Wednesday, 8 February 2017
(10.30 am)
Closing submissions by MR ATHERTON
MR JUSTICE HILDYARD: Yes.
MR ATHERTON: Your Lordship does not need to look to horrified. Yes, it is me.
MR JUSTICE HILDYARD: I think I just have a horrified face.
MR ATHERTON: I am grateful for that indication.
I think it falls to me to go first by way of reply. I hope your Lordship has received something in writing this morning.
MR JUSTICE HILDYARD: Yes, I have. I would not pass a test on it. I have flicked through it.
MR ATHERTON: It is really intended for your Lordship's reference after today. I propose to through it quite quickly because I indicated to Mr Trower and my learned friends that I will try and only take 45 minutes, but everything I need is either in this document or cross referred to in the materials that are referred to. So I will only try to highlight what I consider to be the more important points.
I accept that it is not necessarily restricted to a reply. It is for these reasons. First of all, I indicated to your Lordship that I would give your Lordship some cross references which I didn't give you,

so they are in there.
Secondly, it's an attempt to deal with areas where your Lordship has maintained a concern about a particular issue throughout everyone else's submissions; and insofar as I am able to assist, I have sought to do so.
Thirdly, the points made relate to a point which I believe Mr Trower will be making, relying on Mr Justice Vinelott's decision in the Maxwell Communications case. So that is hopefully a fair explanation of the documents. By way of introduction at the beginning of the document, we set out how we see the three issues on which we have been making substantive submissions inter-relate, but I think I can leave that. I do not need to elaborate upon that any further.
Then if we could go to page 3, my Lord, this deals with issue 1. We refer to where these matters were dealt with by way of oral submission in the course of the opening I made. Then in relation to contractual interpretation, I have given your Lordship the specific references to the paragraphs in the authorities which I am most concerned with, so Rainy Sky, Arnold v Britton -- which for some reason, no doubt by reference to Rugby School, I continued to call Arnold v Brown

during my submissions.
Thirdly, Chartbrook, and this was the point I did make to your Lordship but I didn't the reference, which relates to our argument about the use of the word "solvent" and "solvency" in clause 5. The two references there are to the speech of Lord Hoffmann at paragraph 17, rather than 16 as referred to in the transcript. Then a paragraph from Lord Walker along the same lines over the page at page 4, at paragraph 94 of the report of Chartbrook.
Then at (v), again I think I made these points in opening, but they are really to support the submissions that Mr Marshall was making as regards the question of interpretation of the contract; namely that one does have to have regard to the regulatory regime in which this contract sits. That was accepted by Mr Justice David Richards at first instance.
Secondly, there was no consideration by anyone within the Lehman group as to how any of this would operate in an insolvency, and the reference there is given to the judgments of Mr Justice David Richards.
Thirdly, a submission I did make and which Mr Marshall made, which is that there is no particular thought given to the fact that LBIE was an unlimited company, and I think it is fair to say there was also an

assumption that everyone proceeded on; that LBIE was just like any other company, essentially limited in terms of its incorporation.
Then at paragraph 10 onwards under the heading "Relevance of the contributories' insolvencies", essentially we rehearse there the nature of the contingencies which all the relevant claims are subject to, and essentially for the purpose of dealing with the case referred to at (v) on page 5, which is referred to in our outline submissions in writing but which I did not develop in the course of my oral submissions in opening to your Lordship. Therefore, I just wanted to bring it back into some form of focus for your Lordship's consideration.
The point we get at there is this: it is one thing to say, well, we can return LBIE to solvency in the context of clause 5 by reference to the claim of a liquidator for a call against its members. We have dealt with that already as why that is not within clause 5. But equally, it is not possible to say that it is possible to bring LBIE back into solvency for the purposes of clause 5 by reference to the claim of the administrators through proof in respect of the putative call by a liquidator.
The reason for that is first for the same reason

that we give in relation to liquidator, it is simply outside the scope of the provision. Secondly, because plainly the claim of the administrators in respect of a putative call under section 74 in liquidation is contingent. And assuming for these purposes that that claim or its fruits may constitute an asset, we say certainly at this stage in the proceedings it is a contingent asset; and in those circumstances, a contingent asset is not ordinarily used as part of the calculation of whether or not a company is solvent or insolvent. It is simply irrelevant.

I will not take you to the report, but I will explain the circumstances of Rococo because they are to some extent revealing --

MR JUSTICE HILDYARD: This is Rococo?

MR ATHERTON: Yes, my Lord, and the reference to the authorities bundle is set out in the submissions. Essentially, if you go over the page to page 6, you will see it is Lord Justice Lewison, where he essentially says that a contingent asset is not something which is taken into account in determining whether or not a company is solvent in the context of an insolvency type claim.

In that case, what was happening was a liquidator had brought claims for preferences that had allegedly

been procured by the directors of the company, and of course for those purposes, the preferences were according to the liquidator given at a time when the company was insolvent. And that is the relevant time by reference to section 123 of the Insolvency Act 239 and 241.

Now in defence, the directors said, oh, but the liquidator has a claim for the recovery of an unlawful dividend, and if you take account of that unlawful dividend and put it in the balance sheet of the company as an asset, it means that the company was not insolvent at the time it gave the preferences, and therefore the statutory requirements to bring such claim are not met and as a consequence, the liquidator should fail.

What the Court of Appeal held was by reference to the Chancellor, Sir Andrew Morritt as he then was was that such a contingent asset cannot been taken into account for the purposes of determining or seeking to ascribe solvency to the company in that context.

And for your Lordship's note, the Eurosail case is also in the authorities bundle. That is at bundle 3, divider 88. For reference, if your Lordship could look at the headnote at some point, and also paragraphs 37 to 43 of Lord Walker's speech in that case. There, he

essentially affirms and concurs with the reasoning of Chancellor Morris at first instance in the Eurosail case. Again for your Lordship's note, we deal with this point at paragraph 34 of our written outline submissions.

We say that is a good illustration of why, if one was seeking to rely upon the contingent claim of the administrators as causing LBIE to fall within the provisions of clause 5 of the sub-debt agreement, it simply does not operate in that way.

Then my Lord, issue 3 we begin dealing with at the bottom of page 6. Here again, it's just an attempt to clarify the position which I think your Lordship quizzed me upon during my opening and you have also addressed in questions to Mr Arden.

We say that when a company goes into liquidation, the regime by reference to which calls are made is exclusively that as provided for under the Insolvency Act, principally section 74 and section 150. We say one can garner that from the decision of Mr Justice David Richards at paragraphs 134 to 137 and 214 where there is the citation of the ex parte Branwhite case.

We say the same is apparent in Re Pyle Works, which is tab 49A of the bundle at those references. So it does not matter whether you have existing unpaid calls

on unpaid capital, whether in respect of a limited company or an unlimited company, the regime for calls in respect of such liabilities is by reference to sections 74 and 150. And of course therefore, in particular by reference to the terms of those provisions, for the purposes for which calls can be made, namely to ensure that the assets of a company or the funds available to the company are sufficient to pay its debts, and such as are necessary by reference to the wording of section 150 of the Insolvency Act insofar as they are necessary to pay the liabilities of the company, expenses and any adjustments as between the members.

Your Lordship, I use the phrase in paragraph 14 that they are capped. Of course in a limited company, the liability of the contributes is capped at the amount of the capital, the nominal capital, which is unpaid. In the context of an unlimited company in liquidation -- because it is only a liquidator that can make the calls against shareholders in an unlimited company -- their liability is capped by reference to the specific provisions and the terms of section 74 and section 150.

Then we develop that in paragraph 15. There --

MR JUSTICE HILDYARD: I am so sorry, Mr Atherton. I understood you just now to have said that

the liability of members of an unlimited company is capped prior to insolvency by any amounts outstanding, any nominal amounts on their shares.
MR ATHERTON: Yes, because one could have unpaid capital in the context of an unlimited company. So outside a liquidation, that capital could be called by a director. However, assuming all the capital is paid up in an unlimited context, calls can only be made by the shareholders by a liquidator in a liquidation.
We say the parameters in respect of which the liquidator can make calls is determined by the specific terms of section 74 to ensure it has sufficient assets to pay its liabilities and, section 150 insofar as it is necessary to allow the payment of the liabilities, the cost of winding-up and the adjustments.
So we say that is the regime that is applicable. We say by reference to the cases in paragraph 50, which again was a point made to your Lordship in opening, but this gives the specific cross-references. You can see --
MR JUSTICE HILDYARD: On that footing, an unlimited company prior to any insolvency is really very much like a limited company?
MR ATHERTON: Yes, yes, correct.

MR JUSTICE HILDYARD: It is so odd, isn't it, because an unlimited company can reduce its capital in any way it wants. Why is that? Why are there differences in this way?
MR ATHERTON: I am not sure I can answer that, my Lord, to be perfectly honest. Of course, the protection for creditors arises from the ability of a liquidator to make calls against members up to the amount necessary to ensure, insofar as possible and the means of the contributees is available, to allow for the payment of those liabilities, the winding up expenses and any adjustments.
We say that is borne out by the citation of the authorities in paragraph 15. For example, the Contract Corporation which was a limited company --
MR JUSTICE HILDYARD: One of the reasons I ask the question is looking at it possibly in excessively economic terms, you might expect assets to mean those rights and properties which creditors can look to for their satisfaction if necessary at the end of the day.
MR ATHERTON: Yes.
MR JUSTICE HILDYARD: And one might expect therefore, given an unlimited company can reduce its capital, that they are really being invited to deal with the company on the footing that capital includes the calls against

the shareholders.
MR ATHERTON: I think it may be that the labelling of whatever this at this stage inchoate right is is perhaps if not misleading, then unnecessary.
One only needs to go as far as, we say, Mr Justice David Richards went, and that it creates an asset which is available to the liquidator for the purposes of discharging the liabilities in the winding-up and any subsequent adjustment. When I say liabilities, I include the winding-up costs.
So there isn't any issue or obscurity in that regard. It creates, as we say in a subsequent paragraph, a fund, or the putative right will create a fund which will effectively operate as an accretion to the statutory fund available to creditors against which they can prove and through which the liquidator will discharge the liabilities, expenses in the winding-up and any adjustment necessary for the shareholders.
MR JUSTICE HILDYARD: I quite understand the point. I think you are emphasising that you would not yourself, if there is a choice in the matter, go along with Lord Justice Briggs' analysis.
MR ATHERTON: Correct, yes.
MR JUSTICE HILDYARD: You would prefer to rest with what Mr Justice David Richards actually said and

Lord Justice Lewison's possibly different emphasis.
MR ATHERTON: With the concurrence of Lord Justice Moore-Bick.
MR JUSTICE HILDYARD: Who agreed with everybody. Yes.
MR ATHERTON: So that your Lordship knows where we are coming from, our interpretation of clause 5 of the sub-debt agreement does not, by reference strictly to that interpretation -- whether or not the right of a liquidator is an asset to make a call and the fruits of that call is an asset of the company is arguably irrelevant.
MR JUSTICE HILDYARD: I understand because you say insolvency in effect, putting it very broadly, means pre-liquidation solvency.
MR ATHERTON: Indeed, indeed.
MR JUSTICE HILDYARD: I understand that. By way of question for all of you, I blinked but no more at the cases to the Supreme Court yesterday and I noticed that in Mr Miles' submission in his case, there was quite a detailed treatment as to the nature of the section 74 right, where he made broadly the same point as you and naturally Mr Arden, whose role he was then undertaking as I understand it, as you are making now.
Now is that a matter for direct decision in the Supreme Court, or is it a matter one cannot

necessarily tell because they may or may not reach their decision without it?
MR ATHERTON: I think the answer is the latter. I think for present purposes -- and again, of course, if your Lordship is delaying judgment until such time as we see what the Supreme Court say, I am entitled to say that the Court of Appeal have found that the right of a liquidator, either the right itself or the fruits of that right, is not an asset of the company.
For present purposes that matters, because we say you take it in two stages. First, our interpretation of clause 5 is independent of that issue, but secondly, if one has to analyse that position because it is not an asset of the company, that serves to buttress the submission we make on interpretation.
Then at paragraph 16, we cite Re Pyle Works and Re Mayfair Property. We say by reference to the references -- could I just correct a reference to Mayfair Property in the bundle so your Lordship has the correct reference? It is authorities bundle 2, tab 52A, not 49A. Over the page.
MR JUSTICE HILDYARD: Yes, thank you.
MR ATHERTON: The significance of those cases is that in relation to Re Pyle, that was the decision which Lord Justice Lewison was relying upon for his

conclusion. We say that the analysis in Mayfair Property company -- again, I will not take your Lordship to it, but you will see from those references that what is essentially held there is that any right to call for or to make a call and the proceeds of the call in respect of an unlimited company is not an asset of the company.
It is neither capital nor an asset because it can't be charged, it can't be used as an accretion to the general assets of the company for the company's purposes. And Mayfair Property was an interesting case because it was where there had been some glitches in relation to the 1862 Act, I think. So what was allowed was that when an unlimited company re-registered as a limited company, you could reproduce the protection for creditors by stipulating that certain capital, unpaid or otherwise, could only be realised by a liquidator for the purpose of liquidation and the payment of creditors. So essentially reproducing the unlimited status at least in that regard to that aspect of the uncalled or unlimited capital of the company.
The court was perfectly plain there, saying it can't be charged, and all the hallmarks of an asset of the company were absent in relation to that type of arrangement. So we deal with that in paragraph 16.

Paragraph 17 is a slightly different point.
There is -- and I think I have to accept, if I can rely on elements of uncertainty in my favour in the Court of Appeal -- I have to accept that the Court of Appeal found, as did Mr Justice David Richards, that by reference to section 80 of the Insolvency Act, the contingent claim that the administrators have been found to be able to bring in respect of a future call by a liquidator is a claim in respect of which the company must be characterised as a creditor. The reason for that is, as was explained by Mr Justice David Richards, I think at paragraphs -- it is not in there in error: 141 to 143, but you have the references to where the Court of Appeal deal with it -- on the basis that otherwise it might be not possible for a proof to be placed within the insolvency of a contributory.
We say, well, that is fair enough insofar as it goes. However, that characterisation of the company as a creditor for that particular purpose or for that rationalisation is not determinative of whether or not the corresponding claim or fruits of a claim are an asset of the company. That aspect is really a construct deriving from section 80 in order to plug the gap which Mr Justice David Richards said needs to be plugged in order to ensure that any call could be made in

the insolvency of the contributories where there was one so that the right or the ability to recover not be lost.
The identification of a creditor it does not automatically follow, we say, that the corresponding claim is an asset. The characterisation of the creditor is merely the vehicle which allows the officeholder to ensure that the company and its creditors do not lose out insofar as its contributories are in an insolvency.
And the nature of the claim or the fruits of that claim is as Mr Justice David Richards described. Of course he said, yes, the company must be a creditor. He does not then say the claim which is to be brought or its fruit are an asset. He simply says it is an asset available to a liquidator.
So in my submission, Mr Justice David Richards was not troubled by the potential gap or lacuna between finding a creditor and necessitating a determination of a claim which the creditor has of being an actual asset of that creditor. It really was a means to an end, in my submission.
MR JUSTICE HILDYARD: Would you see a difference -- take the case of another right available only to a liquidator such as you instance in your initial submissions, I think. For example, a claim for preference or wrongful trading, whatever it was. Would that be

different?
MR ATHERTON: This, I think, is the interesting dichotomy. Once one is in the situation where the claim by a liquidator for a call can be treated as contingent in an administration and also by directors -- that was the logical corollary -- then the question is if you have a potential preference in a liquidation, then presumably that is a contingent claim which could be brought by the directors.
That analysis must apply, applying the analysis in the Court of Appeal. Where I think the analysis falls down of course is that the contingency is so remote or may be so remote that you would value that contingency at nil. It does not really have any life of its own.
MR JUSTICE HILDYARD: That would depend upon the circumstances.
MR ATHERTON: Indeed, but I think that analysis must follow through. What implications that has for that type of claim; preference, undervalue, wrongful trading, in my submission is not clear. Certainly it is possible to reproduce, for example, an undervalue claim and a preference claim by reference to breaches of fiduciary duty by the misfeasant director.
MR JUSTICE HILDYARD: One's instinct is that there is a difference between a contractual commitment and an

exposure. Shareholders in an unlimited company do definitely give a contractual commitment to stand by the company to the last farthing.
MR ATHERTON: That is right. But it is only enforceable --
MR JUSTICE HILDYARD: Does it really go to enforceability? It is a right which can only be called in circumstances where the only person who could call it is in fact a liquidator.
MR ATHERTON: But equally you might be able to apply the same analysis to the inchoate claim in respect of a preference.
MR JUSTICE HILDYARD: That is what I am wondering about. Because the one who operates in contract is a deferred or prospective liability. The other is an exposure to claims of a given statutory variety. It feels different, doesn't it? I do not know. It feels different to me.
MR ATHERTON: There is plainly a qualitative difference. Whether or not for the purposes of this analysis one can rely on that distinguishing feature ...
MR JUSTICE HILDYARD: It is almost like liability due and payable, do you see what I mean? It is due. It isn't payable until enforced by the liquidator.
MR ATHERTON: That is right. And that chimes with a submission I made to your Lordship in opening, which

is at the point of insolvency, at the point of liquidation or in the case of an administration, the point at which it becomes distributed, then claims become due under the valuation provisions in the insolvency rules at 281 and 285. They become due and therefore that is why you have to estimate their value, both contingent liabilities and unascertained liabilities and prospective liabilities.
MR JUSTICE HILDYARD: An unlimited shareholder may be due all along, just not payable until a given event and until quantification.
MR ATHERTON: I accept that. That does not necessarily, if I can put it this way, break the circle of reasoning.
My Lord, then I was going to deal with the valuation of the inbound claim --
MR JUSTICE HILDYARD: You say in the last sentence -- leaving aside anything that may or may not be said by the Supreme Court -- the analysis of Lord Justice Briggs forms no part of the ratio decidendi, which means I can look at it and pass on, can I?
MR ATHERTON: That is right. That is in relation to the claim and the fruits being an asset. We say you rely on Lords Justices Lewison and Moore-Bick, and whatever Lord Justice Briggs said, with respect to him, was not -- and I made that submission in answer to your

Lordship's question in opening --
MR JUSTICE HILDYARD: Yes, you did. Yes.
MR ATHERTON: Then if I could go to the valuation of the inbound claim. Here, what I have sought to do is -- if I can put it this way, this issue seems to have been troubling your Lordship.
MR JUSTICE HILDYARD: This is Alka-Seltzer to my worry.
MR ATHERTON: Yes. Hopefully it won't make your Lordship feel worse. We say there are, as set out in Goode at page 9, this was the origin of the nil valuation. Because when then counsel for LBHI2 was making submissions to Lord Justice Lewison, this was the reference he made to Goode and dealing with the nil valuation. There is also a reference in Goode, the footnote in that particular extract, to the fourth addition of Fuller on Borrowing: Law and Practice.
We have set out the corresponding paragraph in the fifth edition. Then your Lordship will see extracts from three Australian authorities, all of which were dealing with subordination and all of which say that the appropriate valuation where there is the contingency is to value the inbound claim at nil.
So we would submit that that should give your Lordship some comfort and support for and perhaps an indication of where Lord Justice Lewison got his nil

valuation from. The important point for issue 3 is this: if the sub-debt claim, the inbound claim, is to be valid at nil, then by reference to the parameters of section 74 and section 150 of the Insolvency Act, the outbound claim must be nil. Because you cannot bring a claim simply for the purposes -- and we say this is essentially the consequence of what the administrators are purporting to do here -- simply to swell the assets of the company beyond what is necessary or sufficient to pay its liabilities.

MR JUSTICE HILDYARD: None of these are in the context of an unlimited company.

MR ATHERTON: No, my Lord, they are all limited companies.

MR JUSTICE HILDYARD: One has the feeling of cart before the horse to some extent -- or chicken and egg -- which is in order for the court to be satisfied in any given jurisdiction the subordination has worked, it has to say nil, because otherwise it has not worked.

MR ATHERTON: That brings me on to essentially -- if we can pause on paragraph 23, I do not think Mr Trower is making this point. We are now into the territory of Maxwell Communications, towards the bottom of page 10. Mr Justice Vinelott concluded in that case that the liabilities were not contingent.

First of all, we say the nature of the subordination

in this case is different so that reasoning wouldn't apply. In any event, we doubt very much whether or not, with respect to Mr Justice Vinelott, that the analysis is correct.

In any event, what your Lordship has just been alluding to brings us into the realms of paragraph 63 of LBHI2's written opening. Your Lordship will remember that this manifested itself as part of an iterative process, a test of the case theory of LBIE to the effect that the inbound claim could be valued at nil but that had no consequence or effect on how one was to value the outbound claim, the contribution claim, from LBIE to LBIH2.

If you remember, the analysis in paragraph 63 was if you have a proof -- what I would refer to as an omnibus proof against LBHI2 -- ie one that took into account the amount that was necessary to clear prior ranking liabilities and the balance of the amount which was necessary to clear the subordinated debt, then if the consequence of that omnibus claim or omnibus proof was that the dividend paid by LBHI2 was sufficient to pay prior ranking liabilities, then we say the correct analysis put forward by LBHI2 is that there would then have to be -- because there would then be a set-off, there would have to be a repayment of the dividends that

should have been paid, because they should not have been paid because the contingencies have not been met.

Our alternative analysis is that you deal with that on the logically anterior position. When you put your proof in and LBHI2 work out what the dividends are, then you work out it will be sufficient to discharge prior ranking liabilities. You don't actually have to recover any repayment of dividends because the analysis would result in the fact that there is a set-off of the cross-claims, reducing them to a nil balance, and therefore the prior ranking claims can't be paid.

Now we endorse the test put forward by LBHI2 and, as I say, accords with our analysis as to why the position in relation to that put forward by LBIE simply cannot be correct. The further point -- and this is where we get into the question that your Lordship was about to posit -- in the context of subordination what happens when, as here, the issue of set-off raises its head?

Now I am assuming -- it is more than an assumption because Mr Trower was kind enough to indicate to me why he was relying on Mr Justice Vinelott's decision is because I think LBIE are going to say that following on from the Maxwell Communications case, one can have as a matter of English law subordination. We don't disagree with that but they will say that our reliance

upon the National Westminster Bank v Halesowen case goes too far.

Mr Justice Vinelott's analysis in Maxwell was: I am not bound by that case because the dicta, notwithstanding it was the House of Lords, was that dicta. But more importantly, it was dealing with the inability to contract out of the set-off provisions. What Mr Justice Vinelott was concerned with was the ability or otherwise to contract out of the provisions which required pari passu distributions to creditors and essentially came to the conclusion that Halesowen didn't deal with that and therefore he was free to say -- to read down in effect the pari passu provisions to allow for subordination to take place.

In the course of his judgment, he noted that there was a substantive difference between the policy that might lie behind the mandatory nature of set-off and the policy behind pari passu, and there were very good reasons why you shouldn't be able to contract out of the set-off provisions.

We are not into the pari passu incident here. We are into straightforward can you contract out of set-off because the justification of LBIE to say why the analysis of the administrators of LBHI2 and the administrators of LBH are wrong, because of

the set-off provisions or the preclusion of set-off in the sub-debt agreement. We say insofar as you have a subordination clause which brings you into conflict with the preclusion from the inability to preclude insolvency set-off, we say subordination has to yield. It is as simple as that.

That we say makes perfect sense. It is entirely orthodox, not least because one creates or one can create subordination in a number of ways which does not fall foul of or create any tension with set-off. So for example, you have -- as was explained in the extract from Fuller and to an extent from the extract in Derham which we referred to -- one can have subordination through the operation of a trust where the proceeds of any proof by --

MR JUSTICE HILDYARD: This is a turnover?

MR ATHERTON: Indeed. One has a turnover and then one might have a turnover of trust arrangement. But the pure turnover may not solve the problem. The trust will because there is no mutuality in the set-off. Equally, you could have subordination created by an agreement not to exercise your right of proof, a waiver of proof.

I think this is an issue which may be up for grabs in the Supreme Court --

MR JUSTICE HILDYARD: That was a difference between

Mr Justice David Richards and the Court of Appeal, I think.

MR ATHERTON: That is right. The reason being that if you waive your right to prove because your claim is not provable, it is not susceptible to set-off. So one can see as a matter of reality there are ways to achieve subordination.

My suggestion is not antithetical in the sentence that I am doing down subordination completely. I am simply saying that where you have a situation as here, where although there is a subordination clause and the operation of set-off would compromise that subordination, we say that is just the way it works. Set-off is mandatory and the particular provisions are not vital enough in order to maintain the subordination in that context.

Now if your Lordship goes to paragraph 28, you will see we refer to Derham there. Derham takes a different view, but the learned author accepts that there is no authority in support of the view that set-off should yield to subordination. We say that is true up to a point. In support of our analysis, we have NatWest Bank v Halesowen and Stein v Blake to say that set-off is mandatory and cannot be contracted out of.

By way of a little bit of background, the question

of whether or not the Halesowen rule, if I can put it that way, should be maintained was considered by the court committee in the 1980s and they concluded that the law should be changed -- by that they meant that statute should intervene -- to overturn the result of Halesowen. My submission is what that means is that Halesowen accurately reflects the law that you cannot contract out of mandatory set-off.

Your Lordship if you like may not find those submissions terribly helpful in the sense of providing your Lordship with an exit route. But we say what this analysis does do is expose what the right answer. This is why Lord Justice Lewison valued the claim, the inbound claim, at nil. Because by doing so you avoid the tension or potential tension between the subordination provision and the desire to maintain that subordination and the inability to contract out of set-off.

So by giving the claim a nil value, you are acknowledging as part of the contingency, if you like wrapped up within that, the fact of subordination. We say that that analysis is also the basis upon which either expressly, or perhaps more particularly but accurately, implicitly the Australian decisions came to the same conclusion; that by giving a nil value, it must

be the position that you don't then create this tension between subordination and set-off.

MR JUSTICE HILDYARD: It is slightly reverse engineering though, isn't it? You say, well, now what I have to do is get to nil. It looks like a contingency which is subject to all sorts of valuation issues. It would be far more neat if I did not enter into them and I said nil, then we can all go away happy. It is not particularly logically satisfactory.

MR ATHERTON: I would like to think I was being slightly more sophisticated than that in this sense; that what your Lordship is doing is looking at the nature of the contingency and that carries with it the fact that it is subordinated. So you factor that into the determination of the contingent right.

That then does allow you to give it a nil value. In any event, leaving aside subordination, you can properly consider, as the Australian authorities do, that the right is so contingent it should be given a nil value.

This then goes to the binary point. It is all or nothing, and therefore until such time as -- because it is not as I said to your Lordship a continuum of a type of contingency, it is one thing or the other, then it is more easy to rationalise the situation as

regards giving it a nil value.
In addition, the alleged binary nature of the contingency also, we say, makes it plain as to how this should operate as a matter of reality. As I said in opening, the administrators are required to take an account.
If on any extrapolation it is binary, so it is either nil and nil -- in which case they don't fall into the set-off account because the contingency has not arisen -- or because it is binary, it is full and full, zero net balance and the thing is absolutely set-off.
Or even if we were wrong in determining that it was binary because of the parasitic nature of the debt, at any level of a continuum or by any reference to a statistic, the debts will always cancel each other out.
That logical analysis and principled analysis we say conforms to what the reality is.
MR JUSTICE HILDYARD: Do you mean the net value will always be nil?
MR ATHERTON: That's right, there is no net balance. So you either don't place it in the set-off account because both claims are nil, or if you do, you can't put one in and not the other in terms of giving an estimate.
We say that is in effect what LBIE has done. They have

given the contribution claim a value of, let's say, $1.3 billion. That must equate and equiparate to the value of the inbound claim of $1.3 billion.
We say that analysis is logical, principled and therefore undermines what we say LBIE is trying to achieve, or the approach that LBIE has taken in relation to the inbound claim and the outbound claim.
MR JUSTICE HILDYARD: That is helpful, even if the lesson might be to a draftsman: for goodness sake, exclude the right of proof.
MR ATHERTON: We say if your Lordship came to that conclusion, it would be in no way heterodox or novel. It is entirely an application of the relevant principle.
Slightly over, those are my submissions, my Lord.
MR JUSTICE HILDYARD: I am very grateful, thank you.
MR ARDEN: Your Lordship had a note in the form of a summary from us this morning.
MR JUSTICE HILDYARD: That is very helpful.
Closing submissions by MR ARDEN
MR JUSTICE HILDYARD: The same applies, I am afraid. It was quite a quick read to see the lie of the land, but I am not able to tell you where the cities and rivers are.
MR ARDEN: I am not going to speak too much of it because most of it is not new. It constitutes a summary of the argument to date.

MR JUSTICE HILDYARD: Yes, that is very helpful.
MR ARDEN: That observation applies in relation to section A, which deals with issue 3. Section B, that is our case on issue 3, 5 through to 8. Then LBIE's answer and our answer to the answer which is paragraph 9.
So that is simply a summary and there is nothing new in that. My Lord, if I can leave aside section D for the moment, the same applies to issue 7 which we deal with very shortly at paragraph 13. My Lord, again, there is nothing new there. It is simply a summary.
MR JUSTICE HILDYARD: Yes.
MR ARDEN: My Lord, that leaves section D. We there deal with essentially the same subject matter that Mr Atherton has covered as part of the submissions that he has just made. We thought we should deal with it because it was one of the points your Lordship raised on a number of occasions, principally in questions directed to Mr Atherton on the clause 5.2 point. But it is a point which arises generally in particular in relation to issue 3.
Your Lordship raised a point about the Supreme Court and the statements of case. My Lord, this point and the authorities that relate to the point, and in particular Pyle Works and Mayfair Property are all relevant to at least two of the issues that are before

the Supreme Court. The first is as to the nature and extent of the liability under section 74; how far does it go and does it extend to statutory interest and then on to unprovable liabilities.
The second is as to whether or not the LBIE administrators can prove in respect of a contingent liability under section 74. So if one looks -- and I am not going to take your Lordship to all of the references, but if one looks at the judgments in Waterfall I, you can see these two authorities I have just referred to being referred to in the context of both of those issues. Then as I said, when one looks at the statements of case in the Supreme Court, ours as well as LBHI1, you can see these authorities being dealt with. Therefore, the same points arise.
In our submissions, my Lord, we have not sought to persuade your Lordship to take a different view to the view taken by the Court of Appeal on the issues that were before the Court of Appeal. But accepting that we are where we are with the Court of Appeal, there are points that can be made which are relevant to the issues before your Lordship on the nature and extent of section 74 liability. In other words, it is not all closed off, not all dealt with by the answers given by the Court of Appeal to the issues that were before it.

So, my Lord, with that background --
MR JUSTICE HILDYARD: In the Supreme Court, is the analysis of Lord Justice Briggs that the contribution call, whatever it extends to, is an asset of the company, considered to be a point which has to be disposed of in order to assess the decision made in that context by the Court of Appeal as a whole.
MR ARDEN: My Lord, I can see how it might not need to be dealt with. If one looks at Lord Justice Lewison's judgment, he says it is not an asset of the company, but nevertheless the company is a creditor. In that respect, he agrees with Lord Justice Briggs.
So in terms of provability, one can see the outcome might be that: it is not an asset but nevertheless it is a creditor of the company. But the nature of the company's rights embrace: is it an asset or not. I think for my part, with some diffidence because I was not there, I can see that as part of the overall consideration of say that issue -- is it a creditor, is there a provable debt -- it is difficult to see how one would deal with the second, is it a creditor, without dealing with the first, what is the nature --
MR JUSTICE HILDYARD: That is as it rather strikes me. The Supreme Court has no need to finesse any of these issues, it can deal with them and probably will. But

there we are, that's that, we will have to await what they say. But it does suggest to me that it would be quite brave precedent to simply assume that Lord Justice Briggs' assessment was mere obiter, or not an integral part of his approach.
MR ARDEN: My Lord, I tend to agree. There is a sort of starting point in both judgments: is it an asset or is it not, and the two Lords Justices take different views about that. Then they proceed from a different starting point, but then on the creditor point to the same conclusion.
MR JUSTICE HILDYARD: The Supreme Court may say, look, the answer is what Mr Justice David Richards gave: you can't prove it, end of story. Subordination works in that way. But they may not.
Anyway, we shall see.
MR ARDEN: I think it would be, although one can skirt around this, one can try and navigate a course which enables your Lordship to come to a view on the issues without -- it is fairly tricky, and I think --
MR JUSTICE HILDYARD: At first instance, you have to navigate. The Supreme Court, you can deal with what you want to deal with.
MR ARDEN: That's true. But it would certainly be very difficult for me to say and I certainly would not say.

These sorts of issues, the Supreme Court are unlikely to touch upon the issues that are concerning your Lordship and the points your Lordship is raising on these issues. So for example, the nature and extent of the section 74 liability, and that seems almost inevitable the Supreme Court will have something to say about that which will have a bearing on the issues before your Lordship.
So, my Lord, I respectfully endorse what Mr Atherton has said on this question about the nature and extent of the liability and how it arises in the context of unpaid capital. In the note, we have drawn attention to or made the point that Mr Atherton makes about the position changing fundamentally upon liquidation. Your Lordship will see that at D under post-liquidation, and we have referred to the same paragraphs in Waterfall I that my learned friend has referred to.
We have given three examples of the way in which things change in respect of unpaid capital. One of them is the same as my learned friend, the third, which is that once the company is in liquidation and when you are talking about calls under section 150 in respect of a section 74 liability, it is no longer an automatic call for the whole of the unpaid capital. The liquidator may do that in an appropriate case, but it does not do it, as it were, as a matter of right in

the way in which, for example, a company could do prior to liquidation.
The liquidator has to justify the call by reference to the debts and liabilities, and that is obviously a point I have made on a number of occasions. We give as an example of that, just a single example, it is the Contract Corporation. I am not going to take your Lordship to it, it is one of the cases that Mr Trower took your Lordship to in opening. But your Lordship may remember it was a case of -- the nominal capital was made up of shares of large amounts, I think £100 shares, of which a very small amount had been paid prior to liquidation -- I think about £10 or £20, but some small amount of the nominal capital.
What one sees in that case is estimates being produced by the liquidator of the unpaid debts and liabilities and then the proper amount of the call, which is less than the unpaid capital, being justified by reference to those estimates.
My Lord, that is the section 150 process being gone through. What one sees in that case is the court not disputing that that is the proper approach post-liquidation. It is more to do with the extent to which the estimates can properly be challenged by the members upon whom the calls are proposed to be made.

MR JUSTICE HILDYARD: There may be unfairness between them and the members who paid in full, because it is at that stage that the unfairness arises.
MR ARDEN: My Lord, that is right. You can just see that, that is one example, and my learned friend has given many more in the written note he has taken your Lordship through today; many more examples of that sort of process being gone through in the case of calls where there is unpaid capital.
My Lord, we have added a couple of other examples of this. I do not think I need to take your Lordship to the authorities, they are now in the bundle. Under D1, we have referred to the Welsh Flannel And Tweed case. I am not sure whether your Lordship --
MR JUSTICE HILDYARD: I can't find the bundle, I'm sorry --
MR ARDEN: It is page 6 of the note, D1, "Interest on unpaid calls", and then it is in the footnote.
If your Lordship wants to go to the case -- I am not going to take you to it now -- it is 31A --
MR JUSTICE HILDYARD: Is that 2/31A?
MR ARDEN: It is 1/31A.
MR JUSTICE HILDYARD: Thank you.
MR ARDEN: That is just a case where the Vice Chancellor, Sir Richard Malins name took the view that if a call is made in a liquidation and not paid, as it was not in

that case for many years, you calculate interest not by reference to a rate of interest specified in the articles, in that case it was 10 per cent, but by reference to the general rate which in that case was 5 per cent.
In that case, he declined to follow an earlier decision of his own which did it by reference to the article. So you don't have regard to the articles for interest. Then there is Fowler v Broad's patent. My Lord, this is a case of -- again, the bundle reference here is authorities bundle 2 and it is 47A. Again, I think the summary we give is probably enough for your Lordship this morning; that where uncalled capital has been charged and the company goes into liquidation, the charge is good -- see Pyle Works -- but you enforce through sections 74 and 150. You enforce it by asking the court to direct or order the liquidator to make the call. You can't do it in an ordinary chargees or mortgagees action.
So, my Lord, I am not sure whether that adds to the sum of knowledge, but it may not add much --
MR JUSTICE HILDYARD: Welsh Flannel may be more interesting because it goes to the right rather than the person in charge of the company.
MR ARDEN: My Lord, that is right. My Lord, that is all.

So far as unpaid capital is concerned, essentially I am in agreement with Mr Atherton, the position changes. What was originally a contractual right is now no longer a contractual right, there is substituted the statutory regime.
My Lord, at E then we refer to Pyle Works and Mayfair Property. Both the cases, as your Lordship probably knows, deal with the issue as to whether or not a company and to what extent a company can charge its uncalled capital, and to what extent that then is good in a winding-up. They are in our submission helpful to your Lordship because in dealing with that question in the case of companies with a nominal capital, they contrast that position -- where the outcome in the case of ordinary nominal capital is you can charge it -- they contrast that with the position, the liability of members of an unlimited company.
So in order to decide whether the company can charge or not, in the case of a company with a nominal capital, you have to consider the liabilities of the member and the rights of the company to determine first of all whether it is an asset and then whether it can be charged. But as I said, they then contrast the position with the liability of a member of the unlimited company, whose only liability is to contribute in accordance with

the statutory regime in the event of a winding-up.
Now, my Lord, we have referred to the relevant paragraphs in the judgment exactly in Pyle Works. They are the same passages Mr Atherton refers to. They are the paragraphs set out in the judgment of Lord Justice Lewison in that section of his judgment where he deals with the issue as to whether or not in the case of an unlimited company, the liability is to be treated as an asset of the company or not.
So far as Mayfair Property is concerned, again we have referred to the relevant paragraphs. This is a slightly different case. Pyle Works establishes that the company can charge its unpaid capital. In Mayfair Property, the court had to consider the same question but in relation to capital which under the 1879 Companies Act had been set aside for the purposes or to be made available for the purposes of satisfying the claims of creditors in a liquidation.
My Lord, there a different view was taken in relation to that sort of capital. But again, your Lordship will find there a consideration of the liability of the members of an unlimited company. As I said, and as Mr Atherton says, it is essentially that the liability is simply to contribute pursuant to the statutory scheme, to contribute to the fund that

the scheme envisages to the extent necessary -- if I can then add the King v Tait reference -- to the extent necessary to meet the proper claims against that fund and with the liability being assessed by reference to those claims.
MR JUSTICE HILDYARD: Where? Oh, I see. I have the references in Mr Atherton's --
MR ARDEN: 44A and 52A.
MR JUSTICE HILDYARD: I think Lord Justice Lindley may have been the last person who really understood all of this, because he wrote the book both on partnership and on limited companies, and the crossover was partly because you couldn't have more than ten members in a partnership. So I expect he really may have been able to explain all of this.
MR ARDEN: I have not taken your Lordship to them. I am happy to go through those cases if your Lordship would find it helpful, but they are probably -- they are leading judgments on this, the difference that I am just explaining to your Lordship.
MR JUSTICE HILDYARD: On the status of the capital --
MR ARDEN: Exactly. And they are worth reading together because Lord Justice Lindley, then as Master of the Rolls anticipates in Pyle Works the issue in Mayfair Property and takes the opportunity in Mayfair Property

then essentially to go back and re-analyse, but in the context of a slightly different capital, the issues that he addresses in Pyle Works.
My Lord, can I leave those there? I am happy to go through them if your Lordship would find it helpful.
MR JUSTICE HILDYARD: No, I will read them.
MR ARDEN: In our submission, they are important for your Lordship.
That may be a convenient moment for the transcribers. I am probably about done, but subject to just checking behind me. Perhaps I can do that over the course of the next five minutes.
MR TROWER: Before your Lordship rises for the short break, there is a note that has been circulated amongst the parties about the issues in the Supreme Court and how they impact on today's, which we will hand in. Can I stress, it has been prepared by the LBIE administrators. It has been commented on by people, but it is not strictly speaking an agreed note.
MR JUSTICE HILDYARD: Would you like to defer it until it is an agreed note?
MR TROWER: I think it is in a sufficient form for your Lordship to see it. There is a short counternote from LBL drawing your Lordship's attention to some other points in relation to the Supreme Court. Can I hand

those in?
MR JUSTICE HILDYARD: There was another case on contract which was heard yesterday in the Supreme Court for one day as to whether you looked at the words first.
MR TROWER: Yes. What a surprising proposition.
MR JUSTICE HILDYARD: Yes. Who knows.
(11.45 am)
(A short break)
(11.55 am)
MR ARDEN: My Lord, just two short points but more in the nature of reference or something like it than substantive points.
My Lord, in the context of the Mayfair Property case, I referred to the 1879 Companies Act. That is not in the bundles. It is a very short Act and the relevant provisions are set out in the report, along with the legislative background. Your Lordship will see from the judgments that it was in fact a legislative response to the collapse of the Glasgow bank, which your Lordship has seen some cases arising out of that collapse.
So a response to that, and the ruin that it caused in the Central Belt and essentially, amongst other things, allowed unlimited companies to re-register as limited, creating at the same time a portion of their capital, which was to be simply devoted to the purposes

of winding-up.
So it is all there, but if your Lordship needs the Act, then we can supply it and put it into the bundles at some point, if that would help your Lordship's understanding of Mayfair Property. The other thing I wanted to mention to your Lordship was this. In Pyle Works, Lord Justice Lindley refers to Webb v Whiffen and to the judgment of Lord Cairns in that case, and says he thinks that supports his approach.
Just for the reference, I think the passage he is referring to is at page 734 of the report. It is the whole of the passage which takes up nearly all of the page, and it is a passage in which Lord Cairns deals with the pre-1862 position. So he deals with the liability of partners and then the liability under the precursors to the 1862 Act, and then just starts, "But by the Act of 1862 that state of things is entirely swept away", and then he deals with the liability to contribute to a common fund. I think it is 734. We have not noted it there, but I think that is the passage which is being referred to.
MR JUSTICE HILDYARD: Thank you.
MR ARDEN: My Lord, those are our submissions, I think more in reply to your Lordship than in reply to Mr Marshall. If there are any matters on which I can assist your

Lordship, I would be happy to do so. But otherwise those are our submissions.

MR JUSTICE HILDYARD: No, thank you very much.

Closing submissions by MR TROWER

MR TROWER: My Lord, I understand that Ms Toube has nothing to say in reply, so it is me next. I will be relying on rather more than Mr Atherton and Mr Arden have. Your Lordship has not heard from me substantively since the beginning, so I have quite a lot of issues to cover. But most of what I have to say relates to issue 1 and issue 3. I have one or two points in reply on 7 and 9 but we will not take so long on those, I suspect.

My Lord, as far as issue 1 is concerned, there are three points as we see it made against us. There is a circuity of action point, there is the sub-debt term construction point, which is put as an express term or an implied term by Mr Marshall, and there is the clause 5.2 point. Can I just reply on those in order.

Mr Marshall took you to Farstad, dealing first with circuity of action, and he took you to Carr v Stephen. The essence of LBL's submission is because LBIE has a right to a section 74 contribution against LBHI2, that is a cross claim which gives rise to a defence to any claim under the sub-debt agreements. So he puts it

forward as a defence of circuity of action.

Three points in response to that: 1, circuity of action is a defence which has to be advanced and pleaded. It is capable of being an answer to a claim if brought, but there is no authority which characterises it in any other way. It does not impair the liability unless and until it is raised in proceedings and pleaded.

Secondly, it is therefore unlike insolvency set-off, which is mandatory and takes effect automatically on the relevant date. In the present case, the set-off operated in LBIE's administration with effect from the date of notice of intention to distribute. Thereafter, there is no room for the operation of the defence of circuity of action.

The third point is that wherever set-off provides an answer, whether through the self-executing taking of the set-off account or through the exercise of a contractual right of set-off, there is no room for the defence of circuity because the claim will already have been dealt with by the set-off, which is why the passage from Ginty which is referred to in Post Office v Hampshire, it was said that the situation is usually provided for by the modern provisions of set-off and counterclaim -- I think probably strictly speaking that was part of the second

point.

The third point is a point your Lordship put to my learned friend Mr Marshall, which is that in any event the cross-claim in the present case is not the straightforward indemnity in respect of liability with which Farstad was concerned. It is an obligation to contribute to an insufficiency which may in whole or in part be referable to the inbound claim, but it is not a straightforward indemnity for it.

Now we have not been able to find any case in which there has not been the direct relationship between claim and cross-claim, and the importance of the link is reemphasised in such cases as we have been able to find which deal with the concept of circuity of action generally. We have put three cases in the bundle which are the best cases we could find on what circuity of action is all about. I think they have been inserted into the back of bundle 5 of your Lordship's authorities.

In bundle 5, there are three cases now.

MR JUSTICE HILDYARD: They are new, are they?

MR TROWER: They are new. I am only putting them in for three circumstances in which courts have given, or three contexts in which courts have given crisp analyses of what it is that the defence of circuity of action is all

about.

The first one is the Luckenbach case. I am afraid -- I do not know how they have made it into your Lordship's bundle. I have them in the authorities bundle 5, right at the back. I am afraid they have only just come in.

MR JUSTICE HILDYARD: Yes, that is fine. Owners of the Steamship Susan?

MR TROWER: Yes, indeed. And this is at the very end the of the judgment of the court given by Lord Justice Somervell. It is the last page, 203, where he gives some general guidance on what circuity of action means. If your Lordship would just read from "the expression" down the end.

MR JUSTICE HILDYARD: Yes.

MR TROWER: Then the second case is a case called Brumder v Motornet Services. I do not know which order your Lordship has them in.

MR JUSTICE HILDYARD: I have that, yes.

MR TROWER: The paragraphs that are relevant are in the judgment of Lord Justice Beatson, paragraphs 37 to 40. This is as far as we could discover the latest -- and I am not warranting this, but it was a very recent Court of Appeal description of what Mr Justice Pearson had said in Ginty. And this is the kind of context in

which one normally finds circuity of action arising as an issue. It is paragraphs 37 to 40. (Pause).
MR JUSTICE HILDYARD: Yes.
MR TROWER: That chimes with the critical line in Ginty which was cited in the Post Office case that we looked at before in the judgment of Lord Justice Geoffrey Lane at page 134 of the Post Office case.
"The plea of circuity of action is not usually found in these days ...(Reading to the words)... but is a valid plea."
So there one has the concept of it being a pleaded defence which arises in proceedings where set-off is not relevant.
Then the last case is a case I shall call the Harding case, because I am completely in capable of pronouncing the first word in the title of the case. There are two parts in the judgments of Lord Justice Scrutton and Lord Justice Sankey which your Lordship may find helpful. Lord Justice Scrutton at page 384, and it is a paragraph beginning:
"The learned judge freed from this liability on a ground of not pleaded in a form stated by him of his own suggestion."
He then goes on and discusses what circuity of action is all about on page 385.

There is a further description of circuity of action in the judgment of Lord Justice Sankey at page 391. The very last words on 390:
"I now proceed to the consideration of circuity of action which induced me to decide in favour of the defendants."
He makes the point that:
"Since the Judicature Acts gave facilities for counterclaim and third party procedure, the doctrine of circuity of action has neither been seen as necessary or as frequently resorted to as in former years."
And he then cites from Bullen & Leake and on down.
So what one gets from all of these cases is a strong focus on the emphasis of this is a defence to be pleaded in legal proceedings. That is what it is all about, its name slightly gives the game away. And our respectful submission is that where in the present case you have the operation of a mandatory insolvency set-off, there is simply no room for the operation of the principle of circuity of action.
MR JUSTICE HILDYARD: Having ordered that there should be no pleadings, I am relieved to see that it is not really dealt with only as a pleading point. It is dealt with as matter of substance although in point of fact, Lord Justice Sankey appears at the end to raise

the pleading point, but only as a further thing.
MR TROWER: But the important point is that it is a defence in the context of legal proceedings. It does not matter whether you call it a pleading point or not. I do not understand why my learned friend puts it that way but the point is that it is a defence in that context and there simply isn't room for it once the mandatory set-off has taken effect.
MR JUSTICE HILDYARD: I understand your point. Your point is circuity of action as a defence is that, although a substantive defence, its prerequisite is that the one should cancel the other?
MR TROWER: Indeed and that is if you like the third way of looking at it. That comes through very strongly from some of those cases, that it is a straightforward indemnity over. My Lord, that was all I was going to say on circuity of action. Can I then move on to the term agreement which was put variously as an express term and as an implied term?
Now, it emerged during the course of Mr Marshall's submissions that the express term was the word "repayment". That was the word that we were looking at to see what it meant. So what we understand the position to be is that he says that whenever the word "repayment" is used, it should be read as

"repayment out of own funds in the section 74.2(e) sense".
The first point in response is that where the word "repayment" is used -- and I think we do need to turn up the note of that agreement -- where the word "repayment" is used in line 3 of paragraph 4 of the variable terms, it is used to introduce the terms on which repayment is to be made. That is what it is being used for. Page 5, tab 1, bundle 4.
MR JUSTICE HILDYARD: Page, sorry?
MR TROWER: Page 5, tab 1.
MR JUSTICE HILDYARD: Yes.
MR TROWER: The word "repayment" there is used:
"The terms for repayment are ... "
So that is what clause 9 is doing; it is setting out the terms. Then there are six repayment terms, each of which is itself subject to the restrictions on repayment contained in clause 4.3of the standard terms and the subordination in clause 5 of the standard terms.
We respectfully submit that it is difficult to see how anything else which is properly to be characterised as a term for repayment, which is what a limited recourse would be, can properly be construed into the sub-debt agreement when it is structured in this way. That is the first point. The draftsman has put in

the terms and effectively Mr Marshall is inviting a further term to be put into the words of this section by use of the word "repayment".

The second point is that the ambit of the repayment obligation is at the core of this agreement, that it is fundamental to this agreement and any restriction or limitation on the extent of the obligation, whether derived from a limitation in the source from which a repayment is to be made or otherwise, is something which can't be read into the word "repayment".

We respectfully submit, because there is simply no other indication on the face of the agreement that the source of the repayment was a relevant factor for the parties in describing the obligation to repay.

In particular -- and it is obvious, but it is worth restating -- there isn't anything on the face of the agreement which identifies, refers to or relates in any way to section 74.2(e), or the words used in section 74.2(e) by which all of this is said to have been inspired.

Now, as we understand it, one of LBL's submissions is that it is not surprising not to find express references to a limitation in recourse in the sub-debt agreement because nobody was thinking about unlimited companies when the standard terms were drafted.

I think this is part of some argument about the inappropriate use of the standard form agreement as well. In support of this, Mr Marshall submitted that the use of this form by an unlimited company was perhaps unique. He also said that unlimited companies were not standard borrowers, it was an unusual type of borrower. It was an unusual beast in the modern day world. He said once "such a rare thing", a very rare thing.

I am afraid we simply do not accept that. There is no evidence to this effect. In fact, as may not be that surprising when one considers the US tax reasons that caused LBIE to registered as unlimited: Merrill Lynch, Morgan Stanley, Goldman Sachs, and Credit Suisse all operate in the UK as banks through regulated unlimited companies. Goldman Sachs International has even appeared in Waterfall II as a respondent, your Lordship will recall.

It is also of some significance on this point that the sub-debt agreement itself contemplates that the borrower may be a partnership. If you look at clause 8 of the standard terms, it expressly contains reference to the borrower being a partnership and what happens in those circumstances. So unlimited liability with no limitation on the source from which the liability is to be discharged is therefore something

that is self-evident from the face of the agreement itself as being something which was contemplated.

Mr Marshall also submitted to your Lordship that the EC directive didn't contemplate unlimited companies. Again, my Lord, we don't accept that submission. The EC directive is entirely neutral on the legal characteristics of persons capable of being regulated entities. My Lord will not find that surprising, given the different characteristics which artificial entities have under different European jurisdictions, as my Lord knows.

We can give your Lordship more particulars if necessary. I appreciate that the material is not in evidence, but we are responding to something which is asserted, and we can easily put it in evidence if it is necessary. But to give your Lordship a few examples: in Ireland, the concept of unlimited liability companies is well known. There are at least three credit institutions and nine other authorised firms listed on the Central Bank's register of authorised firms which are unlimited companies. The three credit institutions are Wells Fargo, AIB Mortgage Bank and Bank of Ireland Mortage Bank.

A French equivalent is an SNC and there is at least one regulated bank which is an SNC, Banque Edel.

We also understand there are examples of private banks in Germany which are formed as KGs, which are a form of limited partnership in which some members have limited liability and some of whose members have unlimited liability.

So it is simply not right to say that the regulations pursuant to which these subordinated debt agreements were put in place with the INPRU reference in relation to capital advocacy at the beginning of them are subordinated debt agreements which were put in place against the background of an EC directive which didn't contemplate unlimited liability.

Finally on this area, my Lord, and it is a slightly different point, you asked me whether it was still the case that unlimited liability companies take the benefit of not having to file accounts. I said it was, and that is right for most unlimited liability companies, section 448 of the Companies Act. There is however a specific exception for unlimited liability companies carrying on businesses as banks and for their shareholders, which shows where those unlimited liability companies under section 448 do have to file accounts.

Now that shows two things. The first is that so far as banks which unlimited liability companies are

concerned, one can't say they have taken that particular benefit of unlimited liability because they plainly haven't, and that was the context in which my Lord asked me the question. But I think what I am entitled to submit is that the companies legislation itself had in mind the very fact that banking institutions may be trading as unlimited companies.

We can all go and look at the accounts of CJ Hoare & Co are one of the best known unlimited liability companies which operates as a bank.

MR JUSTICE HILDYARD: Mr Atherton said the differences between limited and unlimited liability companies only came into play in the event of insolvency but the agreement did not contemplate or -- insolvency was not something in the minds of parties to it.

MR TROWER: That may well be right. Your Lordship has what Mr Justice David Richards said on that subject, and it would be surprising if the parties were thinking in a focused way in relation to insolvency in that sense.

MR JUSTICE HILDYARD: But my point is that on Mr Atherton's view of things -- which I would not hold him to -- but on his view of things, the agreement cannot be any different for a limited or unlimited --

MR TROWER: Yes, my Lord, that must be right.

My Lord, the second aspect that I wanted to reply on

in relation to express and implied terms is the regulatory context and the emails in bundle 5 that your Lordship was taken to.

MR JUSTICE HILDYARD: Yes.

MR TROWER: As we understand the submission, it seemed to be that at the time of the subordinated debt agreements, there was something called the LBUK regulated group, which means there was a concern to protect the interests of the creditors of all members of the Lehman group, including the creditors of LBL, is the way it was put by Mr Marshall. The core of the argument seemed to be that there was a regulatory need to protect the interests of the creditors of those members to the same extent as they were concerned to protect the interests of LBIE's creditors. That seemed to be the thrust of the submission.

We submit that the reason it is clear that the references to the group have nothing to do with the protection of creditors of other members of the group is that as far as is relevant, none of them were regulated entities. In particular neither LBL nor LBHI2 were regulated --

MR JUSTICE HILDYARD: I think you said LBIE was the only one.

MR TROWER: Yes. The only thing -- there is this

qualification. There was a member of LBI, which is not a member of the UK group, but was actually a regulated entity, and it appears at the very top of the tree.

I should stress, there are and were a few other regulated entities within the Lehman's group doing specific regulated activities which don't appear within the structure that people were considering at the time the emails were entered into.

The reason that the concept of a regulated group was used at all -- we submit the obvious reason -- is that looking at the position of LBIE itself, it may have been necessary to consider how others within the group structure who were providing regulatory capital, in particular LBHI2, fitted into LBIE's regulatory position. It is not more complicated than that.

That is made clear, we suggest, when one -- if we can just turn up for a moment the bundle of emails so that one can see what one gets out of them. We have two groups of material. There are the emails behind tabs 1 to 4, which are tax emails or tax materials. They are backwards and forwards --

MR JUSTICE HILDYARD: Which files?

MR TROWER: I am so sorry. Bundle 5.

MR JUSTICE HILDYARD: These were our 11.30 to 12 o'clock canter.

MR TROWER: Yes, indeed they were. I am tempted to go at a gallop, but I need to go a little slower than that to make the point.

1 to 4 are materials between the Lehman group and the Inspector of Taxes, which aren't really to the point so far as the regulatory aspect is concerned. They are simply talking about the purpose for the structuring which is being put in place.

Once you go to the ones where there is communication with the FSA, they are all on LBIE paper. You get it from the bottom. And there is an obvious reason for that: LBIE is the regulated entity. Perhaps the clearest statement of what is going on can be seen from the materials that are behind tab 5, which is 6 October letter from LBIE to the FSA, which includes and has behind it the application for change in controller. And you obviously get that on page 6. The target firm in respect of whom the controller is going to be changed is LBIE, as you would expect.

And the role -- if you go on to page 7, the corporate controllers are LBHI1 and LBHI2, and that is the context in which they come in to the mix. Then if you go on to page 13, you have a pithy description of the rationale behind the acquisition in 5.3, focusing of course as you would expect on LBIE's position. Then

your Lordship sees a description of what is happening in relation to the sub-debt in 5.5.

Then if we go on to tabs 6 and 7, which was a notice of approval behind tab 6, change of control page 1 -- change of control of Lehman Brothers International Europe. So of course one would have expected that is what one is focusing on as LBIE.

Then tab 7, there is another letter from the FSA in relation to group restructuring and change of control. And in the substantive paragraph the focus there is on the sub-debt facilities provided to LBIE, if your Lordship would just read to the end of that. (Pause).

"The firm" is, as my Lord knows, a technical term used by regulators, which means the regulated entity, and that is LBIE. Just to make that point good, the way "firm" is used in the FSA handbook is it is defined to mean "an authorised person":

"An authorised person is a person who has permission to carry on one or more regulated activities and a person is any person including ...(Reading to the words)... and a partnership."

So it is clear that what is being dealt with here is regulation in relation to LBIE and LBIE alone. My Lord was taken to tabs 8 to 11. It is difficult to see what help one gets from them because they are subsequent to

the date of the subordinated debts agreement in any event. I was not proposing to say much more about them. I was not quite clear what it was that --

MR JUSTICE HILDYARD: I think Mr Marshall said he was not relying on them as any evidence of intention, but simply as confirmation of what was then -- ie before the contract was entered into -- the regulatory architecture.

MR TROWER: As we say, the overall point we make is that the regulatory architecture simply required regulation of LBIE to the extent that there was other group involvement. It was in relation to the regulatory capital that was being provided from elsewhere within the group.

MR JUSTICE HILDYARD: His biggest point on this was whether the sort of robbing Peter to pay Paul or the inimical features which would be introduced if you allow subordinated debt to have the results for which you contend. It is a bigger point, isn't it?

MR TROWER: Yes. There are a number of elements to that. As we understand it, the first point is that it had something to do, he said as we understand it, with the fact that because LBIE's regulatory capital excludes the claims which LBIE might have against its contributories under section 74, that somehow affects

the position.

We were not quite sure we understood where that particular bit of the argument takes one -- I will come on to the broader point in a moment. But isn't any part of our case that there is a separate item in the form of the section 74 claim against its members which can be included within LBIE's regulatory capital. We don't say that. Of course the shares held by the members which are paid up have generated payments and are subject to restrictions on their repayment, which render them suitable to be counted as regulatory capital --

MR JUSTICE HILDYARD: This is a slightly different point. This is on the schedules as to what the assets of the company are taken to be, and he accepted that the equity was an asset but not that the call in respect of unlimited equity --

MR TROWER: Yes. The short point on that, I do not contend that a call under section 74, that statutory cause of action, is taken into account for regulatory capital purposes. But the answer to that is sort of, so what? It does not affect the position one way or the other. It does not have anything to do with the question of whether a right of recourse by the borrower against the contributories is to be treated as an asset of the companies, which is the question we are looking at for

the purposes of determining the construction point which Mr Marshall is raising.

So we do respectfully say that the mere fact that the call against the members happens to be available to a company which is an unlimited liability company in the event of an insufficiency is not taken into account for regulatory capital purposes simply does not tell your Lordship anything one way or the other on the question of construction which Mr Marshall invites your Lordship to conclude in his favour.

We simply do not understand why it is there should be a limitation in the right of recourse against the members merely by reason of the fact that it is not included in the regulatory capital.

The point that he does make is that there is a difference in circumstances in which the identity of the lender under the subordinated debt agreement and the identity of the principal member is the same entity. Because then the argument is that it can't possibly be intended that there could be capability of a call in those circumstances.

Our answer on that point, as we submitted in opening, is a short answer in relation to assignability. That is where assignability comes in. I think Mr Marshall when he was addressing your Lordship about

assignability was concentrating on the factual matrix aspect of assignability, because he took your Lordship to what Lord Hoffmann had to say in the investors compensation scheme case about not taking into account assignability when you are thinking about the extent to which you can look at factual matrix.

Now that is as may be, that goes both ways. The real point in relation to assignability is that the sub-debt agreement and the shares, even if they were to go elsewhere within the Lehman group were capable of being assigned. There is no restriction, save for the consent of the FSA in relation to the sub-debt agreement and for other members in relation to the shares on assignments.

So the point we make is that the agreements contemplated that the lender under the sub-debt and a contributory of LBIE may well become different entities, albeit within the same group. It seems likely. That is, we respectfully suggest, a clean and comprehensive answer to the suggestion that somehow the structure does not make sense. The structure does not all contemplate that the inbound claim and the outbound claim are always going to be in the same hands, and it is as simple as that.

MR JUSTICE HILDYARD: Tracking back again -- and again

harping on, for which apologies: am I to take it that the context did not in the parties' minds include looking at the consequences on insolvency, as Mr Atherton suggests?

For the purposes of the implied term, or interpolation of the term, it may be that the authorities rather suggest that you have to say it is a state of things which the parties did not contemplate. Otherwise the court might think if you can't say that, they just decided to keep it out of account or made a mistake or some such, from which the court should not save them.

So the driver on implication or interpolation is to say this was a circumstance not envisaged at the time. The problem with that, if you have to rely on it, is that you then knock out of the context this particular consideration in terms of looking at how the agreement is otherwise to be construed. What do you say I should do in that respect?

MR TROWER: My Lord, it is plain, we say, that the parties must have contemplated the insolvency context, objectively speaking, because of the terms of the sub-debt agreement itself.

You only have to look at the subordination provisions and the way that they are drafted -- you only

have to look at the subordination provisions including within them 5.1(a), which is focusing on the circumstance in which insolvency might have occurred.

There is a definition, as one would expect, of insolvency on page 7 of the subordinated debt agreement and insolvency officer.

MR JUSTICE HILDYARD: So when Mr Justice David Richards said, as he did in the judgment at first instance in Waterfall I:

"There is no evidence to suggest anyone ...(Reading to the words)... any such consideration was given."

What do you say about that? Was he simply talking about LBIA as an unlimited --

MR TROWER: No. I think all he is saying there is that there were some -- well, what he is actually referring to are a number of interviews that were carried out with various people by the office holders.

There is a question of: did anyone subjectively think through how this would all work out in the event of insolvency. And subjectively, that may be right. What that does not help your Lordship at all on is the question of construction of the agreement: the objective issues that have to be taken into account for those purposes where it is plain as a pikestaff that

the agreement was contemplating the consequences of insolvency. It is the very essence of the subordination apart from anything else. The only time you need it is the insolvency.

So I think it is difficult to put too much weight in terms of an argument based on what it is that is said by Mr Justice David Richards there. He was not looking at it in the context of a question of construction of the agreement, I think he was doing it in the context of giving it some general background as to the circumstances in which they came to be entered into.

It is no different when one steps back and thinks about it from any situation in which what appeared, doubtless to everyone at the time, to be a well capitalised international bank based in the United States. People were not on the whole thinking about the prospect of insolvency. Why would they be? This was 2006, not 2008.

MR JUSTICE HILDYARD: This was a point which Mr Atherton raised and which I think he said was in support of Mr Marshall at 5.9 in his note. And I freely admit that I had not really spotted that in Mr Justice David Richards' judgment. I turned it up when I saw that, because it caused me surprise.

MR TROWER: As is always the way when one picks up

statements made by judges in cases --
MR JUSTICE HILDYARD: Absolutely. I agree with what you are going to say there.
MR TROWER: -- one has to think about the context in which it was said.
MR JUSTICE HILDYARD: Maybe I have overegged the point, but I was trying to work out what relevance it had.
MR TROWER: On the construction point certainly, it really does not have any relevance at all. How can it?
MR JUSTICE HILDYARD: No.
MR TROWER: The whole purpose of this agreement was to provide for subordination in the event of an inability to pay the senior liabilities in full. So it contemplated circumstances of what would happen in circumstances of financial distress.
MR JUSTICE HILDYARD: But then that is generally true, as I have said -- and you tell me if I am wrong, and maybe Mr Atherton will shake his head vigorously -- it could have a bearing on implication or interpolation because of the difficulties the court has in determining whether there is a gap which it is reasonable and necessary and in accordance with the contract as a whole to plug, or whether it is an error such that the court should not relieve the parties, or alternatively should assume that they addressed it and decided not to do anything about

it because they could not agree on it, it was too difficult, or whatever it is.
MR TROWER: Yes, yes. Well, we respectfully submit that it does not really help very much one way or the other that subjectively speaking people were not focusing on the imminence or indeed the medium-term possibility that this might happen. Sort of, so what, is the way we would look at it.
MR JUSTICE HILDYARD: But do you pray it in aid that they must have been thinking, or the objective observer would have thought that they were thinking in order to add any firepower against implication?
MR TROWER: Well, the core of our argument in relation to implication is that the terms of the agreement are clearly set out -- sorry, not the terms of the agreement. The terms of the repayment are clearly set out in a context in which the parties were considering two possibilities of the subordination condition being required to be fulfilled. The first is the possibility of an order being made for winding-up and the second is where there is no order made for a winding-up.
So yes, I pray it in aid in that sense, that it was essential in order to understand the way the subordination worked that the parties were contemplating those two separate circumstances. One is

a informal insolvency and the other is not an informal insolvency. To that extent, if and insofar as the argument is made against us that the parties simply did not contemplate insolvency at all and therefore you have to fill a gap, which includes the implication of the term which they wish to imply, if that is the point that is actually being made, we would respectfully submit that the express terms of the subordination make that an extremely difficult point to pursue.
MR JUSTICE HILDYARD: Well, in Aberdeen City Council, which I do not think is in the bundles, because I assume it is summarised at some length in Arnold v Britton, there was as I understand it, a discussion by I think Lord Clarke as to the difference between implication and the process of, as it were, benign construction -- or what they call "the internal context".
MR TROWER: Yes. There was a bit of a move away from that -- or not move away, but Marks & Spencer reformulated the approach in the sense that Lord Neuberger stressed that they are two slightly different exercises. But yes, subject to that.
MR JUSTICE HILDYARD: If you are reliant, as Mr Marshall at any rate was as his fallback position, on implication and accepting the reaffirmation as some would see it of orthodoxy as to the conditions in which you can imply or

interpolate a term, is it relevant for me to have in mind that the parties would have been focused on insolvency and if they had wanted to deal with it in a way which it said was necessary, they would have done so?
MR TROWER: Yes, my Lord, it is absolutely relevant. It must be.
Of course, there may be circumstances, I would accept, where notwithstanding that, the business necessity test, the of course test would still be satisfied. But it is --
MR JUSTICE HILDYARD: You rely on it as another nail in the process of implication?
MR TROWER: It really is not something which -- put it this way: the more the agreement actually expressly deals with something and contemplates something, the less straightforward it is for the court to imply a term that covers the same ground.
MR JUSTICE HILDYARD: Because it would be doing -- this is what they, in a rightly ordered world as it has turned out to be, should have done, rather than this is what actually they did do, sub silentio, or that which anyone would say of course they must have left that out by mistake.
MR TROWER: That is right. And we say we are a million

miles from that situation, given what this agreement was actually all about, which was about the ability to obtain repayment of the subordinated debt in the context of financial distress.

MR JUSTICE HILDYARD: So it may be as to 1 and 3 it is really about not implication but either repayment, which might be more difficult, or clause 5.2, which is solvency.

MR TROWER: Yes, which I will come on to in a moment. I have one or two separate points to make.

Before I get to 5.2, can I deal with one point that was made against us by Mr Marshall in relation to 6F and 7F? This is, as I understood the submission, he said they are strong pointers to the fact that there is to be no source of repayment other than the borrowers, and in particular that the source could not extend to the contributories.

MR JUSTICE HILDYARD: Where is that? I cannot remember that.

MR TROWER: If you go to clauses 6F and 7F on page 12 of the agreement, these are the restrictions on arranging or permitting a contract of suretyship or taking or enforcing any security, guarantee or indemnity from any person.

MR JUSTICE HILDYARD: Yes, I am sorry.

MR TROWER: So this is a representation by the borrower that it will not arrange or permit any contract of suretyship, and a sort of like representation by the lender.

The simple point about these provisions is that they appear in the subordination clause and so one would expect that they are concerned with protecting the interests of the senior liabilities to whom the sub-debt is subordinated. We suggest that it is tolerably clear that their purpose is to prohibit suretyship so there can be no circumventing of the subordination by a surety for the sub-debt seeking to claim against LBIE on its right of indemnity, and it is not more complicated than that.

In the absence of such a prohibition, the economic effect of the exercise of the right of indemnity would be to elevate the ricochet claim to a level above the level where it ought to be. In other words, to a level where it competes with the senior liabilities. That is why suretyship is banned under this agreement. It is to enforce the subordination.

The issue obviously does not arise in relation to a section 74 claim, so it does not really help your Lordship on the point that is made by Mr Marshall. It does not help.

Can I then move on to the 5.2 argument? I think the core of Mr Atherton's case is to the effect that sub-debt is not payable at all until such time as the solvency condition is satisfied. The solvency condition will only be satisfied if the assets, excluding the right to claim under section 74, exceed the liabilities. That is the core of his case.

Our basic response, your Lordship knows, is that this confuses the obligation and ability to pay with the source from which the obligation is able to be satisfied and discharged.

In summary: insofar as source is relevant as a matter of construction at all -- and Mr Atherton focused on the word "it" as being the reason that you could see it was -- can we put the proper characterisation of the rights of an unlimited company against its contributories in the following form? This is where we come in to for the first time the question of what is the nature of the right.

Can we summarise the position this way: even an unlimited company has nominal share capital, my Lord knows that. It may only be part paid. It can be called up prior to the liquidation pursuant to the contract under which the member took the shares. To the extent that it is unpaid, it is properly to be regarded as an

asset of the company's. It is also capital of the company in exactly the same way as unpaid shares in a limited company.

So that is the first bit. The right of an unlimited company to prove in the administration of its insolvent contributories, which is what we were told we could do in Waterfall I, is also an asset of the company's. Now all of the members of the Court of Appeal agreed that the contingent claim --

MR JUSTICE HILDYARD: Technically it is an asset in the liquidation?

MR TROWER: No. What I am here talking about is our right as LBIE's to prove against an insolvent administration of the contributories --

MR JUSTICE HILDYARD: Your right only arises in this respect assuming liquidation?

MR TROWER: No, it does not. We have a right to prove as a contingent claim because our contributories are in -- that was one of our conclusions.

MR JUSTICE HILDYARD: I understand that --

MR TROWER: I am sorry.

MR JUSTICE HILDYARD: But it is an entitlement you are enabled to put in a proof in respect of, although it will not arise unless and until you go into liquidation.

MR TROWER: No, it will. The decision of the Court of

Appeal was that we presently have a right to prove in the insolvencies of our contributories insofar as they have become distributing.

Now there is an issue because Mr Arden's clients are not yet in distributing administration --

MR JUSTICE HILDYARD: I understand what you are getting at. And because of the rule that you must assess or estimate the proof at the time, it converts the prospect into an estimatable actuality.

MR TROWER: Indeed. We accept that the officeholder in the insolvency of our contributories will have to estimate the value of our claim because it is not a straight call. There is an issue as to whether any discount should be given for the fact that we are not yet in liquidation. That is a question, but that is not for your Lordship today.

But we do say it is very difficult to see why that is not an asset in the form of a legal right to prove. That is what the company has at the moment: a legal right to prove. Why is that not an asset?

The third stage is let's assume that we were to go into liquidation. Our rights in those circumstances to make a call under section 74 are also an asset of the company's even before the call is made. That was the point on which there was potential disagreement between

Lord Justice Briggs and Lord Justice Lewison.

We say it is a chose of action in the form of a debt -- that is what section 80 says it is -- based upon on the contract of membership, although it moves through to have the attributes of the statutory right under section 74 and section 80. It remains our -- on this core point, we do submit that Lord Justice Lewison's doubts on this point are misplaced, and they were doubts but they were not characterised as -- he didn't positively disagree. And the view of Mr Justice David Richards and the view of Lord Justice Briggs are to be preferred.

MR JUSTICE HILDYARD: You equate those, do you?

MR TROWER: I do. On this particular point, we say Mr Justice David Richards did go as far as Lord Justice Briggs.

It is of some relevance when looking at what Lord Justice Lewison said, some relevance, that what he was looking at and the cases he was looking at were not concerned with the question of whether or not the right to call under section 74 was an asset of the company's, but with whether the statutory right was to be treated as part of the company's capital.

If one looks at those cases, that is what they were all looking at: the question of whether or not

the statutory right under section 74 once the company went into liquidation was part of the company's capital.

And we do submit that on any view, it is an asset of the company's, whoever the person is who is entitled to realise it --

MR JUSTICE HILDYARD: Where would you place it in the accounts?

MR TROWER: The accounts?

MR JUSTICE HILDYARD: Not capital.

MR TROWER: It would certainly not be capital, no.

MR JUSTICE HILDYARD: What would it be?

MR TROWER: It would be a debt, insofar as it was possible to give it a value. It would be a receivable from the moment in time at which the right to prove arose. And properly prepared accounts would have to identify what was the appropriate figure to give it for the purposes when one knew what the likely recovery was going to be.

MR JUSTICE HILDYARD: So in an unlimited company, you would always have a balanced account, would you?

MR TROWER: Well, no, because -- well, we are dealing with a rather special context here because we are dealing with a context in which the right we are here concerned with is a right to prove in the insolvency of our contributories. That is what I am focusing on, so it is

quite difficult to --

MR JUSTICE HILDYARD: It is a fiendish thing to value for the purposes --

MR TROWER: Of course, and it may well be that anybody who is required to put it into their accounts would give it no value because they could not do so safely. I perfectly accept that. But that is not really the question for my Lord for present purposes; the question is characterising the right.

MR JUSTICE HILDYARD: Yes.

MR TROWER: One point we do make, the last stage when one is looking at the nature of the various assets that arise here: it was common ground as we understood it amongst the judges in the Court of Appeal that once the proceeds of the proof or the call are received, they are an asset of the company's. There didn't seem to be any doubt about that.

MR JUSTICE HILDYARD: How could there be?

MR TROWER: Quite, which is not a bad starting point for saying that the cause of action by which they had got in --

MR JUSTICE HILDYARD: The same would apply if you recovered in a misfeasance claim. Once you got it in, it would definitely be. But what do you say in a misfeasance claim or some statutory claim would be an asset which is

to be put in as a receivable in the company's account?
MR TROWER: You have to identify what it is you are talking about. I quite accept there are some causes of action -- there are issues, and this is actually one of the points that I think was raised before the Supreme Court -- there are issues about how one characterises the claims that are made, for example, by a liquidator for preference and for --
MR JUSTICE HILDYARD: There is some statutory claim.
MR TROWER: Some statutory claims, where the cause of action under the statute, the liability only ever arises at the moment in time at which the court grants the relief, pursuant to a claim brought under the statute by the officeholder.
They are conceptually very different from circumstances in which what you have is a claim, which is --
MR JUSTICE HILDYARD: Where you are revealing the result rather than imposing it after --
MR TROWER: Indeed. The liability is there already, we know that, under section 74 and section 80. We know it goes back to the contractor membership. What is happening under the statute is that the mechanism for bringing the money in is by way of call actually by the court, although delegated to the liquidator.

MR JUSTICE HILDYARD: This is still linked to your antecedent right point.
MR TROWER: Indeed.
MR JUSTICE HILDYARD: It is an existing right under the terms of the subscription.
MR TROWER: Yes.
MR JUSTICE HILDYARD: Yes.
MR TROWER: The root of all these points obviously goes to the question of why is it that one extracts from or takes out of the solvency concept in section 5.2 the ability of the company to effect a recovery from its contributories, which is an ability which has always been there from the moment of inception of the relationship of company and unlimited liability contributory, albeit one which only reaches the stage of enforceability at the moment in time at which either the contributories become insolvent and you can prove or the time at which the section 74 call can be made.
MR JUSTICE HILDYARD: I cannot remember which the case was where the director said: oh, don't worry about us looking a bit peaky financially, we have this claim against the contributories, and they got rather dusty answers, didn't they?
MR TROWER: I will have to remind myself of the case.
MR ATHERTON: I think that is the Rococo case.

MR JUSTICE HILDYARD: Yes, that is it.
MR TROWER: The case we were shown this morning, yes.
MR JUSTICE HILDYARD: Yes. is that a good moment?
MR TROWER: I have not quite finished on 5.2, but it will take me a few more minutes to do so, and then I was going to go on to issue 3.
MR JUSTICE HILDYARD: Very good.
(1.05 pm)
(The short adjournment)
(2.00 pm)
MR JUSTICE HILDYARD: Good afternoon.
MR TROWER: My Lord, two more points on 5.2 before I move on.
The first point relates to a slightly different but linked aspect of the interrelationship between this argument on what the Court of Appeal actually concluded in Waterfall I.
All of the members of the Court of Appeal considered that it was wrong to characterise the argument that statutory interest could be funded from a call or a realisation of the members' liability to contribute under section 74 is boot straps. They said that argument was wrong. They agreed that statutory interest could be funded from a call.
The reason they all reached that conclusion was that

statutory interest ranked before members and as an adjustment call could be made to protect members' rights, it made no sense that a call could not also be made to fund statutory interest. They also agreed that sub-debt ranked between statutory interest and members. That is why they put it.
So we do respectfully suggest, given that this is the case and they all agreed that the sub-debt ranked after statutory interest, there isn't really a logical reason why a call could not be made to fund the sub-debt as well.
I quite appreciate the argument which is now being made by Mr Atherton in relation to "it", which is the way he puts his case, was not made before the Court of Appeal. But it is difficult to see how the argument based on clause 5.2 could be run without cutting across the reasoning of the Court of Appeal. That is the first point.
The second point is reminding oneself that the analysis depends on the meaning given to the word "it" in the clause. We suggest there is no commercial reason why the sub-debt holders' ability to recover should depend upon the happenstance of whether or not the prior ranking liabilities had been paid without making a call, or whether recourse is required to be

made to contributories in order to pay those prior liabilities, which is the logical consequence of Mr Atherton's position.

We say that makes no commercial sense, all the more if one assumes that is the sub-debt holder and the contributory are separate people which, as I have made submissions to your Lordship already, is within the contemplation of the clause.

My Lord, that is all I was going to say further on 5.2. The only other point that sort of linked -- although it leads into issue 3, which is the next one I am going to deal with -- is that in his paper this morning, much was made by Mr Atherton of the fact that LBHI2 is not yet in distributing administration. Therefore, the asset in the form of the claim against the contributories is, he says, contingent.

That rather misses the point because the whole purpose of the Waterfall application -- and one can see this in the formulation of issue 3 -- is to assess whether there would be a claim in a distributing insolvency of LBHI2. That is the purpose of it. We are looking at it in that hypothetical context. We are not looking at it in the context of both of the contributories actually being within a distributing process at the moment. The reason it is necessary is so

that the parties can assess what their position will be.

One day of course, there will have to be a distribution. LBHI2 is sitting on a slug of money, it needs to know how it is going to distribute it. The whole purpose of these applications is to bring the parties closer together in understanding of what their legal rights and remedies are.

As I say, issue 3 does proceed on the basis that we are proving in a distributing process for the contributory, which we will come on to. My Lord, I was going to move on to issue 3 next. I was going take my Lord through a summary by way of response to what has been said against us as to the way we say it works.

We have prepared, and I hope it is helpful -- and I will go through it after I have made some points. We have prepared a table which explains what we say happens on the basis of varying possibilities as to the position of the contributories. The reason we have done it is twofold, really. First of all, for my part I find it helpful sometimes to see in the form of figures what one says the consequences of a particular argument are. And secondly, it is designed to try and assist on how it is that we say in various hypothetical situations the result works through, with particular reference at the end to the point that has been made in

relation to paragraph 63 of Mr Arden's skeleton argument, which we have spent a little bit of time on. But I was going to come to in a moment, if I may, when I have been through the various steps in the argument that have been put against us.

What is contended as we understand it is that -- and on issue 3 we are dealing with value -- the amounts to be included in the section 74 claim in respect of the sub-debt is the amount estimated as the provable debt in accordance with rule 2.81. That is the way it is put against us.

What is said therefore is that the same estimation process applies to both sides of the account. You have to look at the estimation, take it in one side and out it goes the other side. The way Mr Atherton put it in his submission was the reason for that is that the sub-debt contribution claim is entirely -- and I think he used the word "parasitic" -- on the sub-debt claim itself and it was false to draw a distinction between them.

The idea of estimation in this context is that unless you estimate under rule 2.81 as we understood it, you cannot work out what the extent of the debts and liabilities are for section 74 purposes. That was as we understood it the way the point is put.

Our case is that we submit it is not the correct approach. We need for this purpose I am afraid to go back again to what Lord Justice Lewison said in those critical passages in his judgment, paragraph 41 in particular, in bundle 1 behind tab 9.

The critical question here is to identify what Lord Justice Lewison means, we suggest, when he describes the subordinated debt as a contingent debt, and more particularly what is the nature of the contingency.

If you go back to the language of paragraph 38, further back, he describes clause 5 of the sub-debt agreement as:

"Giving rise to a contingent right to payment contingent on the satisfaction of the relevant condition."

Now what that means, we submit, is that the nature of the contingency is having enough money to pay the liability and still be solvent. That means it is necessary to have enough money to pay the liabilities higher in the Waterfall. Having enough money to pay is, as your Lordship put it in I think some of the discussion, is the essence of dependency. That is the distinction, if you like, between dependency and a conventional contingency.

So if one wants to think of it in the language of dependence and contingency, it can properly be said that contingency in this case is nothing to do with usual contingency of whether or not an extraneous event will or might occur. It is all about whether or not the stage is reached within the insolvency at which payment can be made.

Against that background, we submit the point that Lord Justice Lewison was making in the third sentence of paragraph 41, which is the point we have spent a little bit of time on, is that the contingent characteristics of the debt arise not because that is the way it is characterised by the statutory code but because that is what the sub-debt agreement provides for. That is what he means.

Put another way, its positions in the rankings in insolvency is as an unsecured provable debt, but the agreement amounts to an enforceable and effective means of subordinating the debt to a lower level in the Waterfall. That is what he is talking about. We suggest that one can also see this is what he must have meant from the opening sentence of paragraph 41, the very first one:

"I do not consider that it matters whether or not a proof is lodged. What matters is the subject matter

of the proof."

He was therefore quite conscious of the fact that while proof was permitted in principle, and indeed that was the whole purpose of it, it was only permitted to the extent that it did not impair the subordination.

We suggest the position of statutory interest provides a helpful analogy here. Because like the subordinated debt, the statutory right to payment of interest only arises where a sufficiency condition is satisfied. In the case of interest, it is if and when a surplus is established. That is the way it was put by Mr Justice Richards in the Waterfall IIA judgment.

Your Lordship may recall -- and I am not sure whether we put it in the bundles -- but when your Lordship was hearing the withholding tax case, you had to consider the nature of statutory interest, and you adopted what Mr Justice Richards had said in Waterfall IIA. It is as and when the surplus is established, that is the concept which underpins it.

In the case of the subordinated debt, one has a very similar concept. One has a case of insolvency as defined within the subordinated debt. In both cases, the liability is not one which is given value before the time the condition is satisfied. What I mean by that is inbound value. Statutory interest is neither

provable nor payable at all until such time as a surplus arises. Sub-debt is provable but not to any extent that may impair the subordination.

So you have a very similar analogous situation, we suggest, between the subordinated debt and the way one needs to think about it and statutory interest.

Now, Waterfall I established that notwithstanding the fact that statutory interest was not payable because there was no surplus, it was still a liability in respect of which a contribution could be sought from the contributories. That was the essence of one of the holdings.

What this shows is that where the characteristics or features of the liability include a contingency in the form of an ability to pay, the valuation consequences of that contingency do not fall to be taken into account in quantifying the outbound section 74 claim, otherwise you could not have had a situation in which in statutory interest it was possible to have a call to recover.

So that is the essence of the way we say my Lord can most helpfully approach this question. The analogy with statutory interest is a good one, it is an apt one. It helps explain the approach that Lord Justice Lewison took in paragraph 41 and gives it sensible meaning in

the context of the nature of the valuation process which was going on, which is very far removed from the estimation process under rule 2.81.

Now, my Lord --

MR JUSTICE HILDYARD: You say Lord Justice Lewison was simply saying that the contingency is not referable to the ordinary statutory scheme, but arises from the specific terms of the subordination agreement?

MR TROWER: Yes. He is recognising that what gives it its characteristics is the subordination agreement, not an insolvency ranking with it derived from the insolvency scheme.

MR JUSTICE HILDYARD: Why is he wanting to make that point?

MR TROWER: His point here was that the debt was actually provable. And the consequence of the debt being provable in normal circumstances is that you would get into a situation where you would go through the estimation process. The issue as I think my learned friend Mr Arden identified most clearly on the other side was, well, the consequence of that would be immediately to impair the subordination. Because if you go through what one might characterise as a standard estimation process, that is what you are bound to end up with.

Some of the cases my learned friend Mr Atherton put

in his note this morning in the context of subordination agreements actually do talk about nil valuation, as my Lord will have seen. I do not know whether that is where Lord Justice Lewison got it from, I do not think if any of the material which Mr Atherton cited was actually cited to the Court of Appeal.

MR ATHERTON: If it helps my learned friend, I think we refer to it in our notes. Mr Snowden made a submission based on Goode, the extract from Goode, which talks about nil valuation.

MR TROWER: Yes, that must be where it was then. That is where it comes from. But it does not come from a standard estimation process, we respectfully suggest.

So another way of thinking about this, which is the way we put it in opening and we reiterated in reply by way of response to what has been said by my learned friends, is that what has happened under the subordinated debt agreement is that the parties have agreed for the purposes of subordination to slot this liability in a different level of the statutory rankings.

Nothing, we suggest, that Lord Justice Lewison says is inconsistent with that. It may be -- I think the very fact we have all spent a very long time debating it indicates that it maybe was not expressed as

clearly as we would have hoped. But that, we respectfully suggest, is what he is driving at.

It is noticeable -- I do not put a great deal of weight on this -- but it is noticeable that he does not use the concept of estimation anywhere in this. He talks about value. He does not seem to have been thinking about going through a rule 2.81 process and coming up with a zero figure. So what was he thinking of doing? What he was thinking of doing, the way he was thinking about it, was what do I do with this inbound claim? How do I think about it? What then happens to the outbound claim?

What I do with this inbound claim is I do not give it any value because that is what the sub-debt tells me should happen. And that impacts not one jot, we say, by reference to the statutory interest analysis on what happens with the outbound claim.

I am going to deal with the Halesowen argument in a moment, but can I take your Lordship through the illustrations, because I hope that helps to show you how it is. I could leave you with a cold towel around your head to do it yourself, but I think it is probably easier to do it together, if you are happy to do that way.

We start with some simple assumptions. LBIE has

sufficient funds to pay everything at levels 1 to 5, that is down to unsecureds, inclusive in the Waterfall, and has done so with £100 cash left over. It has debts and liabilities at the remaining levels of the Waterfall as follows. So we have statutory interest of £500, non-provable claims of £200 and sub-debt of £300.

Now because it has £100 cash in hand, it has a deficit of £900. Then you could perhaps read to yourself the next three lines, which are the bases on which we proceed, which I think are relatively uncontroversial.

What we have done next is given two example, example A and example B, and we have done it deliberately. Example A is obviously not the position we have, but it is helpful to test. Because what it does is it strips out the complication of set-off. So.

"Although in admin the contributor is able to pay 100p in the pound ...(Reading to the words)... £900 is received."

And then it is easy, everything is satisfied in full.

Possibility 2:

"The contributory is able to pay 50p in the pound, so you get £450 back from your £900 claim. The sums of £400 and £50 are paid in accordance with the Waterfall

leaving a deficit comprising 150 in respect of the CCCs, non-provables, and 300 in respect of the sub-debt. The sub-debt does not become payable at all."

You then have:

"The contributory is able to pay 90p in the pound ...(Reading to the words)... and £810 is received. Sums of £400 and £200 are paid in accordance with the Waterfall. The prior ranking liabilities have therefore been satisfied in full. The sub-debt is payable. The sub-debt is partially repaid using the balance remaining, £210."

That is all relatively straightforward in the absence of set-off. We then go over the page.

LBIE's contributor is the holder of the sub-debt:

"Although in administration the contributor is able to pay 100p, ...(Reading to the words)... and set off against the aggregate amount of the deficiency."

So you get effectively the sub-debt is satisfied in full by set-off and you get £600 into the estate, of which £400 goes in statutory interest and £200 goes on non-provables.

The reason the set-off is permitted in full there, and this is where we start to move into the Halesowen point and the paragraph 63point is because it does not interfere with the subordination in any way.

The second point is:
"The contributory is able to pay 50 pence in the pound. A contribution claim is made and admitted in the sum of £900 calculated ...(Reading to the words)... sub-debt does not become payable."
So that is identical to the situation where you have different ones.
Then the final example is one where one gets into the potential for paragraph 63, slightly more obviously:
"The contributory is able to pay 90 pence in the pound. A contribution claim is made and admitted in the net sum of 666 calculated on the basis that the amount of the sub-debt which goes into the set-off account in LBIE's administration is £233 being the maximum sum which can be taken into account for the purposes of set-off which does not prevent LBIE from meeting its prior ranking liabilities in full.
LBIE must have a net provable claim of 666 to ensure that the dividends payable to it equal 600 to enable the prior ranking liabilities to be paid. The sums of £400 and £200 are paid in accordance with the Waterfall. In effect by way of set-off, the contributory receives £210 ..."
Which is equivalent to the result for the lender under example A3.

What that example shows is the way the set-off works, we respectfully submit, in the context of the restriction on set-off which is provided for by clause 7 of the agreement. Because what it does is ensures that the set-off only operates to the extent that it does not interfere with the entitlement of the senior liabilities to receive in full.
So if you have a situation where there isn't payment in full but there is capable of being receipt of enough money to pay the senior liabilities, the set-off as between the inbound claim into LBIE and the outbound claim against the contributories only operates to the extent that it does not so interfere.
So against that background, can I make the submission that we make in relation to Halesowen, because both Mr Arden and Mr Atherton referred to Halesowen as a reason why our straightforward solution to the conundrum raised by Mr Arden in paragraph 63 does not work. In essence, they say we can't do it the way we suggest in example B because that cuts across what was said in Halesowen.
We respectfully suggest that it is now well established -- and we are going to have to look at MCC -- that subordinated debt agreements under which creditors agree they will rank behind a borrower's other

creditors are valid. It is obvious when one thinks about it that set-off restriction clauses are required in order to enforce such arrangements, because otherwise the subordination will very often not be effective.
The juridical basis for allowing both subordinated debt and set-off restriction clauses is that there is no reason why a creditor can't waive his right to take the benefit of a mandatory route of this sort so long as it does not adversely affect the position of other creditors, which is all explained by Mr Justice Vinelott in MCC in authorities bundle 2 at tab 69A.
Now as my Lord will know, this case was all about whether holders of certain subordinated loan stock could properly be excluded from a scheme on the basis they had no interest. To answer that question, it was necessary to decide whether contractual subordination was effective in English law.
What is critical for present purposes is that this required an analysis, so far as Mr Justice Vinelott was concerned, of both Halesowen and British Eagle. So he was looking at the mandatory nature of set-off and the mandatory nature of pari passu in order to reach his conclusions.
One gets that from the top of page 1407 between A and B. He then embarks on pages 1408 and 1409 in

a detailed description of what was going on in Halesowen. The bit that matters starts at 1411 between C and D, and it goes down to 1412 between B and C. Those are the core paragraphs on this bit of the analysis.
I would invite my Lord just to read that. (Pause).
MR JUSTICE HILDYARD: Yes.
MR TROWER: He then goes on and looks at British Eagle. We need not go through the analysis, but the conclusion is at page 1416 at letter E. If you would please read from there down to A on the top of 1417.
Then what Mr Justice Vinelott does is examines the position in other jurisdictions and says things like he is happy to have reached the conclusion to be consistent with those other jurisdictions.
There has obviously been a lot of academic discussion of this. I will take my Lord to one or two of the texts in a moment. But in Belmont, this point was considered, although it was not essential to everything. But what you find is that in the judgment of Lord Mance, who agreed on the principles in Belmont but dissented on the facts, he refers to MCC with approval at paragraph 148 of his judgment. And it seems to have been what Lord Collins had in mind, although he does not specifically refer to MCC, at paragraph 11 of

his judgment in Belmont.
To the same effect was Mr Justice David Richards in Waterfall I in the present case, because an argument was run by Mr Trace who was I think -- I am just trying to get this right -- I think he was Mr Arden's predecessor in interest. He ran an argument based on the inability to contract out under a subordinated debt agreement. It was dealt with by Mr Justice David Richards at paragraphs 82 to 85 of his judgment.
MR JUSTICE HILDYARD: Yes.
MR TROWER: And it is clear from the approach the Court of Appeal adopted that they accepted that contractual subordination was possible, although in paragraph 38 of his judgment, Lord Justice Lewison went through the three categories of subordination that had been described by Professor Goode and talked about which was the most controversial on that type of issue.
MR JUSTICE HILDYARD: An essential logic, as I understand it, is: do not for the purposes of set-off treat as provable that which the holder of the instrument has promised not to prove.
MR TROWER: Promised not to -- yes, that is right. For this purpose, to the extent that it will impact in the subordination is the way one construes it in this case. That is absolutely right, my Lord.

Can I just give you the academic references for the discussion of this area? You get it in -- there is a chunk in McPherson in chapter 13, which is paragraphs 13-009 to 13-013, and it is bundle 5, tab 122A. There is a passage in Derham, and we will have a quick look at that if we may, which is also in bundle 5, paragraph 6.114, but it is in bundle 5 at 122B -- and paragraph 6.115. The point about 6.115 is that it draws the set-off consequence into the analysis. (Pause).
MR JUSTICE HILDYARD: Yes.
MR TROWER: The only other academic bit which is cited is helpfully set out in Mr Atherton's note from this morning at page 9, the passage from Fuller.
MR JUSTICE HILDYARD: The rationale for why it does not infringe the pari passu rule, I wonder about that.
MR TROWER: Sorry, the rationale as to why it doesn't?
MR JUSTICE HILDYARD: It is stated -- it has been said in a case in Victoria:
"Not infringe the requirement of pari passu ...(Reading to the words)... are not a party to it."
I mean, in British Eagle was there any infringement of any rights of the parties by reference to the pooling arrangements in the airlines?
MR TROWER: Yes, I think there was. Yes, they were.

MR JUSTICE HILDYARD: So sub-creditors were the worse off because if there they were not IATA members, or whatever it was --
MR TROWER: Yes, that is definitely right. Yes.
The position is that the net recoveries would have been less which would have meant that there would have been a reduction in the amount of the dividend that was actually payable. That was the vice that was struck down in British Eagle.
So if you have a situation where the consequence of the non-compliance with the rule is that the position of other creditors are either unaffected, or in this instance actually enhanced by the arrangement, there is no vice to be attacked. And it chimes with the other way of analysing it, which is that you can in the normal course waive a statutory right where you are the only person for whose --
MR JUSTICE HILDYARD: Yes, yes.
MR TROWER: The other academic passage as I say was the passage from Fuller which you see in paragraph -- it is in the bundles as well, it is set out helpfully in full in 20(ii) of Mr Atherton's note from this morning on page 9.
MR JUSTICE HILDYARD: Is that in the bundle?
MR TROWER: It is. It is in the bundle at page 109A/5,

the very first tab, paragraph 8.17, page 151.
MR JUSTICE HILDYARD: (Reading).
MR TROWER: And that was actually I think the substance of the dissent, whether or not it was going to have that effect.
MR JUSTICE HILDYARD: And SSSL Realisations?
MR TROWER: Well, what happened in SSSL was that there were some quite trenchant things said by Lord Justice Chadwick in SSL about subordination and the obviousness that it was okay. The slight trouble with SSSL Realisations is that it was heavily criticised in Kaupthing subsequently by Lord Walker, so one always treats it with a little bit of circumspection, although I think not on this point. Having said that, I am afraid I did not go back and look at SSSL for this purpose. I should have done.
MR JUSTICE HILDYARD: It seems to be on this point saying the same thing as Mr Justice Vinelott.
MR TROWER: Yes, indeed, I think that is right.
MR JUSTICE HILDYARD: If you just withdraw from participation, that is not offending pari passu, it just means you are just a non-starter in the process.
MR TROWER: Yes. So what you do is you make a series of incremental steps towards the stage at which you have done so much that your participation has to be governed

by the mandatory rule. But that is right, the starting point is of course you can't. If you simply don't prove, you can't be forced.

One of the arguments based on Stein v Blake was that set-off is not about actually proving, set-off is about a situation in which you it treat the inbound claim as having been proved for the purpose of taking the account. But that is a rather different point to the question of what it is that people are entitled to do in order to ensure first of all that they comply with the contractual obligation they have taken, and secondly that they don't offend one of the mandatory aspects or characteristics of the statutory rule.

Maybe it is not right to think of the statutory rule as having mandatory and non-mandatory aspects, but they don't offend the principle that they can enter into an agreement which has an effect of abrogating the statutory rule because nobody else is prejudiced by it.

MR JUSTICE HILDYARD: A pre-existing agreement?

MR TROWER: Yes, absolutely.

MR JUSTICE HILDYARD: Because it is too late by the time -- it has to be a commitment not to do anything such that it would be perverse to treat it as having been put forward.

MR TROWER: Yes. That was one of the issues the House of

Lords in Halesowen was thinking about, whether it interfered with -- and that was ultimately the real mischief in Halesowen -- whether it interfered with the administration of the estate if it was allowed to take place at a later stage. But you have this -- where you have people's pre-existing rights, that consideration does not come into play in the same way.

I was inviting your Lordship to look at 8.17 of what is said by Mr Fuller, if your Lordship would just read that. It is the last bit that is interesting, on valuation. (Pause).

MR JUSTICE HILDYARD: Yes.

MR TROWER: So in summary, my Lord, we say -- and this really is on Mr Arden's much-cited paragraph 63 point -- the right way of thinking through what would happen is what we have set out in example B, footnote (iii). That is what happens.

That is what the subordinated debt agreement provides for and there is nothing in the principles, which are now relatively well established in relation to subordinated debt agreements which cuts across that in any way as a matter of public policy.

That in short, my Lord, is what has been described as the Halesowen point.

MR JUSTICE HILDYARD: I must think this through. How does

this fit in with the Court of Appeal's finding that it was provable?

MR TROWER: It fits in -- well, the point here is what you can prove it as, to what extent can you prove it. It goes into the set-off account at zero.

MR JUSTICE HILDYARD: It is that last bit you are really relying on. It is not a "I do not want to participate" but, "I shall not participate at more than nothing", except in a --

MR TROWER: -- "or more than such amount as I can participate in without affecting the subordination".

MR JUSTICE HILDYARD: Right.

MR TROWER: That is entirely consistent with the language of 7B and does not cut across policy, because the policy is all about protecting the other participants within the estate.

MR JUSTICE HILDYARD: Yes.

MR TROWER: My Lord, that really is issue 3 as we see it. I have explained the series of steps which I say one goes through. We have given our answer to what at first blush was Mr Arden's powerful submission but which on analysis proves, we submit, to be flawed.

We respectfully suggest that the way we submit your Lordship should think about the valuation is the correct way of thinking about it and is entirely consistent with

both what Lord Justice Lewison said in the Court of Appeal on proper analysis and the approach the Court of Appeal took generally to allowing a contribution claim in respect of all items in the Waterfall higher than the members.

MR JUSTICE HILDYARD: I will not put this very well, but the unease one feels with it is because it rather feels, certainly at first blush, to be conjuring something out of a deeming or curious sequence of things. I mean, you conjure up the 1.2 billion upon the footing that the nil valuation is necessary in order to perfect the subordination agreed. But because your deemed proof, if you like, flies free of any particular subordination, you get the full amount. It just sort of feels uncomfortable, it feels a bit like magic.

MR TROWER: It is no different, we respectfully suggest -- it is a bit like the bootstraps point actually, in a way. It was a kind of -- what my Lord has just said was the kind of reason why people wondered about the bootstraps point as part of the argument. How can you create your surplus out of which the interest is paid by a call? And it is similar: a call where the interest has no value at that stage, it is a sort of similar point.

We accept we are generating the call off the back of

a liability, of course we do. But when one thinks about it the other way round, which is what are the liabilities in respect of which the unlimited liability contributories have committed to contribute to their last farthing, we suggest it becomes less problematic, because it is at the end of the day a liability which in certain circumstances is capable of being discharged.

MR JUSTICE HILDYARD: They are thinking, God, this is unfair because they've put a nil value on the liability which has given rise to my crisis.

MR TROWER: And if I were to be solvent, it would not matter. The only reason this matters is because I'm --

MR JUSTICE HILDYARD: But that is the point -- sorry to chat it through with you. The unlimited shareholder thinks it will all be all right in the end, as long as there isn't a shortfall.

MR TROWER: That is right. The only reason there is a problem for the unlimited liability shareholder is because he himself is insolvent. And the way your Lordship might like to think about it is that there is no principled reason why his insolvency should reduce amount for which he is ultimately reliable, which is what the result would otherwise be, which is actually what would happen if my learned friends are correct.

MR JUSTICE HILDYARD: I am going to ask you a question which will seem rather hair raising because I ought to know the answer, but is it disputed in the Supreme Court whether these things are provable at all?

MR TROWER: What, section 74 claims?

MR JUSTICE HILDYARD: Yes.

MR TROWER: Yes, it is. It is. Which is why -- at the end of the day, my Lord, we all have to accept, and the more one goes through the thinking through of the issues and so on, the clearer it becomes. Issues 1 to 4 are all affected --

MR JUSTICE HILDYARD: They very much are, and to a greater degree than possibly I had understood. That is often the way because for the purposes of legal analysis, you should divide everything up and forget what the sausage looked like at the beginning, that sort of thing.

MR TROWER: There are plenty of people who may be guilty of not appreciating --

MR JUSTICE HILDYARD: But they are very, very intimately connected, aren't they? Because there are all sorts of approaches or findings in the Supreme Court which could put a very different complexion on things; in fact in some cases simply cut it off at source.

MR TROWER: That is right my Lord. That has become more apparent as the argument has gone on.

I was going to go on. I will be able to deal with these issues much more shortly than 1 to 3, just to make a few short submissions on 7 and 9 if my Lord is content with that.

MR JUSTICE HILDYARD: Yes.

MR TROWER: So far as 7 is concerned, there is no doubt that the dispute has narrowed considerably. The original issue was whether --

MR JUSTICE HILDYARD: Do you accept Mr Arden's description of the extent to which it has been confined?

MR TROWER: My Lord, I regret to say I cannot remember exactly how he put it. As we understand it, the only remaining issue -- because the question of rateability has gone in the sense that it is now accepted all round, as we understand it, that there is prima facie liability across the board for everything by both members, which was the first bit.

The second bit of it, which is linked to it, is whether or not the court can or should restrict the officeholder in making a call. We say that the test is actually very simple when it comes to it. It simply boils down to what is in the interests of the estate. And if the estate -- there may be plenty of circumstances in which it is not in the interests of the estate to make a full call against each member.

The most obvious example is where you have small holder and a large holder and the large holder is fully solvent, and indeed the small holder is too. It may well be perfectly appropriate in those circumstances to make a call which reflects the size of their shareholdings so you don't then have to make an adjustment call, and making an adjustment call may be more expensive, who knows, in the interests of the same.

That may be a perfectly appropriate way of proceeding depending upon the circumstances. It becomes very much more difficult to limit or restrict when both of your contributories are insolvent because you don't know what you are actually going to get. So when you are thinking about the extent of the proof which has to be put into each contributory's insolvency, you should in the interests of your estate put a proof in based on the maximum extent of the liability in order to maximise your recovery. It is as simple as that.

MR JUSTICE HILDYARD: It is the extremity of the figures here.

MR TROWER: Yes, I certainly accept that. But in a sense, where both members are insolvent, the extremity of the figures are unlikely to become very relevant because we are not going to get back the full extent of the call, because we are only going to be able to prove for

whatever dividend we are going to get paid out of each of these insolvencies and receive whatever dividend we are going to get. So there is not going to be an adjustment call in a case where you have two heavily insolvent contributories.

So that was that. My Lord, on the whether or not you can call point and whether or not we ought to be directed not to call. I realise it went in a particular direction, you did have a debate with Mr Atherton about ex parte James. We respectfully agree with the approach your Lordship took.

Just for your note, in a not dissimilar context, Lord Neuberger had quite a lot to say about ex parte James in Nortel in the Supreme Court. We need not turn it up; bundle 4, tab 97, paragraph 122 and following.

MR JUSTICE HILDYARD: Tab 97?

MR TROWER: Paragraph 122 and following. He followed just the approach your Lordship indicated in explaining why it was but in that case it was all about liabilities under financial support directives and contribution notices and contribution notices under pensions legislation. He followed just your Lordship's approach. Once the court had decided whether it was a provable debt, an expense or fell into a black hole, that was the end to it. The court could not under ex parte James

principles say the administration behaved in a particular manner simply because the court thought it was the right thing to do. It is all based on legal rights.

That was the first point I wanted to make about issue 7. The second point I wanted to make about issue 7: your Lordship did have a debate about whether or not there will always be a need for an adjustment call. We are probably not into the realm of adjustment calls in this case, for the reasons I have indicated. We did in our skeleton argument when we were considering the cases on adjustment calls respectfully suggest that that is not always the case because we included in paragraphs 181 and 183 two different categories of case in which there needed to be -- and I deliberately use this word -- equalisation between shareholders.

Those referred to in paragraph 181 are where the equalisation process is between part-paid and fully-paid shareholders and is achievable out of the surplus realised in the liquidation. In other words, there was enough money realised by way of surplus to make a further call unnecessary because the part-paid shareholders simply didn't received any distributions at all until the fully-paid shareholders had been repaid the equivalent of the amount that had not been paid up

on the part-paid shares. So you achieve equalisation through the distribution of the surplus. Those are the cases in paragraph 181.

The cases in paragraph 183 of our skeleton are the ones where a call was necessary because although enough had been realised in the liquidation to pay the creditors in full, the surplus was not sufficient to equalise the positions of part-paid and fully-paid shareholders without making but in both instances you will only get to the stage of the an adjustment call where the debts, liabilities and expenses have been paid in full.

Finally, on the contribution bit, as we understand it, LBL's position is they accept that there is no right of contribution available as part of the adjustment process. That is plainly right on the authorities but they say there is a right of contribution which arises extraneous to it and is capable of being asserted in the present case by LBL against LBHI2.

Now, because of the adjustment we were rather unclear to be frank as to what the basis for that entitlement to an extraneous contribution would be but the important point for present purposes is that one theoretical concept we can see that an extraneous right may be capable of being exercised if there is, as

between members, it can't come into play we suggest until after the debts, liabilities and expenses have been paid in full.

The reason for that is that any contribution which is sought by the overpaying member against the underpaying member before the debts, liabilities and expenses have been paid in full will cut across the rule against double proof. It will compete with the primary claim which is available to the company against the underpaying member. Because you have a situation where the underpaying member is still liable to the company for the full amount of the deficiency in the debts, liabilities and expenses and along comes the other member seeking a contribution.

Now, to the extent that those are the same, related in any way to the contract of membership, it is almost certain to be problematic with the rule against double proof. So if it is a completely extraneous entitlement to contribution. Well, it is a bit difficult to tell, but we had understood the argument to be raised that the right of contribution arose out the contract of membership in some way and we say that it runs into difficulties for those reasons.

You were taken in that context, by Mr Marshall to Black's Case. He did it at pages 91 and 92 of Day 4, in

support of a submission as we understand it that the rule against double proof does not apply to protect the creditors of LBIE because it is an unlimited company.

He said that the analysis was analogous to the fact that set-off is permitted as between a section 74 call by an unlimited company and any independent dealing with the relevant contributory because the contributories are liable anyway for the full amount of the liabilities and it follows that the creditors of the unlimited company are not prejudiced by the set-off. That is what we understood the submission to be.

Now, we submit that that analogy is not apposite and it is dealing with a rather different point. But it is inapplicable anyway where the contributories are insolvent because the rule against double proof is always required where there are two proofs in the estate of an insolvent debtor. In this instance it would be in LBHI2's estate. It matters not that there is unlimited liability. What matters is whether or not the principal creditor, which in this case is LBIE, has been paid in full.

So, we actually submit that Black's Case, your Lordship does not really get very much assistance from. It is dealing with a different point and it does not

help anyway where the limited liability company is insolvent.

MR JUSTICE HILDYARD: I am just trying to remember, is it Paraguassu?

MR TROWER: It is. That is all I have to say on issue 7.

I have a little to say on issue 9. That is contracting out. It is the preliminary point for Waterfall IIB. It is contracting out. It is actually a relatively short point that I have to make on this.

Now, as I understood Mr Marshall's submission, what he did was he looked at the anti-deprivation principle in the British Eagle rule, that it is not possible to contract out of a pari passu distribution. He took you to Belmont which I had taken you to and drew an analogy between the consequences of his recharge agreement in the present case and the anti-deprivation principle, because he wants to get his situation into the anti-deprivation principle. The reason he wants to get it into the anti-deprivation principle is because he then says all he has to show is that the contract might have been commercially reasonable and it then survives.

I say the analogy is actually with the British Eagle because it is a straightforward question of whether or not it is a breach of the statutory rule. So that is where the battle lines are drawn, if I can put it like

that.

I think I should say this. We don't accept -- although I think I do accept that your Lordship can't decide this point for today's purposes -- that there is any genuine analogy between what he says his recharge agreement achieves as a matter of effect and the good commercial grounds for entering into an agreement which are considered in cases like Belmont in the anti-deprivation context. So we don't accept that there could ever be a good commercial reason for entering into a recharge arrangement that enabled him to recharge his contributory's liabilities back to us.

But leave that to one side for a moment. What his submission really failed to grapple with was the fact that the liability under section 74 is a statutory liability in the form of a mandatory statutory rule and we get all that from the Oregon case and all the rest of it which entitles a company as a statutory right to recover from the members their liability to contribute. And in the context of assets recovery as opposed to assets distribution, it falls into the same category as the pari passu rule which is mandatory without regard to commercial justification. So you have an similar situation. The only circumstance in which it can be contracted out of is by a creditor who agrees to

subordinate himself to nobody else's prejudice.

Perhaps one might say this, my Lord, in the same way -- and there is a symmetry to this -- that a creditor is able to contract out of the pari passu rule where it does not affect anybody else, which we know from the subordination cases, one can also see the same policy in play in relation to the operation of section 74.2(e) enabling a creditor to contract out of his entitlement to take the benefit of any call under section 74. But what they are both doing is you have in both instances a mandatory statutory rule and a recognition that people can contract out of the benefit of them if nobody else is prejudiced.

All of that is completely different from the way the anti-deprivation principle operates. The anti-deprivation principle, as is clear from Belmont, is a judge-made rule extraneous to the statutory code which requires conduct akin to a fraud on the bankruptcy laws in order to justify its interposition. And the mere fact that the section 74 claim is more akin to an asset than the distribution of liabilities pari passu is neither near nor there. The question is: you have to work out is there a statutory rule, who is it designed to protect, does the contract breach the rule to the potential prejudice

of the people it is designed to protect?
The answer to the present case is that there is a statutory rule, it is designed to protect the creditors and if Mr Marshall is correct, they are prejudiced by his recharge agreement.
The only other point I wanted to make in relation to issue 9 is that he characterised the rule prohibiting the issue of shares at a discount as one that was linked to the issue of the shares and the vires and authority of the directors at the time of issue. He took you to Welton v Saffery again which we had looked at and some passages in the judgments that were expressed in those terms. What he basically said was that the cases were all about the fact that the directors did not have authority to do what they did.
Now, our simple submission on that is that that is a limited submission that is only available on the precise words that were used in that particular judgment. If you look at the way Lord Halsbury looked at the position in Oregon, that submission is not, respectfully suggest, maintained. He expresses himself much more broadly.
If we could just turn that up so that I can make good that submission, it is behind tab 47 of volume 2. It is the passage at page 133: the paragraph "my Lords"

down to the end, which I think we have looked at already. Yes:
"My Lords, the whole structure of a limited company ..."
(Pause).

MR JUSTICE HILDYARD: How does the fact of it being an unlimited company impact?

MR TROWER: How does it help? Well, yes, I was making a rather limited point that the way he expresses himself here is that it is not possible by any expedient to arrange with the shareholders that they will not be liable for the amount unpaid ...
The only point here, I was dealing with a very narrow point that is made against us. It is not always put on the basis of authority at the time of issue.

MR JUSTICE HILDYARD: A company limited by shares in the old days until shares of no par value had to issue shares at a certain nominal value and it was not to pretend that the nominal value was one thing and offer a discount on the other hand.

MR TROWER: Yes. And in the present case what you cannot have is a situation where the unlimited characteristics are rendered nugatory by recharge --

MR JUSTICE HILDYARD: It is not a question of the directors' vires. It is a requisite characteristic of a limited

company. You say it is a requisite characteristic of an unlimited company which has issued nominal shares.

MR TROWER: Yes, indeed. I understand the point you are asking me.
My Lord, that was all I was going to say subject to any other questions which I am very happy to try to deal with on the main points on which I was going to reply. Your Lordship may want to have a discussion about the other issues, where we should go from here, what if anything we should do about the Supreme Court and so on. But I did not have anything more substantive to say in reply, unless I can assist further on any particular point.

MR JUSTICE HILDYARD: No. I am presently minded to think -- and we will have a bit of a break now -- I think I am almost certainly going to have to ask you back when the oracle has spoken because I do not trust myself to remember everything with sufficient clarity and be brainy enough to go through it without your assistance, so I think it will be almost inevitable to have you back.
What is the position of Mr Marshall, just so I gauge the afternoon's events? There have been some cases mentioned.

MR MARSHALL: There have been and in fact there are quite

a few points which have not arisen previously too, so there will be a few areas I would like to address your Lordship on and hope to assist your Lordship on. That is particularly on issue 1 and there are a couple of things that have come out on what you have just heard on issue 9 that I would like to briefly deal with.

MR JUSTICE HILDYARD: I need to leave at 4.25. Am I going to be all right?
Can I mention one thing? Poring over the transcripts -- and I may have made a mistake in this -- but at transcript Day 4, page 45 you told me that you were going to say three things, the lunch time adjournment came in and I think you had only told me two. It may be that I miscounted but if not, please check.
A long five minutes.

(3.18 pm)
(A short break)
(3.25 pm)

Final submissions by MR MARSHALL

MR MARSHALL: On issue is: the first point concerns circuity of action and armed with I think three additional authorities, Mr Trower submitted three things in answer to our submissions on that topic. The first submission was that you had to plead circuity of action and raise

it formally and unless that was done, it could not properly be taken into account.

My Lord, that is in fact incorrect, as we know from the Post Office case, because exactly that objection had been taken in that case and the Court of Appeal didn't accept it. Your Lordship will see that from the judgment of Lord Justice Geoffrey Lane at page 134 letter H. It is in authorities bundle 2 --

MR JUSTICE HILDYARD: It was a defence of law unavailable?

MR MARSHALL: If it arises from the facts, then it is available and that submission can be made on the basis of it.

The second point was: if you have a set-off available, particularly an insolvency set-off, there is no room for circuity of action. My Lord, the short answer to that is that you can only set-off if there is a claim. There has to be a claim to be set-off. If there is no claim because there is a complete defence to it, you don't get to set off.

So, there is a prior question: do you have a claim, which is not really being addressed.

The third point that was advanced --

MR JUSTICE HILDYARD: It would give rather wide space for circuity of action, wouldn't it?

MR MARSHALL: It really boils down to this: is it a defence

or not? The in authorities from the earliest times -- and I showed your Lordship one of the very earliest -- it has always been treated as a defence, not a counterclaim or cross-claim that is dealt with in that way. It is correct to say that it has to be circuity in the sense that the claim that comes back is for the same sum, for the same thing.

But, my Lord, we respectfully submit that that is what this case is about. It is exactly the same thing that is being claimed back for. It may be added to with additional items but there is claim coming back to LBHI2 for the subordinated debt in the form of a call under section 74. It might be a specific call under section 74 just to deal with that but there might be other items added in but that does not make any difference. The same sum is being sought.

I show your Lordship by reference to one of the authorities that Mr Trower has produced that that is sufficient.

The third point was, I think, that one had to have a relationship between the claim that was going outbound and inbound, on the quantum of it and source of it. We say that is satisfied if and insofar as it is suggested that there has to be an actual right of indemnity in some form of contractual sense. That is

clearly not the case, as the Post Office case establishes. It could be a tortious claim as it was in that case.

In fact, the authorities that Mr Trower has produced, several of them are cases where the claim coming in the other direction was in fact a claim for salvage or something similar to that, which seems to have been some form of restitutionary claim. So it certainly does not have to be a contractual right of indemnity. It happens to have been that in Farstad but that is not the only way in which it can arise.

MR JUSTICE HILDYARD: You have to know that they cancel each other out, don't you?

MR MARSHALL: Yes.

MR JUSTICE HILDYARD: They must be of such a nature that one is not of lesser value than the other and will be established to the same degree as the other and therefore will be a waste of time.

MR MARSHALL: Ultimately, at the end of the day, you look at where you will end up at the end of the process. A lot of these claims --

MR JUSTICE HILDYARD: You do that and say: I am going to deprive myself of mandatory set-off. I am just going to see what happens.

You are positing, aren't you, that in an insolvency

situation, mandatory set-off is subject to a prior and even more potent defence, as it were, which is circuity of action? And I say to you that you have to be absolutely sure, haven't you, on circuity of action that what the claimant says gives rise to opposite and equal claim of equal substance and therefore the court should not waste its time. You say, no, I am not sure about that, you might have to weigh them in the end and if they are the same, same degree, same amount, then there is circuity of action and it is a defence.

I am just saying why didn't the court just say: set them off?

MR MARSHALL: In these cases that we are concerned with and in some of the ones that we have looked at, you have a situation where a claim is being made -- in the Post Office case it is for the damage to the cable -- a claim could at a subsequent stage be made for in that case I think misrepresentation on Hedley Byrne lines. But you don't wait for that claim to be made before you get to the circuity. You look at what is going to be the ultimate position. If the claim is made, there would inevitably be a right to compensation for the same amount and if that is ultimately going to be the outcome, you do have circuity of action and therefore a defence to the claim.

MR JUSTICE HILDYARD: I have a funny feeling that if that was the common law, there would be an ugly rush for set-off. But there we are.
MR MARSHALL: The reason why set-off and counterclaims are a more flexible method of dealing with the matter is because there can be complications. There might be a limitation of liability, as there was in one of the cases that we are concerned with which have just come up, with results in the amounts not being saved.
Or there may be a counterclaim or an attempt to set-off what is an unliquidated damages claim. You can't say it is going to be for the same amount, again reflected in one of the cases. I think it is the Ocean v Harding case.
MR JUSTICE HILDYARD: Yes.
MR MARSHALL: Set-off and counterclaim are much more flexible whereas circuity of action is very much looking at claiming back for precisely the same loss or the same amount, either by virtue of contract or some other form of recovery. So it is obviously a lot less flexible and thereby presumably more rare than counterclaim and set-off is.
My Lord, can I just address the three authorities in a little bit more detail? The Ocean v Harding decision, which is a decision of the Court of Appeal -- I think

reliance was placed on the judgments of Lord Justice Sankey I think it was at page 391 --
MR JUSTICE HILDYARD: Sorry?
MR MARSHALL: I think it was at the back of the bundle of authorities at authorities bundle 5, my Lord. I am afraid I do not have a flag number. I do not know exactly where it was put.
MR JUSTICE HILDYARD: Yes.
MR MARSHALL: I think it was a passage from Lord Justice Sankey that was relied upon at page 391. Just so your Lordship can see how the matter was ultimately decided, the holding which is on page 372 makes it clear what was actually happening here was that it was a three-party case. I think claimed by owners against people who had ended up purchasing under some bills of lading and then they wished to claim over against their vendors who would then have a claim back against the owners of the vessel.
So it was a three-party affair and the difficulty was, as the holding makes it clear on page 372, that it was not possible to conclude that the same amount was going to go around the circle. In between the purchaser and the vendor in particular, it was not clear that amount recoverable between them was going to be the same that would ultimately be recoverable from the owners of

the relevant vessel. That is why the circuity of action defence did not get applied in that case.
Turning to the judgment of Lord Justice Sankey at 391, the first part of the judgment on that page makes the point:
"Since the Judicature Acts gave ...(Reading to the words)... circuity of action has neither been as necessary nor as frequently resorted to as in former years."
We would respectfully submit that the reason for that is because of the flexibility which those defences have that circuity of action does not have.
The interesting thing is that when there is then a reference to Bullen & Leake where there is a quotation:
"Wherever the rights of a litigant party ...(Reading to the words)... same amount of damages which the plaintiff seeks to recover, the defendant may plead the facts which constitute such right ... "
And then it emphasises the same point which we made previously, which is that it is a defence for the purposes of avoiding circuity of action.
His Lordship then makes the point that the circuity of action defence, one of the aspects which make it less flexible is for example where you have an unliquidated

damages claim and they are not necessarily going to be identical or a mere cross-claim from liquidated damages on equitable grounds. You have to show it is the same sum that is going to be going around.
So that is an example of where there is a more limited use for the circuity of action defence and where the set-off counterclaim doctrine has got more flexibility.
His Lordship then concludes at the end of 391:
"In that particular case, neither of the pleas relied upon to bring into operation the doctrine appeared on the pleadings ...(Reading to the words)... put forth for the first time before the Court of Appeal."
And he concluded that it was not clear that the doctrine applied on the facts:
"It is doubtful that the ...(Reading to the words)... knowing the rights and position of other parties affected."
So there was just uncertainty over whether or not they were going to end up dealing with the same sum going round and round and it was for that reason that they could not apply it in that case.
My Lord, the two other cases: I think one of them was called the Luckenbach. We would respectfully submit

you don't get an awful lot from that because all that seems to have happened in that case is, because of a limitation of liability applying to one of the owners of the vessels that had been in a collision, one could not say that the amounts that were being claimed by way of salvage were ultimately going to be recoverable from the owners of the vessel which was at fault. So consequently there was going to be a mismatch between the amounts that were being claimed on one side and amounts being claimed on the other. Your Lordship will see that that comes out of the second holding on page 197.

There was also a further problem which was that there were two different departments of the Crown involved. Accordingly one could not say that the claim was going to be coming back as against the same party. That is what comes out of the third holding.

So it was decided really effectively on those two factors which were specific to the facts in that case. But your Lordship will see that in the course of the judgment of Lord Justice Somervell he refers at page 201 to a previous decision in the House of Lords called Katirastan(?) and in particular the speech of Lord Wright in that case. He says at the very end of page 201:

"The argument under consideration was that if the colliding vessel was to blame in whole or in part, no salvage would be recovered by the owners of the salving vessel if both are in the same ownership. This is the emphatically negatived ...(Reading to the words)... of the defence."

He goes on to say:

"The question of avoiding circuity of action ...(Reading to the words)... as Lord Wright points out [and it is the speech from Katirastan]:

"The fact that ...(Reading to the words)... an item in the damage claim by the salved vessel against the vessel that is in whole or in part to blame for the collision."

So it rather indicates that you can potentially have it amongst other items but as long as it is one of the items that you are claiming for the same amount as is being claimed against you, that would be sufficient to invoke the circuity defence.

One sees actually towards the end of that paragraph where there are several quotations from Lord Wright's speech that there is a passage I think beginning about 7 lines up from the bottom of that paragraph, he said:

"If the other colliding vessel is solely to blame, the owner of the salved vessel ...(Reading to the

words)... in any case, there may be questions of limitations of liability which would mean that circuity of action was not available as a defence."

But the observation is being made that if the circuity of action principle does apply, it means that the whole claim does become superfluous and would not be made, which is in line with the other authorities I took your Lordship to indicating that it is not merely a matter of counterclaim but it is something that disposes of the claim completely.

^^^ .

My Lord, the third authority which was Brumder, another decision of the Court of Appeal, I would respectfully submit, is of rather limited use because the court didn't actually analyse circuity of action as a doctrine in any detail and do not actually seem to have necessarily applied that defence. What they seem to have done is potentially used a different type of defence, derived from the case of Ginty v Belmont Building Supplies and another case called Kodak to the effect that if you are claiming, you can't claim where the claim arises out of your own wrongdoing, which is more akin to an ex turpi causa type of defence and your Lordship can see that in the passage from Lord Justice Beatson's judgment at paragraphs 37 through

to 41. He calls this the Ginty, Boyle v Kodak defence.

I do submit your Lordship is not going to get a huge amount of assistance from Brumder. But the interesting point that Lord Justice Beatson makes at page 2797 at paragraph 51 is that he floats the idea just at letter D that there was also the possibility of a valid plea of circuity of action, and it is not clear whether it would be sufficiently dealt with by provisions for set-off and counterclaim in this situation. But he says it would not be inaccurate to describe the litigation as going round in a circle. So it is a rather tentative set of observations which don't give any detailed guidance on how the doctrine would apply.

It does seem that the matter was ultimately resolved on the basis of what the learned Lord Justice referred to as the Ginty, Boyle and Kodak defence as your Lordship will see from paragraphs 56 and 57, which resulted in the claim being dismissed.

MR JUSTICE HILDYARD: As you say, the actual decision appears to be based on what he describes in 48 as a common sense proposition of Lord Diplock's speech in Boyle:

"You are liable to (Inaudible) for my own wrongdoing is neither morals nor good law."

MR MARSHALL: Exactly, it is paragraph 30 where he quotes

it.
I am not sure they take matters very much further and certainly, we would submit, do not result in any change in the approach from the authorities I showed your Lordship in the course of our submissions.
My Lord, the points that were raised on the issues of construction, just a number of new points raised there --
MR JUSTICE HILDYARD: For example, looking at the accounts, you say it would be actively wrong in these circumstances, do you, for the liquidators concerned to enter into the set-off account a set-off arrangement?
MR MARSHALL: We would, given that they have this right to claim over under section 74 to cover the liability -- precisely this liability, and this is the liability they are wanting to claim over for.
On the construction issues, it was suggested that we were wrong in submitting to your Lordship that a limited liability company was rather unique or special and does not seem to have been in contemplation when the FSA was regulating in this area at the relevant time.
A number of things were given to your Lordship by way of example by which various other entities -- Goldman Sachs was mentioned and a number of other financial institutions as ones that might be using

unlimited liability companies. As to when that might be; whether that's happening today or in 2006, I have no idea. But there is certainly no material before your Lordship to come to a view about that.
What we do have and what I was basing my submission on was the observation made by Lord Justice Briggs, which I rather thought was not terribly controversial. It is in the judgment of the Court of Appeal in Waterfall I in volume 1 of the trial bundles at tab 9, paragraph 167, where he describes an unlimited liability company as being, for the last 100 years at least, an extremely rare species and talks about navigating in waters which are rather uncharted or very old indeed as a result. We respectfully submit that is an accurate description of the situation.
MR JUSTICE HILDYARD: I think it is and it isn't. The problem is neither have you particular evidence, nor could you. There are examples around of a number of unlimited companies which may have become more fashionable in light of particular fiscal rules, and they may have become more popular given the terrible calamity of 2008. It is just, you know, an imponderable.
You would have to go so far as to say, wouldn't you, that they really wouldn't have cottoned on to

the particular features of an unlimited company at all, it would just have been totally alien, and I think that would be a tough ask.
MR MARSHALL: The second thing we draw upon is the fact that when one looks at both the actual FSA handbook and what they set down as a form of capital, and when one gets to the actual correspondence with the FSA -- and indeed with the Revenue, telling the Revenue what is being going on with the FSA, because that's what the Revenue correspondence is there for -- there is no mention at all about the possibility that capital coming potentially from the shareholding companies.
MR JUSTICE HILDYARD: I am sure you are right that limited company is the template and the unlimited company is to some extent the surprise. But it is not unheard of and it must be simply worked through as to its consequences, I think. Everything is quite unusual, after all, in the circumstances of a 8 billion surplus. So there we are.
MR MARSHALL: Indeed. Well, it perhaps becomes of particular relevance when one considers what has been described in our submissions as the Aberdeen City Council approach or point arising out of that.
MR JUSTICE HILDYARD: Is there anything you rely on in Aberdeen City which is not repeated in --

MR MARSHALL: Arnold v Britton. Not that we relied on. We have a copy of it if your Lordship would like it.
MR JUSTICE HILDYARD: I had better have it. I remember the discussion in broad terms that Lord Clarke has as to the difference between implication and reading into the words what you want to find there.
MR MARSHALL: I will hand that up to your Lordship. I have a copy here.
What we got from Arnold v Britton, contrary to what Mr Trower submitted, is that in fact Lord Neuberger didn't question our Aberdeen City Council at all. In fact, he affirmed the approach taken in Aberdeen City Council as being an appropriate approach, as did Lord Hodge in the passage I took your Lordship to previously. So there is absolutely nothing in Arnold v Britton which calls into question at all what is said in that case.
MR JUSTICE HILDYARD: I think it is only whether it is properly characterised as implication or constructive interpretation of existing words.
MR MARSHALL: And if your Lordship looks at the sixth point of Lord Neuberger, it would appear quite clear that he is treating it as part of interpretation of express terms, not implication. So we do not accept there is any conflict of any kind between those two authorities.

On the question of what the FSA also had in mind, we of course had referred to the EC materials. Your Lordship has been told, well, it is possible that various entities in Europe may have some sort of unlimited liability. But your Lordship has been given the EC directives, and again they don't reflect the possibility of companies of this kind with the possibility of calls upon shareholders.

There are other provisions referring to different types of entity altogether, where there may be the possibility of various forms of capital other than paid up capital. But in the corporate context, there is no indication of anything like that. And in terms of partnership, I think Mr Trower referred to that as being a type of business arrangement that was covered by both the EC directors and the FSA regulations.

When one looks at what the FSA require in terms of details of capital, when you look at partnership, it is the partnership capital account that they are concerned with, not the possibility of calls being made on partners thereafter.

A number of points were made about the documents --

MR JUSTICE HILDYARD: Can I take you back to Aberdeen? This is a slightly pedantic point, I fear. But if you go to Arnold v Britton at page 29 in Lord Carnwath, which was

a dissenting speech --

MR MARSHALL: Would your Lordship allow me to --

MR JUSTICE HILDYARD: It is volume 4, 100 at page 29. Lord Carnwath thought that what Lord Clarke had been doing was implying a term. Do you see that just above J?

MR MARSHALL: Yes.

MR JUSTICE HILDYARD: And I think the discussion about Aberdeen is where does one stop and the other begin? I think some people see implication and some people see interpretation, which is one of the reasons why you get this sort of tension which Marks & Spencers is meant to resolve. But maybe it is not as straightforward as all that. I do not know.

MR MARSHALL: Certainly Lord Neuberger at paragraph 22 is dealing with it as part of the interpretation of express terms as one of his six points.

MR JUSTICE HILDYARD: They vary sometimes as to the way they look at it.

MR MARSHALL: And Lord Hodge certainly seems to be looking at it as a matter of textual analysis.

MR JUSTICE HILDYARD: I think that is why maybe Lord Bingham used to use the word "interpolation". If you actually had to insert new words into the clause, you were interpolating. If you were inferring from the existing words some meaning which you thought the contract could

legitimately bear, you were construing. But it may not matter ultimately.

MR MARSHALL: Yes. At the end of the day, we submit that if we have to, we rely on Aberdeen City Council as an approach your Lordship could adopt in this case.

MR JUSTICE HILDYARD: Yes. Does your argument rely on or is it prejudiced according to whether it is to be thought that the context of insolvency with unlimited companies was or was not within the contemplation of the parties, not subject to be --

MR MARSHALL: That would be a support for bringing in Aberdeen City Council as an approach.

MR JUSTICE HILDYARD: If it was not?

MR MARSHALL: If it was not.

MR JUSTICE HILDYARD: If it was, wouldn't the inference be that they'd had a look at it and been unable to agree?

MR MARSHALL: If they had it in contemplation, we would submit that would mean there would be support for taking the express term approach to interpretation and looking at the other contextual circumstances more closely in order to determine whether or not it could really have been intended that they were going to have recourse to the shareholders to meet the subordinated debt, if that was in their mind. We would then say the materials we have in bundle 5 become all the more important in

those circumstances.

Regarding the bundle 5 materials, I think Mr Trower submitted to your Lordship that items 1 to 4 of the bundle were all correspondence with the Revenue. That is not correct. Item 1 is in fact correspondence with the FSA, and it makes the points I had been making before. I am sorry that in the transcript I did not complete the three points on the --

MR JUSTICE HILDYARD: Had I counted wrong?

MR MARSHALL: I was actually making this a number of times during the course of the day, but the three points were that the structure would not be changing very easily because it was a very carefully constructed one, and therefore there would not be assignments or changes of shareholder. It was intended to be a reasonably permanent arrangement and one of the letters that was sent to the Revenue made that point.

The second was that the group was being regulated as a group and there was an intention to protect the creditors of the group.

Then the third point was that when one looked at the various charts and structure charts and descriptions of participants involved, your Lordship could see that there was not any consideration given or reference to the possibility of calls upon the shareholders, and

indeed LBL was not even referred to.
That was the third point which I am afraid I did not complete before the short adjournment on page 45. But your Lordship will see that that was made in other places. For example, I went through I think the three points in the course of pages 28 to 30 of the same transcript where it is made there.
The only other point I wanted to make regarding the materials in the trial bundle 5 is that the later materials in -- I think it is tabs 8 through to 11 are designed to show your Lordship what the FSA was addressing before November 2006 and how they were addressing it. It was not for any other purpose, and that is its significance.
Insofar as one has regard to the letter of the FSA which is in tab 7, where they give their consent to repayment of the subordinated loans as they were then in place and their substitution by the LBHI2 subordinated debt, Mr Trower suggested that the word "the firm" has to be treated as a reference to LBIE. If your Lordship has that in bundle 5, tab 7, this is on the last line of the third paragraph:
"We respectfully submit in the context of the other correspondence that has been ongoing with the FSA and the other materials that your Lordship has in

the subsequent tabs, that has to be a reference to the UK group. And in particular, why one would have a reference to UK capital structure in relation to LBIE would be a bit of a mystery because it was a UK company. The UK capital structure is a UK capital structure for Lehman Brothers as a group and that is consistent with the way in which FSA had been approaching regulation in the correspondence about this particular matter all the way through."
MR JUSTICE HILDYARD: The FSA focuses on LBIE as the regulated entity, doesn't it?
MR MARSHALL: It is the regulated entity --
MR JUSTICE HILDYARD: They would be concerned to see claims coming in. It may have a general paternal concern of the group, but its focus is on LBIE.
MR MARSHALL: If your Lordship has the same bundle, if I go back to the first document with the FSA which led up to this, which is at tab 1, talking about the UK restructuring, the very thing that is being referred to in that passage. It is in the pre-penultimate paragraph:
"The final form of restructure would not lead to an overall reduction of capital at the group or a reduction in the quality of the capital available to the group."
That is the concern of the FSA, we submit, and it is

reflected in all of the other documents in this bundle.
I am just reminded by Ms den Besten that in the letter we were looking at in tab 7 that where they refer to LBIE, they do so as a defined term in that passage.
MR JUSTICE HILDYARD: I have enough contracts to interpret without interpreting very closely ...
MR MARSHALL: Your Lordship has our submissions on that. We submit it was the group being considered and there were good reasons for that, because you don't want to have creditors of certain group companies which are providing services ultimately for the benefit of the trading company being prejudiced by virtue of claims over against another member company. Your Lordship obviously has our point about that from our earlier submissions.
My Lord, I think the only other matter on issue 1 was the suggestion that clauses 6F and 7F were simply concerned with circumvention of the subordination provisions of the subordinated loan agreement. We respectfully submit that can't be the right interpretation. If they had simply been concerned about the possibility of some substituted creditor or subrogation rights, they simply could have provided that any arrangement that provided for a suretyship, security or anything of that nature were not to include any right of subrogation. That would have been possible for them

to do and that is not what they did.
They simply prevented any possibility of any form of recourse to anyone else in relation to the debt, and we submit that is entirely consistent with the approach to the construction we adopt, which was that it was to be LBIE's own assets without recourse to its other shareholders or other members of the group in order to meet the debt.
My Lord, on the remaining issues which concern LBL particularly, the only others I wanted to say something briefly regarding were issue 7.
It was suggested that it was not clear there would be independent rights to be pursued between LBL and other parties. Well, that is exactly what we do say is the case. We do have independent rights, quite separate from just rights to contribution as a result of the extent of our shareholding and the amount that may be called under section 74 based simply on the size of shareholding.
We have quite separate independent legal rights, for example, potentially a right to indemnity as agent or as nominee in terms of the shareholdings that we held for others, and of course we also rely upon a contractual entitlement under the recharge agreement. So these are independent claims which we wish to pursue and it may

not be possible to have -- well, it won't be possible, we submit, to have those as part of an adjustment process.

They would be dealt with as an independent claim as part of the proving process and the other insolvencies. They don't simply disappear as a result of the adjustment provisions in section 74.

MR JUSTICE HILDYARD: I do not think it is suggested they do? But they just think it is res inter alios acta, in effect.

MR MARSHALL: Issue 9, to conclude, the suggestion is we aren't concerned with the anti-deprivation principle but rather with the pari passu principle. The way that is suggested is -- I think it is put this way -- because we are dealing with a statutory liability under section 74 rather than an asset that has been removed from the grasp of LBIE, or at least its solvency officeholder as a result of the recharge arrangement.

This really boils down, to an extent, to a semantic type of argument. If they are right in their contention, and as I understand it is their contention, that Lord Justice Briggs' description is correct and the right to make a call is an asset of the company, then the effect of the recharge agreement which preceded the membership of LBL has the effect incidentally of

depriving LBIE of the asset so far as it concerns a claim against LBL. That is the effect.

If one adopts an alternative analysis, that of Lord Justice Lewison, it deprives LBIE of a right of recourse. That is its effect. That being so, it is in our submission something which naturally falls within the anti-deprivation doctrine rather than the pari passu doctrine.

Insofar as it is suggested that section 74, because it is a statutory provision and the effect of the agreement is that you come out of it. But that is something that distinguishes it because it is a statutory provision from the anti-deprivation rule which is said to be a judge-made rule. We don't really understand that suggestion, because in Lord Collins' judgment in Belmont, what you have is a general principle stated that you can't contract out of the insolvency legislation and then these two things are said to be sub-rules of that general principle. So it is not a question of one involving a statutory provision or not, they are both treated as involving the insolvency legislation and the effect of their application.

MR JUSTICE HILDYARD: They are both under the umbrella of the insolvency and they are both the consequences. But

just like in a different context, the rule in Trevor v Whitworth is judge-made. It wasn't statutorily enacted for a very long time but no less effective for it, it is judge-invented. But rather like your implication of terms, it was thought to be implicit, as it were, in the architecture. But pari passu is very much there for all to see, isn't it?

MR MARSHALL: It's been treated as having a certain effect, and that was done British Eagle. Prior to that, there was probably some uncertainty about the position. But they are both judge-made in the sense that has been developed in the authorities.

Lastly, the suggestion was made that we referred to Welton v Saffery and we made points about the fact that the focus of that case was upon ultra vires and it was said that was a rather narrow way to look at the case and we ought to look at other cases, and so on.

We went to that case because in my learned friend's skeleton argument at paragraph 279, that is the case. It is just that case relied upon for the proposition that the purpose of the agreement -- in our case the recharge agreement -- does not matter. That was the authorities said to support that, and that was derived from the passage at pages 304 to 305 which I took your Lordship to.

So that is why I addressed it. When you look at those passages, they are all about the reason purpose did not matter is because there was no authority because it was ultra vires.

Can I just check if there was anything else?

MR JUSTICE HILDYARD: Yes.

MR MARSHALL: Those are our submissions. I hope that was within time. If there is anything else I can assist your Lordship with?

MR JUSTICE HILDYARD: Thank you very much, Mr Marshall.

Mr Trower, you have some sweeping up to do.

MR TROWER: No replies to replies to replies from me.

MR JUSTICE HILDYARD: Well, you will all get another go when the Supreme Court answers.

Final submissions by MR TROWER

MR TROWER: My Lord, I think I need to sweep up on anything your Lordship needs help on and how it is that we see the shape of what is going forward, particularly in the light of the Supreme Court and the agreed issues.

As far as the agreed issues are concerned, we have put in the materials, we have not spent a lot of time addressing them. We hope my Lord sees what the ambit of them is and why they are likely to have been agreed.

My Lord, can I just say this about them? It may make a difference -- we are all here seeking directions

as office holders. I think so long as my Lord directs the office holders to proceed in accordance with the conclusions my Lord reaches, that would be sufficient for everyone, rather than a full declaration of rights if my Lord is still concerned with that. It may slightly depend upon the issue as to where my Lord was on it. The important point is that everybody should actually be directed to act in a particular manner so everybody is then bound by it.

That is all I was going to say in relation to the agreed issues in addition to what we have already put in writing. As we have indicated, the second and fourth issues which are agreed are also issues on which the decision of the Supreme Court made there.

It may be that -- because the agreement has been reached on the basis of the decision of the Court of Appeal, so we may have to revisit the exact formulation of the agreement if the Supreme Court says something different in relation to any of the issues. But subject to that, I was not going to say anything further in relation to that.

So far as the Supreme Court is concerned, we will obviously notify your Lordship as soon as we get wind that their Lordships are about to say something and produce their judgments. We will then obviously give

your Lordship the judgment as soon as it is available. It may be premature until we see it to know exactly how we should take matters forward, but what I am sure we can all do is consult together when we see the judgment as to what we think the best course is. We are all at the end of the day representing office holders and I am sure we will be able to find an appropriate way forward.

My Lord, subject to that, I do not think I had anything further to sweep up. But I am very happy to answer any further questions of a general or specific nature your Lordship may have, or try to.

MR JUSTICE HILDYARD: Well, I have interrupted quite a lot and don't want to ask any more specific questions. I may have some more questions as I read through the transcripts and try and get it more orderly.

As I indicated, I think it is inevitable we will have to meet again, and I would certainly -- as presently I stand, I very much welcome that to see what will by then be a slightly different jigsaw. I want to see where the pieces fit in and I do not want to trust myself to squeeze them into the wrong slot.

So we will have to do that. My own timetable is tricky. But as I presently see it, I doubt we would need more than a day. So we will simply have to I think

work together towards finding a day once we know when the Supreme Court's judgments are available and you have had sufficient time to really see how they impact.

Of course, if it is delayed in a way which begins to impact at all on the part B trial, I think we will just have to touch base again.

MR TROWER: I can quite see that if we are waiting for longer than we all hoped, we may have to come back and have a short hearing to explain the position and get your Lordship's direction.

MR JUSTICE HILDYARD: Yes. Basically, just so that you should know, presently from 8 May until the end of the summer term in July, I will be engaged on the RBS trial. There is therefore a little bit of time I have in March, if the Supreme Court answers quite soon. And in June and July, I have one or two free days -- because I am only sitting Monday to Thursday by and large, so Fridays might be available. That is just to give you a sort of foresight of what my own difficulties are.

MR TROWER: Yes, that is extremely helpful.

MR JUSTICE HILDYARD: I think Mr Bayfield may know that he has Friday 30 June on another Lehman matter.

MR TROWER: Yes. Your Lordship did indicate there may be a day in September.

MR JUSTICE HILDYARD: Yes, I am hopelessly vague about it.

I do apologise. If I can engineer it, it will either be taking out Friday 22nd, which in fact coincides with your own, in which case there is no additional problem, or Friday 29th. As soon as I know, I will let you know.

MR TROWER: That is very helpful.

MR JUSTICE HILDYARD: It is only likely to be one day, possibly one and a half, depending upon travel arrangements. That is the lie of it and I will let you know as soon as I can.

On the agreed issues, I think I just need to figure -- I may very well have further questions on the agreed issues if, because I have not had as much of your time on those as on the others, I am not really sufficiently up to speed on them.

So I do not know what the formula is, but we will adjourn this until we have heard from the Supreme Court and then reconvene unless everyone is of the view, including me, that it would be unnecessary, which I think is pretty unlikely.

MR TROWER: That is indeed the case. Before your Lordship rises, could I just say this: it has come to our attention that your Lordship's clerk is retiring and on behalf the Bar, can I say how much we have gained from the service he has provided to your Lordship over the course of the Lehman matters and we very much hope

that he has a long and happy retirement.
MR JUSTICE HILDYARD: That is very nice, and I would concur and join in with that. Richard has been brilliant.
Thank you very much indeed all of you. Thank you all also for your very great assistance and very efficient submissions.
(4.20 pm)
(The hearing was adjourned to a date to be fixed)

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