3(a) wording inside a winding up, just as the solvency condition does outside of a winding up, but the payability addressed Mr Dehal's tax concern relating to the way the subordination was expressed in a winding up and one can

construe it consistently, and the approach makes sense against the backdrop of different tiers of regulatory capital which a firm like Lehman of course had and which we addressed in our skeleton argument at 382 for your Lordship's note, and Mr Grant provided a detailed explanation of this in re-examination which was Day2/138:5 to 25, and just to remind your Lordship, at the very bottom you have the ordinary shares, then there are the preference shares, then you might have innovative tier 1 which is at the level of the most senior preference share, above that you have the upper tier 2 securities, either in existence or in the future. The upper tier 2 securities would normally be expressed to float -- he described them as floating above all issued preference shares, so that they would always rank above the preference shares whenever issued. And then above that you would have the lower tier 2 securities.

The amended LBHI2 subnotes were expressed to have rights of return above the upper tier 2 whenever issued. It ensured that they remained at lower tier 2 level. The result -- and this really is the point. The result of the bottom-up mechanism is the same as the result of the top-down mechanism.

Can I just look at the counter-arguments. There are two key weaknesses. First, the mistaken assertion that

through the amendments to condition 3(a) the amended LBHI2 subnotes rank alongside the actual preference shares. Second, the continuing failure to address the fact that as drafted the LBHI2 subnotes are expressly described as ranking above creditors and therefore cannot rank below creditors.

My Lord, if I can just turn to my learned friend's skeleton, which is in B2/30, B2, page 30. My Lord, I want to just look at 85 and you can see the seeds of the problems, because he misdescribes the actual wording of the 2008 amendments. So if your Lordship looks at 85.2(b), where he says:

"In that event the payable amount is deemed to be the amount ...(Reading to the words)... other creditors with rights equivalent."

And then in 85.3(b):

"It is a deeming provision to the effect that claims of the noteholders are to be treated not at the priority level of debt claims but at the priority level of claims by preference shareholders satisfying the definition given."

So your Lordship sees there the difficulty, because that's not right. Then in (c):

"Of necessity this provision affects priorities because creditors and shareholders stand in a different

place in the applicable waterfall."

Well, that's true, but not in the way that they're describing.

"By deeming the noteholder claims to be equivalent to those of preference shareholders and making payable only such amount as would have been payable if they had been a preference share within the definition the amendment ..."

Of course they don't tell us about the definition:

"... the amendment relegates noteholder claims ...(Reading to the words)... accordingly expresses the desired ranking of the subnote."

And then in (e):

"The fact that the ranking at preference share level involves a demotion below other debt is plain and indeed was a technique utilised in other related Lehman documents."

And they then go on to look at the subordinated guarantee. You see, my Lord, what they have done is they have described the notes as if they were preference shares and they are not. Their analysis rests entirely on the submission that the amended LBHI2 subnotes are at the same level of the preference shares and are therefore necessarily inferior to all other debt and that's what they get to in 88 and for all the reasons we

have given, we say this is overly simplistic, it's not borne out of the language and it is also conceptually wrong.

The way my learned friend put it in opening was to say "By defining it at a preference share level you are automatically putting a ceiling on it". That was the language he used and that was Day1/138:15-18. His argument is that once you define it by reference to a preference share, you put a ceiling on it and presumably the ceiling is the ceiling of recovery that a preference share can make.

First, your Lordship has seen the payability condition does not without more define the level at which you sit. That is done by 3(a), which is the referential part. So the argument assumes its conclusion.

Secondly, what is the ceiling posited by this hypothetical preference share? Because it is a hypothetical preference share that assumes 100% of the principal and interest are payable on a winding up, so that's not a ceiling at all, and it is also a share that ranks above other creditors, which we say that's not a ceiling. As we said in opening, you cannot confuse the rights associated with a preference share if -- my learned friend describes this as a very odd

preference share. You cannot confuse the rights which do not resemble equity rights at all and the rights which flow from the status of an actual preference share.

In other words the right way of analysing how this works is not to say "This is a preference share, this is what as a matter of law a preference share would get, therefore I can look to the contract and I can construe what is put in the contract by reference to those rights", that doesn't work. It is the rights, it is not the status that matters. And it is one of the reasons why the use of the words "preference share" in some ways is slightly misleading, because you immediately think "Ah, what is the status of a preference share?" and then you go off looking at status, but in fact what one has to do is one has to analyse the rights given and the rights given are entirely descriptive by reference to the different layers, just from the bottom-up and in our submission it doesn't put a ceiling on it, it puts a floor under it. That's what he has done. The only ceiling is in condition 3(a) which is that the noteholder cannot obtain payment ahead of senior creditors, whose definition is unpaid.

There are two further points that PLC runs in footnotes and I'm not sure how much weight can

realistically be put on them but I'm going to do this quickly. Paragraph 31, it is footnote 71, where they describe the notional holders as a special type of creditor being one that is also pegged by deeming provision to the level of preference shares. Well, that's just wrong. And it also says that:

"As PLC is aware, LBHI2 has no creditors which fit the description."

First of all, it ranks the notional holders at the same -- it's not a deeming provision that ranks notional holders at the same level of actual preference shares and your Lordship has seen that, and secondly, the notional holders are not deemed to be at the level of preference shares at all, they sit above them. Your Lordship has seen that.

The second footnote, 72, I took your Lordship to this earlier, which supports the submission that upper tier 2 capital in the confirmatory note is a reference to shareholders only. This is footnote 72, which is B2/32, I think your Lordship has got.

MR JUSTICE MARCUS SMITH: Yes, I've got it.

MR PHILLIPS: Thank you.

A preliminary point: it is not even clear that the relevant defined term is securities. A more natural reading of the words in brackets in the confirmatory

note is that the defined term is "upper tier 2 capital", but if your Lordship has the handbook -- and I think we looked at it briefly during the openings, it is J2/12. My Lord, we showed this to your Lordship, which is the GENPRU definition of security and your Lordship sees a share, a debenture, government public security, warrant, certificate and so on and, you know, a very significant example is a debenture and what is clear is a security as defined can plainly include a debt because a debenture is a debt, it is a debt secured on the assets of the company. That is a debenture.

So these points are really at the core of PLC's analysis and once they are addressed, there is not a great deal left.

Final point is that at paragraph 90 my learned friend argues that the purpose of the amendments was to affect priority and the evidence of a more general commercial purpose from the factual matrix may be admissible. He says that in paragraph 90. That's helpful but it begs the question where is the factual matrix that shows any commercial reason for a ranking alteration? And there is none. Once one starts looking at factual matrix, once one starts looking at the background to the amendments, there is nothing that shows any commercial reason for the ranking alteration,

or indeed any intention, but we're going to come on to that when we come to rectification.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: And the dividend stopper we have already said cannot possibly assist. I mean it doesn't assist in the earlier context, but it plainly doesn't assist in this context. If the notes of the debt were pari passu to begin with. And PLC does not seem to rely on it.

When considering both the ordinary language used, the relevant matrix materials, it is quite obvious that the objective meaning of the amended LBHI2 subnotes manifest no change in ranking and that the reasonable reader would conclude that they continued to rank pari passu with the LBHI2 subdebt and of course back to your Lordship's conclusion, the topic I'm about to move on to, doesn't come too heavily into play.

I'm about to move on to rectification, so if that was a convenient moment for a break for the shorthand writers --

MR JUSTICE MARCUS SMITH: Yes indeed. We will rise for five minutes. Thank you, Mr Phillips.

(3.10 pm)

(Short Break)

(3.18 pm)

MR PHILLIPS: My Lord, your Lordship has got our written --

I'm onto rectification.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: And your Lordship has got our written opening submissions at 406 to 472 and I would like to hand up a document -- and there are copies for everybody, I'm not going to personally deal with that -- which is a chronology, we call it the rectification chronology, in which we have put the evidence and the documents in a more granular, walk-through sense. (Handed).

I'm not going to take your Lordship through it, but I hope that that's going to be of some assistance.

I'm reminded I might refer to it a bit depending on how we go time-wise.

MR JUSTICE MARCUS SMITH: Well, I will keep it handy.

MR PHILLIPS: But anyway, it is important to be clear at the outset on how the rectification case arises. It assumes that your Lordship finds in our favour on the true construction of the LBHI2 subnotes, the LBHI2 subnotes ranked pari passu with the subdebt in May 2007, that's the first proposition, but on a true construction your Lordship concludes that the 2008 amendments had the effect of subordinating the notes to the debt and that the amendments to condition 3 are indeed engaged in a distributing administration. The third point we will come back to.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: There are six key elements of SLP3's rectification claim.

1, the common intention of SLP3 and LBHI2 was no more and no less than to permit the deferral of interest in the context of an existing contract.

2, that was the sole focus of the relevant individuals. That was what they asked Allen & Overy to provide a corporate benefit memorandum in relation to, that was what they instructed Allen & Overy to do and that was the sole purpose of all the board level approvals referred to.

3, given that it was intended only to achieve that one sole and specific end, it follows that it was not intended to relegate or demote SLP3's rights against LBHI2 under the LBHI2 subnotes below those of PLC under the LBHI2 subdebt. In other words, to effect what we call the ranking alteration and we say that is clear.

4, the common intention was shared and communicated to the necessary extent. It did not remain an uncommunicated, subjective intention.

5, if, contrary to our primary case, the legal effect of the 2008 amendments was to give rise to the ranking alteration, then that was a mistake and the 2008 amendments should be rectified.

6, the criteria for rectification have been made out and the court should exercise its discretion in favour of SLP3.

What PLC's case requires your Lordship to conclude. Now, we will address each of the criticisms Mr Beltrami made of our rectification case in his opening, but given how the issue arises, it's important to stress three points that are made against us that my learned friend's case necessarily involves your Lordship accepting.

They are, first, that the legal effect of the 2008 amendments was to cause a fundamental legal change to subordination in a winding up, subordinating SLP3's $6.13 billion claim under the notes to the claims of PLC under the LBHI2 subdebt in a winding up. That's the first thing that your Lordship would have to accept.

Second, that the 2008 amendments had this effect in circumstances where the Lehman Group never discussed subordinating the notes to the debt in 2008, they never sought advice on the ramifications or consequences of the ranking alteration, they did not instruct Allen & Overy to subordinate the note to the debts, Allen & Overy's own evidence before your Lordship that they didn't intend the changes they made to condition 3 to subordinate the notes to the debt.

Third, that this ranking alteration occurred without

any identified or identifiable commercial reason.

Now, taken cumulatively, these factors would require your Lordship to accept that a fundamental change occurred with no one intending that it should, with no one having discussed it, with no commercial or other driver to explain it, where the only intention was to put in a relatively minor amendment. We say this can only point to the conclusion that the parties' intention was to do no more, no less than to enable the deferral of interest. That is our case.

To the extent that the amendments did result in the ranking alteration, that was because the parties intended to do X to their existing arrangements but legal change Y took place by mistake and that's why we say this makes it a classic case of rectification.

MR JUSTICE MARCUS SMITH: Well, that's where I have a little difficulty. I mean taking two of your six points, your second point is that the sole focus of the relevant individuals was to arrange for the permission to defer interest.

MR PHILLIPS: Yes.

MR JUSTICE MARCUS SMITH: But my recollection of the evidence is that it was accepted that there was a watching brief to ensure that potential problems in the unamended wording were dealt with and that's why one

restructured the ranking provisions in order to avoid a difficulty that I think Mr Dehal had identified, so there was a secondary purpose: that if there is a problem with the instrument, it will be corrected as part of a solicitor's watching brief to make sure that its client's interests are protected and that's what appears to have occurred, which leads me to the second point. Your fifth point was that if a ranking change occurred, this was a mistake.

Now, let us accept all of your assumptions regarding the construction of the unamended words, that they rank where you say they rank, and that certainly there was no intention on the part of anyone to alter that, but in addressing the problems identified by Mr Dehal, new wording, substantial new wording was introduced. Now, if by a mistake that affected a change in the ranking, how is that rectification given that rectification focuses not on mistakes in the abstract, but a mistake in recording the anterior common intention of the parties?

MR PHILLIPS: Well, my Lord, that -- it's not very different to Four Seasons, because in Four Seasons the intention of the parties and the job, as it were, of Allen & Overy was to try and get to the point where the hole in the security documents was fulfilled and Allen & Overy were

the ones who were tasked with coming up with how to deal with the problems that had emerged in the documents that they were presented with and they came up with a solution and the solution involved taking on a lot of additional obligations and that all came from Allen & Overy. It fell outwith what the actual parties intended and this is very similar.

So of course in every case where a solicitor gets involved in drafting amendments to a document, not every consequence of what they're doing is necessarily something that they're going to be saying "And while you're at it can you do this, and while you're at it can you do that", which I think is the point that your Lordship was making.

MR JUSTICE MARCUS SMITH: Well, indeed, but -- sorry, do go on.

MR PHILLIPS: If what they do goes outwith the overall intention of what they were being asked to do then that is no the intention, that is a misrecording of what it was that the contracting parties invited them to do. And we mustn't lose sight of the fact that this is an amendment case. It is an amendment case and amendment cases work differently.

MR JUSTICE MARCUS SMITH: I have that well in mind. I think the difficulty I have, and it may be that this is the

distinction between this case and Four Seasons, is that the change to the way in which ranking was defined, not, I accept for the sake of argument, the intention of where these instruments should rank, but the change in the mechanism, was intended. Now, if by some mistake the consequence of changing the mechanism was to change the ranking, why is it that an anterior intention expressed in the unamended document saves you? All one has is a mistake, but not a mistake in the expression of the intention, a mistake simply in the compiling of the revisions.

MR PHILLIPS: Well, when you are dealing with an amendment, what you start with is you start with a record of the parties' intentions generally and that is why when you're looking at an amendment you really ought to look to see what is it that they are trying to amend. It's not like the normal case where there might be a myriad of different provisions and your solicitor is going to come up with all sorts of different clauses that deal with different things and there's going to be to-ing and fro-ing and the parties are going to compromise on certain things and so on and so forth. When you're dealing with an amendment to an existing suite of rights you have to start by looking at the rights. So it's not a question of that saving you; that is what you

intended, unless you intended to change it.

So on the subnotes you've got a whole suite of rights and obligations contained in the unamended subnotes and that's your starting point and then you have a situation in which the parties decide that they want to make a change and you have to look at the change and you say "Well, the change the parties intended to effect was X", and the solicitors in giving effect to change X have actually changed Y and that falls outside of general instructions to make sure the thing works. They weren't asked to do a general review of the subnotes to see whether or not there should be any other changes, they were just asked to make one change and that's the change that the party intended. Now, anything else is a misrecording of that intention.

MR JUSTICE MARCUS SMITH: So -- all right. The trouble is the changes -- and I'm talking about the changes to the ranking -- were on one level, the rewriting, absolutely intended.

MR PHILLIPS: Yes, and Lordship saw the "alternatively" -- sorry, it's the language which makes it clear that it is 100% payable.

My junior rightly points out, yes, the words were intended, I mean Mr Grant didn't write them down accidently, but the consequences of those words were

not --

MR JUSTICE MARCUS SMITH: The words that were intended were given a great deal of thought. The problem is that --

MR PHILLIPS: Yes, but this consequence was not intended.

MR JUSTICE MARCUS SMITH: The consequence was not intended, indeed. But that I suppose brings me back to this point about rectification being actually a very superficially straightforward correcter of simply where the instrument fails to reflect the anterior intention and my point is that the instrument on one view reflects precisely the intention, it's just that it didn't do quite what the parties wanted it to do.

MR PHILLIPS: If the consequence is not intended then we do come within the test. So I mean we're going to have to obviously look at -- there are a few cases that I do want to look at on this because it's very important.

MR JUSTICE MARCUS SMITH: No, of course.

MR PHILLIPS: And I think, my Lord, that you will see that the consequences test we hit and the other thing that I will obviously do, having regard to what your Lordship has said, is I'm going to go back to Grant's evidence -- not now, but I will go back to Grant's evidence and then we will see exactly what it is that Mr Grant said he was doing and what's of course interesting is that your Lordship against anything that he may have said,

you've got everything that's in the rectification chronology, you've got the evidence of everyone else involved and you've got every other document. So, yes, I'm going to come on to that.

Before I get on to the law, I just want to cover my learned friend's criticisms and our answers, if I may, and there are six of these.

The first one is that my learned friend takes issue with the formulation of the test, the "no more, no less" test, and he questioned whether that intention can found a claim for rectification and we submit that it plainly does, especially -- and this is an important point that I did just allude to -- when one is dealing with amendments to a pre-existing arrangement, because you can have an intention, no more or less, to make an amendment and that is very different if you're dealing with an existing arrangement to a new arrangement.

The second point is that it is said that Ms Dolby's intention was to agree to whatever drafting was prepared by Allen & Overy and she contradicted that in evidence. I put it to her she did not say that she was just there to agree to whatever Allen & Overy came up with and that may be a point that your Lordship should have in mind when considering how general Allen & Overy's instructions were on this. The suggestion that she had

no intention at all in relation to the amendments save blindly to sign off on any document is not what she said in the witness box.

Third, my learned friend suggests that our case does not involve Allen & Overy having made a mistake. Well, that is correct on our primary case, we do not think that on a true construction the amendments did alter the ranking. Indeed, your Lordship will recall that in his re-examination Mr Grant explained to your Lordship how it worked, but if your Lordship does construe the amendments to condition 3 as giving rise to the ranking alteration, you have heard clear and unequivocal evidence from Mr Grant that's not what he intended and it must follow that -- and your Lordship will see and has seen the evidence about no more no less. If your Lordship was for whatever reason to find in PLC's favour on construction, then a mistake was made insofar as the legal effect of the changes was to cause the ranking alteration which Mr Grant told you he didn't intend and your Lordship has had all the evidence from Lehmans that shows that they didn't intend it.

Fourth, it is said that there was no outward expression of accord and we say that there very obviously was one here. This is not a case where the subjective intention only to do X was uncommunicated;

it's everywhere. Wherever one looks in all the contemporaneous material, it's on the board minutes, it's in the approval of Allen & Overy's first draft, it's in the internal emails and in any event in an intra-group context, when one is dealing with an amendment which only had to be consented to by the noteholder, SLP3, and where we say the relevant intention is that of Ms Dolby, this additional requirement has no application. It's what the pensions cases deal with and we will look at those.

Fifth, PLC take a point on the attribution of Ms Dolby's state of mind. Mr Beltrami said it is only in very narrow exceptions that one did not look to the authorised decision-makers. He said that on Day1/148:17 and we disagree that the law of attribution is so restrictive. But in any event, Ms Dolby gave clear and unequivocal evidence that she shared her intention with the authorised decision-makers. In particular your Lordship will remember her evidence about Mr Rush being in the next office and so on, Mr Triolo in the United States; all of them shared the same intention.

It also emerged in evidence that the amendments may have been implemented prior to the board meeting in late August and there are documents that your Lordship has seen that show the interest deferrals implemented

in June 2008, all of which points to a fait accompli and to Ms Dolby being the actual decision-maker, or at least that her intention was adopted and shared by the formally authorised decision-makers.

Sixth, a point was taken about the scale and ambition of the claim. Your Lordship will see that the rectification sought only simply puts condition 3 in the same form as the first draft that was approved by Ms Dolby and others and that would have had the intended legal effect of deferring interest, no more no less.

So no more no less than to permit the deferral of interest is a central point. We say "no more no less" is the correct legal test on the facts and made out on the evidence.

The principal legal difference between the parties really boils down to this. We say that where you are amending an existing contract or scheme and intend to do no more no less than X, it follows that you are not intending to make change Y. The amending parties do not have to apply their minds actively to Y and say to themselves "This Y is not what I intend to do with my amendment". As your Lordship will appreciate, the more absurd or obscure Y and its legal effect is, the more onerous and unrealistic that exercise will be and I will take your Lordship to some cases, including a case

my learned friend relies on, to make good that proposition.

Second, my learned friend on the other hand says that the parties need actually to positively address their minds at the time of the approval to the particular legal consequence which they did not intend in order for the subjective intent requirement to be made out and one gets that from Day1/148:3-5, Day1/154:22-24 and Day1/148:3-6, in which my learned friend said:

"So what we are looking for, what the court is looking for is a positive intention in this circumstance not to make these changes."

And it is important that he used the word "changes". In none of the cases is such a formulation -- the need for such an intention used.

PLC's case on the law is set out in two subparagraphs of its skeleton at 175.5 and 177.2 and if I can just quickly look at those. They are in bundle B, tab 2, 74 to 75. 175.5:

"In such circumstances ...(Reading to the words)... cannot be a basis for rectification."

So first, my learned friend describes the "no more no less" as a bald assertion that is ambiguous and irrelevant, but that is exactly the subjective intention

found in Four Seasons, it's exactly it. In that case there was an accession to pre-existing rights and obligations.

PLC then says, the second thing it says is:

"It is ambiguous because it may well be the case that the deferral of interest was the only change that Ms Dolby consciously desired, but that does not mean she intended that the amendments should do nothing but defer interest."

And that is a non sequitur. Just because she only consciously intended X doesn't mean that she did not intend that Y shouldn't occur.

Second, PLC says:

"She was prepared to accept all of the changes ...(Reading to the words)... inspiration for this approach appears to be Lansing Linde."

And obviously I will take your Lordship to that because it would be helpful in the context of your Lordship's question as well, because that shows the sort of extreme facts that are needed before such an approach can be taken, so we will look at that.

Then 177.2, they deal with:

"It is not the common intention of the parties that the amendment should have the legal effect of changing the priority."

And they say it is misconceived because:

"... while rectification may be available ...(Reading to the words)... could have had an actual formed intention ..."

So it is the same point: because they intended X they cannot have had a formed intention not to do Y and we say that in the amendments context, there is no legal requirement for the relevant person to have an actual formed intention as to the particular legal consequence Y, in the sense of having positively turned their mind to it to say "I actively do not want this to happen". In the amendments context, that is not the law.

So before we go to a couple of the cases, the critical distinction to have in mind is on the one hand newly entered into bilateral context and on the other hand, an amendment case. So, I think, my Lord, I have done this slightly already, but the obvious distinction is where you've got a new contract there will be a raft of rights and obligations and it might not be possible to simply say that the parties subjectively intended only to achieve X. And it becomes an impossible or difficult exercise to show the parties gave specific thought to the inclusion of every clause in a major contract, but of course that's not the case here. Both

Lehman entities must have had a subsisting intention in relation to the ranking. That is the case because they had already entered into the subnotes, so the ranking of the subnotes was the subject matter of an existing intention at Lehman.

Then because it's an amendment case, you then have to ask what were they intending to do by way of the amendments and your Lordship heard from Ms Dolby she had no issue with condition 3 in its original form in the original LBHI subnotes and for your Lordship's note I put it to her -- that was Day3/66:8-11 -- and for the rectification claim to arise, condition 3 before meant that the subnotes ranked pari passu with the subdebt. That's the starting point. That's what they intended. She had no problem. And Ms Dolby's evidence, all the surrounding materials show that the only intention and purpose after that was deferral of interest, and we will come back to it in due course, but your Lordship has to think about, well, how far in that sort of context can a solicitor's views on what may or may not be improved alter the situation where you've got a client that says "This is what I want to be done" and perhaps something different is done.

So can I take you to four cases, my Lord.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: First of all, Four Seasons which is in bundle A6 at tab 137. So this is Four Seasons at first instance and I just wanted to show your Lordship Mr Justice Henry Carr's judgment to start and I wanted to start with paragraph 3 because it gives you the framework of the facts:

"The terms of a private equity financing transaction completed in 2012 ...(Reading to the words)... as the parent put it, to fill the gap."

And then paragraph 18, he said:

"As indicated in the passage cited above from Pitt v Holt, there is a distinction between mistake as to the legal effect and a mistake merely as to the consequences of the document. This may not be an easy distinction to draw."

And he then refers to Mr Justice Lawrence Collins as he then was in A v P. He says this:

"Rectification may be available if the document contains the very wording that it was intended to contain, but it has in it law or as a matter of true construction an effect or meaning different from that which was intended."

So your Lordship can see the obvious point.

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: The language may well have been the language

that Mr Grant intended, but if it has in law or as a matter of true construction an effect or meaning different from that which was intended -- and of course your Lordship knows Mr Grant didn't intend this, your Lordship knows that no one at Lehmans intended this:

"It is sometimes said that equitable relief against mistake is not available if the mistake relates only to the consequences of the transaction or the advantages to be gained by entering into it. If anything it is simply a formula designed to ensure the policy involved in equitable relief is effectuated to keep it within reasonable bounds and to ensure that it is not used simply when parties are mistaken about the commercial effects of their transactions, or have second thoughts about them. The cases certainly establish that relief may be available if there is a mistake as to law, or the legal consequences of an agreement, or settlement, and in the present case Mr Simmons ultimately accepted that if there was a mistake it was a mistake as to legal effect and not only merely as to consequences."

And it is not about commercial consequences, it is about legal effect.

So if I can then move on to 44, if we can pick it up at 44 he here deals with absence of discussion as

evidence of intention and he says:

"It was contended by Mr Wolfson on behalf of the parent that an objective common intention can be discerned even where that matter is not discussed between the parties. In certain circumstances the very absence of any discussion can itself be evidence that the parties did not intend it."

And he then referred to Saga Group v Paul, Industrial Acoustics v Crowhurst and Konica Minolta v Applegate.

Picking up at 45:

"Mr Wolfson submitted that the more unexpected result X is, the more likely the court will be to find a common accord that it was not intended, even where it is not expressly discarded."

So your Lordship sees the point about unexpected: more unexpected, less likely.

Then in paragraph 46 he goes on to deal with Mr Howard's submissions:

"Mr Howard sought to distinguish those cases on the basis that they were concerned with amendments to pension schemes which raised particular issues as they are neither bilateral contracts, nor voluntary settlements. He submitted that in determining whether a change was intended to be made to a pension scheme the

circumstances may justify starting with an assumption that the parties intended that the existing version of the scheme would be preserved, save insofar as they had made a positive decision to change some provision of it. In those circumstances, if it can be seen from the evidence that the change in question was never discussed at all, the absence of discussion may itself support the conclusion that the parties did not intend to make the change on the footing that the court can assume that if they had intended it they would surely have discussed it."

And of course, my Lord, the crucial point here is the assumption of continuity, if we can describe it as that, which is that you start from the assumption that the existing scheme is going to continue and so the absence of discussion of change is strong evidence that the existing scheme will not be changed.

MR JUSTICE MARCUS SMITH: Yes. Mr Phillips, I understand you say this is an amendment case and that amendment cases are different. Looking at paragraph 46 we see that Mr Howard is suggesting that the test for rectification is to an extent instrument dependent in that one has got, for instance, rebuttal and no one has a unilateral instrument.

MR PHILLIPS: Yes. Can we go to the next paragraph, because

of course Mr Howard lost --

MR JUSTICE MARCUS SMITH: Well, yes, this is what I was reading ahead on, in that Mr Justice Henry Carr seems to be importing the pensions cases as being not particularly distinguishable from cases of mutual mistake.

MR PHILLIPS: Absolutely.

MR JUSTICE MARCUS SMITH: Whereas I must say my understanding was that one had got two streams: on one side the contract where the intention is a mutual one and on the other stream re Butlin where one has in that case unilateral settlement where actually it is far easier to rectify than in the case of a contract. And pensions cases exist somewhere in the middle, correct me if I am wrong, where you have unilateral set of changes to an instrument, in other words the power in the trustee to change the instrument, subject only to the consent of a counterparty, but the consent is to the changes, not a sharing of the intention that creates the change.

MR PHILLIPS: And of course here we have amendments to the notes which --

MR JUSTICE MARCUS SMITH: Which were consented to, yes. That's all I'm --

MR PHILLIPS: Well ... we will show you condition 12,

because it required consent --

MR JUSTICE MARCUS SMITH: Well, indeed.

MR PHILLIPS: -- which in one sense is similar. But one of the things that's going to be interesting and perhaps when we get to the end of the cases we can think about it --

MR JUSTICE MARCUS SMITH: No, I was just putting down a marker that I'm not clear at the moment whether your case is that this is a pure mutual mistake case, ie rectification of contract, albeit an amendment the to a contract, or whether it is moving away, not quite towards re Butlin but some way down towards re Butlin, whether that makes a difference to the test I must apply.

MR PHILLIPS: Yes, well, if one is looking at it on graded scales we do think we are somewhere in the middle, because of the unusual nature of the notes and the fact that this is all internal. But let's have a look and see where we end up on the principles when we have looked at the cases, because in 47 Mr Justice Henry Carr then says:

"I accept that amendments to pension schemes raise the particular issues identified by Mr Howard. I do not accept that the principle is confined to pension cases."

And that's quite important because whilst

your Lordship is absolutely right that the pension cases are of course a body of sui generis cases in that sense, but what Mr Justice Henry Carr says and I respectfully suggest that this survives through the Court of Appeal, is that it is not confined to the pension cases and what he says is:

"In my judgment, the authorities illustrate the proposition that where an important change is made to an existing arrangement between the parties, the absence of any discussion of change may itself be evidence the parties did not intend it. Whether that is true in any case depends on the circumstances."

So what he is saying is, yes this applies in the pension cases, it may apply in other cases, it depends on the circumstances. And similarly to the pension cases here, where one has an amendment of this type for this sort of instrument, I respectfully submit I don't know where on a scale one is going to find oneself, but, you know, the pension cases are material in our submission certainly.

So your Lordship has seen that Mr Justice Henry Carr accepts the broad proposition and then if I can go forward to 158, and this comes under common intention objectively assessed, above paragraph 155, however you will see that this is a case where what the learned

judge did is he assessed the intention on both an objective and a subjective basis, so he looked at both, covering on all his bases and in 158 one sees:

"In my judgment it is very significant that the entire focus of the parties was on filling the gap and that there is nothing in any of the communications between them to suggest that the parties intended in executing the 2016 accession deeds for the parent to go further than required under the 2012 accession funding and security structure. The additional obligations resulted in a fundamental change to that structure. The absence of any discussion about such a fundamental change is in my view convincing proof of an intention not to incur the additional obligations. Had there been such an intention it would have been the subject of substantial discussion between the parties."

And then if you look above 160 you see he moves on to subjective intention and what the judge says:

"Certain of the issues I consider ...(Reading to the words)... these issues are relevant to subjective intention."

So there is a crossover between the two and then if I can move forward to 170, just looking at the conclusions of fact:

"The evidence of the parent's witnesses, which

I accept, is that their subjective intention was to do no more than to provide third party security which had been identified by Allen & Overy as missing and it believed that this was the effect of the 2016 accession deeds. Prior to entering into the 2016 accession deeds there is no evidence as to any internal discussion by any of the relevant individuals concerning the additional obligations. Had any of these individuals been aware of them, given their significance the effect of the additional obligations would have required very careful consideration. In my judgment a mistake was made by the parent as to the legal effect of acceding to the IRSAs and it was unaware of the additional obligations."

So he is saying that had they been aware of the additional obligations, given their significance, the effect of those additional obligations would have required very careful consideration.

Then over the page, "Intention of Barclays", which is just above 174, these are the conclusions of fact for Barclays' intention and the key factual witness for Barclays sought to say he didn't have a particular intention when entering into the accession deeds and his evidence was that he didn't think about what he was doing, he just relied on his advisors. So just looking

at that:

"Mr Braithwaite explained in his witness statements that he did not read in detail the documents that Allen & Overy emailed to him and he did not review the draft accession deeds. He relied on Lathams for advice on whether to sign them on behalf of Barclays as security agent. He was concerned to ensure Barclays had sufficient authority to enter into the accession deed, specifically whether it needed to obtain consent from the lender group. He was also concerned that Barclays was not undertaking onerous or non-standard obligations in relation to whatever security the parent was offering."

And he explained that he presumed that entering into the 2016 accession deeds was in response to some obligation of the parent. And he then picks it up in 176:

"Based on that evidence, Barclays submitted that even if the parent did not have an intention to enter into the additional obligations and made a mistake in so doing, that intention was not shared by Barclays, nor did it make a mistake. As security agent it intended to enter into the 2016 deeds submitted by Allen & Overy."

And that's what I mean when I say that the question your Lordship put to me is very close to precisely this,

because the submission that was being made was that what Barclays intended to do was it intended to execute the deeds, enter into the deeds submitted by its solicitors, Allen & Overy. And then in 177:

"This evidence was clarified during the cross-examination of Mr Braithwaite where he explained that he understood from his communications with Mr Barker that the parent was doing no more no less than putting in place a document to fill the gap in the missing security and that that was the only purpose for executing the 2016 accession deeds. In particular Mr Braithwaite was referred to Mr Barker's account of their telephone call and his evidence was as follows:

"'And would you understand Mr Barker to mean, wouldn't you, that he was going to put a document to fill in the gap of the missing security, wouldn't you?

"'Yes.

"'And that was the only purpose in executing the proposed document, wasn't it, to fill the gap?

"'Yes.

"'Just to replicate what should have happened?

"'Yes'."

What he clarified was that he understood from his communications that the parent was doing no more no less than putting in place a document to fill the gap and

that was the only purpose and again it's nothing about subjectively having to actively apply their mind to the additional obligations. His subjective evidence was that was the only purpose.

Then 182, which are his findings on subjective intention, where he says:

"Since I have concluded there was a common intention ...(Reading to the words)... there would be no basis for rectification."

At 183 your Lordship sees the conclusions and nowhere in those conclusions, if your Lordship is minded just to cast your eye over those conclusions, nowhere does the judge make an express finding of fact that Barclays actively thought to itself "We do not want to accede to the additional obligations" and that is because the law does not require that state of mind in the amendments or quasi amendments context where it can be said that the only intention was to do X. And that's really significant. The evidence as to subjective intention, as Mr Justice Henry Carr accepted, was that the decision-maker only intended to fill the gap and it was not necessary to prove a positive intention not to accede to the additional obligations.

So if your Lordship will permit me, may I go to the Court of Appeal?

MR JUSTICE MARCUS SMITH: Yes of course.

MR PHILLIPS: That is in file 7 at divider 154. My Lord, this is a decision of Lord Justice Leggatt, as he then was. It seems that everybody involved in all of these cases one can say "as they then were". But Lord Justice Leggatt, with whom Lady Justice Rose and Lord Justice Flaux joined, they agreed, and I will start with paragraph 4, if I may.

"The trial judge Mr Justice Henry Carr found as a fact that when the deeds were executed both the parent's representatives and those acting for Barclays understood and intended the deeds to do no more than provide the missing security. However, the mechanism chosen to achieve this was for the parent, by entering into the deeds, to accede to pre-existing security agreements."

And, my Lord, of course your Lordship will be aware that was a mechanism selected by Allen & Overy. The fact it is Allen & Overy is neither here nor there, I should say: the solicitors.

"The effect of acceding to these arrangements was not only to provide the missing security over the shareholder loan but to undertake additional onerous obligations. The judge found that no one involved in the transaction realised before or at the time of

execution of the deeds that this was their effect. The judge also concluded that it was both objectively and subjectively the common intention of the parties to execute a document which satisfied the parent's obligation to grant security over the shareholder loan and which did no more than this. In these circumstances the judge granted rectification of the deeds so as to exclude from their scope the additional obligations."

So that summarises the findings of fact.

Paragraph 8, they then look at Chartbrook and they look at Lord Hoffmann's obiter dictum which your Lordship will be familiar with and paragraph 42:

"The judge found as a fact in relation to each of the parent's witnesses that their subjective intention was to do no more than provide the third party security which had been identified by Allen & Overy, the solicitors, as missing and that they believed mistakenly that this was the effect of the accession deeds."

And your Lordship will note, because this is key, that the finding did not involve a positive intention not to accede to the additional obligations, which of course is the very onerous test that my learned friend asks your Lordship to apply, he just identifies that they had a subjective intention which was to do no more than provide third party security.

Then at paragraph 44:

"On this basis the judge concluded that the parties subjectively had a common intention at the time of execution of the accession deeds to execute a document which satisfied the parent's obligation to grant security over the shareholder loan and which did no more than this. The judge also held that an objective observer would have concluded from the background facts and communications between the parties that they had such common intentions."

So an objective observer would also have concluded that was the common intention.

Then moving on to 51, your Lordship sees there is a heading and I'm not going to go through all of this, this deals with the traditional approach of the courts of equity and they describe the equitable nature of rectification and then moving on through to 78, we get to the pensions cases and if I can just look at 78 and 79:

"The nature of the requirement to show an outward expression of a court can be further brought out by contrasting [interesting] a line of cases involving the rectification of amendments made to the rules of employee pension schemes where the trustees of the scheme have the power to alter the rules provided they

obtain the consent of the employer."

And he then looks at A v P and he says:

"In this situation no agreement between the trustees and the employer is needed in order to effect a change. In such a case it is sufficient to justify rectification of the intentions of the trustees and the employer coincide in that they both independently have the same intention regarding the effect of the amendment. It is not necessary to show that the trustees and the employer had a common intention as a result of communication with each other because the validity of an amendment does not depend on the parties having mutually agreed it only on one having approved what the other has done."

And then the analysis is followed in Gallagher v Gallagher and IBM and this is important. So there is no requirement for an outward expression in the usual sense. I will just show your Lordship he then goes on to deal with tacit agreement and he moves on and reaches his conclusion on the law in 176, where he says:

"For all these reasons ... unable to accept that the objective test ...(Reading to the words)... to share that intention."

And moving on to just 182, he deals with the present case and then he went on to deal with the conclusions, the findings of objective common intention and he looks

at the factors which your Lordship will see in 186, 190 and 191 and then I will just pick up 192:

"It is true that the solicitors did not say in so many words that the parent did not intend to do any more than satisfy its obligation to provide the missing security in respect of the shareholder loan, but as Mr Wolfson pointed out the very nature of the mistake made in overlooking the fact that the deeds did more than this explains why no such express statement was made. Parties entering into contracts do not spell out the fact they lack intentions which no reasonable counterparty or observer would imagine them to have. Rather it was the complete absence of any reference to the additional obligations in any of the relevant communications which in this particular context spoke louder than words."

So in our submission the critical finding in Four Seasons was the no more no less finding, in other words that the subjective intention was to do no more and no less than provide the missing security and that was found to be both Barclays' and the parent's subjective intention; that was upheld by the Court of Appeal and we say that's the test that your Lordship will need to apply.

Will your Lordship give me one moment?

MR JUSTICE MARCUS SMITH: Yes of course.

MR PHILLIPS: My Lord, if your Lordship will indulge me, can I just do the two pensions cases? It is entirely a matter for your Lordship. It is now 20 past 4. I can't do it in ten minutes.

MR JUSTICE MARCUS SMITH: Right. Well, I'm quite happy to go on until half past 4, but that may not --

MR PHILLIPS: Let's see how we get on.

The two pensions cases are significant. The analogy between the present case and the pensions cases we submit is very strong and your Lordship will have noted that my learned friend Mr Arden has said this case has much in common with them. They do not have an additional requirement of outward expression of accord, converging intention suffices and they show an application of the no more no less approach to intention. That's how we would fit it in.

Before I do that, I would like just to take up E4 at page 60. So this is meetings of the noteholder modifications and waiver and that deals with the requirements and:

"The procedures memorandum contains provisions for convening meetings of noteholders to consider matters relating to the notes, including the modification by extraordinary resolution of any provision of these

conditions."

And then further down:

"In addition, a resolution in writing signed by or made on behalf of all noteholders who for the time being are entitled to receive notice of a meeting of noteholders under the procedures memorandum will take effect as if it were an extraordinary resolution."

Then on page 70, which is in divider 5, which is in the written resolution, and if your Lordship looks at the background:

"The issuer has resolved to amend the terms and conditions of the notes and Lehman Brothers SLP3 intends herein by way of written resolution to assent to the modification of the conditions."

So your Lordship sees there's a requirement for a modification of the notes to be assented to and SLP3 by this resolution is assenting to the modification of the conditions and I just draw that to your Lordship's attention --

MR JUSTICE MARCUS SMITH: Yes thank you.

MR PHILLIPS: -- because of course that is similar to the sort of situation one sees in the presentation cases.

So if I could look at Lansing which is at A2, tab 54. It is in the nattily named "Pension Law Reports" and if your Lordship turns to the decision --

and there are bullets, they're not numbered, but it is the bottom two, what I think are 4 and 5, of the decision:

"There is and was no outward expression of accord ...(Reading to the words)... must anyway fail."

And the fifth one:

"On the construction question ...(Reading to the words)... approach to construction ..."

I'm just trying to pick up the relevant point --

MR JUSTICE MARCUS SMITH: It is fair to note this is in fact a summary of the decision, isn't it?

MR PHILLIPS: Yes, I was going to -- because there's limited time, let's go straight -- so paragraph 2, if your Lordship casts your eye over that. It's not a simple amendment case. The rules governing the scheme were replaced in whole.

Paragraph 75, and, my Lord, would your Lordship cast your eye over 75 rather than me read it out and your Lordship will see that it is an egregious case in the sense that there were prizes for the signatories, individual and collective irresponsibility and so on.

(Pause).

So against that background could I ask you to turn to paragraph 136 where we can see what Mr Atherton's, as he then was, submissions were. So at 136:

"Mr Atherton submits that the fact that the question of concern ...(Reading to the words)... reliable record of precisely that."

So your Lordship sees that when one was trying to identify "no more no less" what it is that the trustees actually intended to do, they didn't have the evidence to actually answer the question.

Then two more paragraphs, 148 and 149. In 148:

"It is a document running to 160 pages involving a consideration ...(Reading to the words)... sought an explanation about it."

Then 149:

"In the circumstances I regard it as unattractive ...(Reading to the words)... even as regards its position in relation to the deferreds."

Now, your Lordship might recognise this as my learned friend Mr Beltrami's second criticism --

MR JUSTICE MARCUS SMITH: Yes.

MR PHILLIPS: -- of our case, namely that Ms Dolby signed whatever was put in front of her and we are simply not in that sort of territory. It's not what she said in evidence, it's not what -- she is not someone who did things wholly blindly and, as your Lordship has seen, Mr Justice Rimer was at pains to point out the slightly unusual circumstances in the Lang case and, my Lord,

that of course is relied upon heavily by my learned friend.

I promised to stop at this point. My Lord, can I just very very quickly tell your Lordship where we are.

MR JUSTICE MARCUS SMITH: Yes of course.

MR PHILLIPS: We will finish at or around lunch tomorrow, hopefully before. I've got to do release, I've got to consider how to deal with partial release and I've got to deal with discounting and I'm in discussion with my juniors about the most efficient way of doing that, but your Lordship will appreciate we have covered a huge amount of ground today. I would be hugely grateful if we could start at 10 o'clock again tomorrow, my Lord.

MR JUSTICE MARCUS SMITH: Any --

MR BELTRAMI: My Lord, no objection to 10 o'clock. I do hope we can finish at lunchtime because obviously I would quite like to come out the following side and that is the timetable.

MR PHILLIPS: I know. I'm completely alive to that and that is my intention, absolute intention.

MR BELTRAMI: I was sure it was, but I just wanted to ...

MR JUSTICE MARCUS SMITH: Well, we will say 10 o'clock tomorrow morning, but I think you should take lunchtime as a fairly firm time for --

MR PHILLIPS: I will do that, my Lord.

MR JUSTICE MARCUS SMITH: I have in mind that whilst you have a great deal to cover, that is also true for others I'm afraid.

MR PHILLIPS: Absolutely, my Lord.

MR JUSTICE MARCUS SMITH: Thank you very much. 10 o'clock tomorrow morning.

(4.30 pm)

(The hearing adjourned until 10.00 am on Wednesday, 20 November 2019)

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