CR-2009000052
CR-2008-000026

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

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

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

LBHI2 Applicants

-and-

(1) LEHMAN BROTHERS HOLDINGS SCOTTISH LP 3
(2) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)
(3) DEUTSCHE BANK AG (LONDON BRANCH)

LBHI2 Respondents

AND BETWEEN:

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

PLC Applicants

-and-

(1) LEHMAN BROTHERS HOLDINGS INC
(2) THE JOINT LIQUIDATORS OF LB GP NO 1 LIMITED (IN LIQUIDATION)
(3) DEUTSCHE BANK AG (LONDON BRANCH)

PLC Respondents

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

I. INTRODUCTION

1. This Position Paper is filed on behalf of the Joint Liquidators ("the **JLs**") of LB GP No. 1 Limited (in liquidation) ("**LBGP1**") pursuant to paragraph 8.b. of the 24 July 2018 order of Mann J.

2. The focus of this paper is on the PLC Application, to which the JLs are party. The issue of the appropriate order of distributions on the PLC Application will, however, only arise if the issue of the appropriate order of distributions is resolved in favour of Lehman Brothers Holdings Plc ("**PLC**") in the LBHI2 Application.

3. For that reason, the JLs consider that logic compels the determination of the LBHI2 Application *before* the PLC Application.

4. The JLs accordingly disagree with the suggestion made at §7 of the Position Paper filed by Lehman Brothers Holdings Inc. ("**LBHI**") and Lehman Brothers Holdings Scottish LP 3 ("**SLP3**") that the ranking issue in the PLC Application should be determined before the ranking issue in the LBHI2 Application.

5. That approach is designed to disguise the fact that the ranking issue in the LBHI2 Application is comparatively straightforward – and should be determined against SLP3: the LBHI2 Sub-Debts rank above the LBHI2 Sub-Notes in that application. That is the clear effect of the 2008 Amendments.

6. Conversely, the position in the PLC Application is more complex. Four issues arise. Deutsche Bank AG ("**DB**") is a party to the PLC Application in its capacity as the holder of Enhanced Capital Advantaged Preferred Securities ("**ECAPS**") issued by the various Partnerships of which LBGP1 is the general partner (and as defined below) so as to raise funds to purchase the PLC Sub-Notes. DB is therefore an underlying investor in the PLC Sub-Notes held by LBGP1 (albeit one step removed, as being invested in the ECAPS used by the Partnerships to purchase the PLC Sub-Notes). LBGP1 and DB's interests are accordingly aligned, and they have coordinated so as to avoid too much duplication of argument. In outline, LBGP1's position on the PLC Application is, therefore:

   6.1 **Issue 1**: LBGP1 will leave it to DB and LBHI to advance the competing submissions on this issue, which will likely turn on questions of US law.

   6.2 **Issue 2**: On their true construction, the PLC Sub-Notes rank: (i) *pari passu* as between themselves; and (ii) ahead of the PLC Sub-Debts.

   6.3 **Issue 3**: LBGP1 remains neutral on the question of whether the Guarantees have terminated, as that is a matter for the ECAPS holders (including DB for these purposes). LBGP1's view is that if they are enforceable they rank behind the PLC Sub-Notes and the PLC Sub-Debts, essentially for the reasons given at §§43(2)-(7) of LBHI's position paper.

6.4 **Issue 4**: LBGP1 is satisfied that the competing arguments as to whether, and how, the PLC Sub-Notes should be discounted will be fully canvassed by LBHI and DB. LBGP1 therefore does not advance any particular position on this issue, and will be bound by the Court's determination.

7. Accordingly, this Position Paper focusses on the second issue in the PLC Application.

PLC Sub-Debts and Sub-Notes

8. For ease of reference:

8.1 The PLC Sub-Debts were originally lent by Lehman Brothers UK Holdings LLP ("**LBUKH**"), and the benefit of the loans were assigned to LBHI at the conclusion of LBUKH's administration in 2016. They are:

(i) €3bn Long Term Subordinated Loan Facility Agreement dated 30 July 2004.[1]

(ii) $4.5bn Long Term Subordinated Loan Facility Agreement dated 30 July 2004.[2]

(iii) €8bn Short Term Subordinated Loan Facility Agreement dated 31 October 2005.[3]

8.2 The PLC Sub-Notes:

(i) Involve three limited partnerships (LBGP1 being the general partner of each):

(a) Lehman Brothers UK Capital Funding LP ("**LP1**"), established by Limited Partnership Agreement dated 22 March 2005[4] between LBGP1 as general partner and LB Investment Holdings Limited as preferential limited partner.

(b) Lehman Brothers UK Capital Funding II LP ("**LP2**"), established by Limited Partnership Agreement dated 25 August 2005[5] between the same entities.

(c) Lehman Brothers UK Capital Funding III LP ("**LP3**"), established by Limited Partnership Agreement dated 17 February 2006[6] between the same entities.

Collectively "**the Partnerships**".

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*References to documents are given by their page numbers in the exhibit to the Third Witness Statement of Gillian Eleanor Bruce in support of the PLC Application ("**GEB3**"), and the Second Witness Statement of Derek Anthony Howell in support of the LBHI2 Application ("**DAH2**")*

[1] GEB3 p.87
[2] GEB3 p.99
[3] GEB p.112
[4] DAH2 p.123; Supplemented on 24 March 2005
[5] DAH2 p.351
[6] DAH2 p.800

8.3 PLC issued:

(i) €225m of Fixed Rate to CMS-Linked Subordinated Notes to LP1 pursuant to an Offering Circular dated 29 March 2005[7], with a closing date of 30 March 2005.

(ii) €200m of Fixed Rate Subordinated Notes to LP2 pursuant to an Offering Circular dated 19 September 2005[8], with a closing date of 21 September 2005.

(iii) A further €50m of Fixed Rate Subordinated Notes to LP2 pursuant to an Offering Circular dated 26 October 2005[9], with a closing date of 27 October 2005, to be consolidated with the earlier €200m issue.

(iv) €500,000 of Fixed / Floating Rate Subordinated Notes to LP3 pursuant to an Offering Circular dated 20 February 2006[10], with a closing date of 22 February 2006.

Collectively "**the PLC Sub-Notes**", which were listed on the Channel Islands Stock Exchange.

8.4 The Partnerships financed their acquisition of the PLC Sub-Notes through the issuance of the ECAPS to third party investors, such as DB.

II. APPLICABLE PRINCIPLES

9. The JLs' position is that the ranking issue in the PLC Application is one of contractual construction. As a result:

9.1 the Court may have regard to the factual matrix as an aid to construction, though textual analysis will be the primary tool where – as here – the documents have been prepared by professionals: e.g. *Wood v Capital Insurance Services* [2017] UKSC 24; [2017] AC 1173;

9.2 the Court will also be careful not to have regard to inadmissible evidence of subjective intention: e.g. *Mihail Tartsinis v Navona Management Co* [2015] EWHC 57 (Comm).

10. SLP3/LBHI's Position Paper relies – at key parts of the analysis – on the parties' *"objective intention"*.[11] The use of the term *"objective"* does not make it so. What SLP3/LBHI are seeking to do is impermissibly appeal to what they perceive to have been the parties' *actual* (i.e. subjective) intention as an aid to construction. Even if it could be possible to glean or infer this

[7] GEB p197
[8] GEB p.220
[9] GEB p.243
[10] GEB p.266
[11] E.g. §13(8); §15(1); §30(1)

subjective intention(s) from isolated documents that does not make the exercise *"objective"* or less objectionable.

11. Further, what was known or intended within the Lehman Group is of limited assistance in circumstances where the PLC Sub-Notes (in particular) were addressed to and would be relied upon by a potentially wide number of third-party investors who would lack knowledge of internal Lehman Group restructurings or intentions. They are not ordinary commercial contracts, and that fact serves to limit the extent of admissible background facts to the construction exercise: *Mannai Investment Co v Eagle Star Life Assurance* [1997] AC 749; *Homburg Houtimport BV v Agrosin Private Ltd* [2003] UKHL 12; [2004] 1 AC 715; *Re Sigma Finance Corp* [2009] UKSC 2; *LB Re Financing No.3 Ltd v Excalibur Funding No.1 Plc* [2011] EWHC 2111 (Ch); *Toth v Emirates* [2012] EWHC 517 (Ch); [2012] F.S.R. 26; *Cherry Tree Investments Ltd v Landmain Ltd* [2012] EWCA Civ 736.

12. LGBP1's position is that the answers to the ranking questions arising on Issue 2 (and, for that matter, in the LBHI2 Application) require – primarily – consideration of the actual terms of the various notes and debt instruments. LBHI/SLP3 overstate the significance of the background in that exercise, and seek to draw on impermissible subjective intentions as an aid to construction.

13. That being said, the background (including the applicable regulatory context from time to time) is somewhat complex. For ease of exposition, this Position Paper commences with a review of it – though without prejudice to the JLs' position that the background is ultimately of limited relevance to the requisite construction exercise.

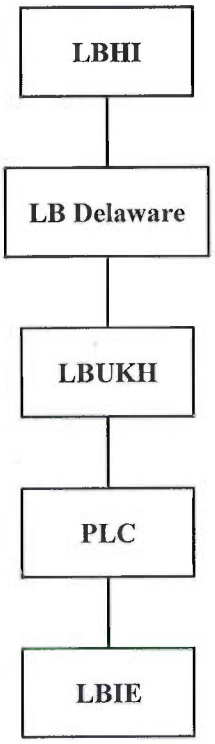
III. FACTUAL BACKGROUND

Basic corporate structure

14. LBHI is the ultimate US parent company of the Lehman Brothers Group. Ignoring irrelevant intermediate companies, prior to the creation of the debt arrangements which are the subject of these applications: LBHI owned LB UK Holdings Delaware Inc (**"LB Delaware"**) which in turned owned LBUKH, which in turned owned PLC, which in turn owned LBIE, the main European trading entity.[12]

[12] Structure chart at MJAJ1 p.86

15. Thus, at the time that the relevant arrangements were put in place, the simplified corporate structure was:



Creation of the PLC Sub-Debt and PLC Sub-Notes

Outline of Relevant Regulatory Regime

16. LBIE's activities were funded by a series of sub-debts lent downwards from LBHI through each entity in the chain.

17. It appears that that lending was intended to provide capital (or "Financial Resources") for regulatory purposes. The then current regime was under Chapter 10 of the Interim Prudential sourcebook: Investment Business ("**IPRU(INV)**") section of the FSA Handbook, entitled *"Financial resources for Securities and Futures Firms which are Investment Firms"*. The basis of this regime was the Capital Adequacy Directive (issued in 1993)[13].

18. Chapter 10 contained certain requirements concerning the inclusion of subordinated loans when calculating a firm's "financial resources". Those rules included:

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

[13] See explanation in first instance judgment of David Richards J in *Waterfall 1* [2014] EWHC 704 (Ch) at [35] to [38]; the regime was replaced in 2006 to give effect to Basel II – and it is that later regime which is of application and potential relevance to the LBHI2 Application)

(a) *if it is drawn up in accordance with the standard forms obtained from the FSA..."*

G *If a firm wishes to use a form which differs from the standard form it will need to seek a modification to, or waiver from, this rule."*

10-63(4) R *"A firm's subordinated loans must be classified as one or other of the following:*
(a) long term subordinated loan; or
(b) short term subordinated loan.

10-63(5) R A firm's long term subordinated loan must have an original maturity of at least five years.

10-63(6) R *"A firm must not (except in accordance with the terms of the loan):*
(a) repay, prepay or terminate a long term subordinated loan before the agreed repayment date unless it has provided the FSA with at least five years' written notice; and
(b) make any payment of interest if after such action the firm's financial resources will fall below 120% of its financial resources requirement."

(10-63(8) & (9) related to short term subordinated loans and were in materially the same form as (5) & (6), save that they provided for two year not five year periods.)

19. Annex D to IPRU(INV) contained the relevant standard forms which firms could use to create subordinated loans. The correct form depended upon whether the firm was regulated on a "consolidated" or "non-consolidated" basis. For example, Form 10.1 provided for a long term subordinated loan (non-consolidated basis), Form 10.6 provided for a long term subordinated loan (consolidated basis) and Form 10.7 provided for a short term subordinated loan (consolidated basis). The forms were in two parts; the first part ("Schedule 1") contained "Variable Terms"; and the second part ("Schedule 2") contained Standard Terms.

20. Further:

20.1 Guidance notes in the body of Schedule 1 directed the draftsperson as to how the form should be completed. For example, the notes to paragraph 9 of the standard forms direct that the repayment date should be more than five years hence (in the case of long term loans) and two years (in the case of short term loans).

20.2 The FSA guidance (behind the forms at section 10.8) directed that *"Rather than re-type the Standard Terms (Schedule 2), **firms should simply photocopy Schedule 2 of the FSA precedent or print it from the website and include it as part of the Original Agreement**"* (emphasis original).

The Long Term PLC Sub Debts

21. It is convenient to explain the creation of the various PLC Sub Debts and PLC Sub Notes in chronological order. As outlined above, LBUKH's funding of PLC was under three sub-debt agreements (together the PLC Sub-Debt). LBUKH was, as its name suggests, the immediate holding company for PLC and the provider of finance to it via the PLC Sub-Debt agreements (in turn, it appears LBUKH borrowed from its immediate parent via mirror arrangements). The first two of those agreements were both dated 30 July 2004, namely the:

21.1 €3bn Long Term Subordinated Loan Facility Agreement;[14] and the

21.2 $4.5bn Long Term Subordinated Loan Facility Agreement.[15]

22. Both are in materially the same form, which appears to be *based on* Form 10.1 of IPRU(INV).[16]

23. Notwithstanding the very prescriptive approach of IPRU(INV) as regards standard forms, these two long-term facilities contained significant amendments to that standard form. For example:

23.1 The front page does not refer to the indebtedness as being intended to be in accordance with IPRU(INV) 10-63 (Form 10.1) (or, if the precedent was Form 10.6, as contributing to the firm's Financial Resources Requirement – as that form provides).

23.2 The following standard form wording for paragraphs 4(2) & (3) of the Standard Terms (dealing with Repayment) was omitted:

> *(2) the terms concerning repayment are set out in the Variable Terms but are subject to paragraph 4(3).*
>
> *(3)(a) Except where the FSA otherwise permits, no repayment, or prepayment of the Loan or any Advance may be made, in whole or in part, before the relevant repayment date provided for in paragraph 9 of the Variable Terms.*
>
> *(b) The FSA may permit the early repayment or prepayment of the Loan or any Advance, in whole or in part, only where, immediately after such repayment or prepayment, the Borrower's Financial Resources would be greater than 120% of its Financial Resources Requirement.*
>
> *(c) Payments of interest at a rate not exceeding the rate provided for in paragraph 3 may be made without notice to or consent of the FSA, except that where-*
>
> *(i) immediately after payment, the Borrower's Financial Resources would be less than or equal to 120% of its Financial Resources Requirement; or*
>
> *(ii) before payment, the Insolvency of the Borrower commences,*

[14] GEB3 p.87
[15] GEB3 p.99
[16] Notwithstanding that Lehman Brothers was regulated on a consolidated basis, and this was the non-consolidated template

No such payment may be made without the prior written consent of the FSA."

23.3 The effect of that omission is that the reference to paragraph 4(3) at paragraph 5(1)(a)(i) of the Standard Conditions makes little sense. (And §3 of Ms Bruce's third witness statement may, therefore, be inaccurate to the extent that she assumes that the literal cross-reference to paragraph 4(3) in those notes is the correct interpretation.)

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

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

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

24. It is unclear what reasoning, if any, was behind these amendments. It may be that they were drafted using out-of-date forms (using forms, for example, which did not take into account latest Handbook Releases published by the FSA, including update 26 published in January 2004).

25. Further, the ability of PLC to prepay the sums due under the debts on two Business Days' notice (paragraph 9) does not sit easily with the instructions in the guidance notes that repayment must be at least five years hence.

26. Whatever the reason(s), it would appear that: (i) it was not necessarily the practice of the Lehman Group to give the FSA standard forms the deference they appeared to demand; (ii) these PLC Sub-Debts were somewhat sloppily drafted; and (iii) the FSA Regulatory Requirements may not have been fully complied with in respect of this borrowing.

<u>€225m of Fixed Rate Subordinated Notes to LP1</u>

27. The next arrangement (chronologically) was the €225m of Fixed Rate Subordinated Notes issued to LP1 pursuant to an offering circular of 30 March 2005. The sums to be raised pursuant to this

note issue (as with the subsequent PLC Sub-Notes) were intended to be used to strengthen the regulatory capital base of the Lehman Group, to pay off existing loans and for general corporate purposes,[17] and, therefore, intended to form part of Lehman Brothers group's ("**LB**") "financial resources" for the purposes of IPRU(INV).

28. Because LB wanted to take these into account for the purposes of their financial resources, and because the standard forms were not apt to deal with a note issue as opposed to a debt arrangement, new documents needed drafting and a waiver needed to be obtained from the FSA (IPRU(INV) 10-63(2) R). The waiver application for the €225m PLC Sub-Notes has not, thus far, emerged, but the waiver application in respect of the subsequent LP2 PLC Sub-Notes is available – and it can be inferred from the cover letter to the FSA[18] that such a waiver was sought and obtained in relation to the LP1 PLC Sub-Notes.

29. It was no doubt considered easier to obtain a waiver the closer the document in respect of which the waiver was sought mirrored the standard forms. The drafting of the subordination provisions is therefore based upon the standard form at Form 10.6.[19] One sees that – for example – from the Allen & Overy advice on the UK law treatment of these notes on 15 April 2005, where it was said that the Notes were *"[m]aterially identical to the corresponding Standard Terms in the Financial Services Authority's Form 10.6 (Approved form of Long-Term Subordinated Loan Agreement for the purposes of Consolidated Supervision)... contained in the Interim Prudential Sourcebook: Investment Business of the Financial Services Authority."*

<u>€200m of Fixed Rate Subordinated Notes to LP2</u>

30. Next, these PLC Sub-Notes were issued to LP2 on 21 September 2005 (pursuant to an offering circular dated 19 September 2005). A further €50m of Fixed Rate Subordinated Notes were issued to LP2 on 27 October 2005 (pursuant to an offering circular dated 26 October 2005), to be consolidated with the earlier €200m issue.

31. Again, the intention was that these PLC Sub-Notes would mirror the drafting of the FSA standard form for subordinated loans. Curiously, Allen & Overy's advice of 26 September 2005[20] (which is otherwise in materially identical terms to the 30 March 2005 advice) refers to the PLC Sub-

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[17] GEB p.212
[18] Dated 5 October 2005, which refers to *"The notes to which this waiver application relates are very similar to the notes covered by Direction 147457 which was granted to Lehman Brothers on 26 May 2005"*
[19] NB that the 100% resourcing requirement was provided for at paragraph 5(1)(a) of the Standard Terms to Form 10.6 ("consolidated basis") – but not at the same paragraph of the Standard Terms to Form 10.1, where it was 120%.
[20] DAH2 p.521

Notes corresponding to the FSA form 10.7 (short term subordinated notes) rather than 10.6 (long term).

32. The advice attaches a marked-up version of that Form 10.7 (which does appear to mirror the then up-to-date version in force), which explains which of the provisions are being co-opted into the wording of the PLC Sub-Notes, and which were thought to be inapplicable.

33. It is unclear whether this document was prepared back when the (first) €225m Fixed Rate Subordinated Notes were drafted, or whether it was drafted subsequently in order to cross-check that the key provisions of the standard form were mirrored in the €200m of Fixed Rate Subordinated Notes. Accordingly (and in any case) it cannot be inferred from this document that the PLC Sub-Notes were *only* intended to put the standard form into a note-appropriate form and do nothing beyond that.

$8bn Short Term Subordinated Loan Facility Agreement

34. This was the final facility which forms part of the PLC Sub-Debt. It was created by an agreement dated 31 October 2005. Unlike the earlier long-term PLC Sub-Debt, this agreement does properly mirror the standard form FSA Form 10.7.[21]

35. The subordination provisions in this short-term note are the same as in the earlier long-term notes, save that the "Liabilities" definition includes the "*the Loan or*" phrase deleted from the earlier notes. Thus, "*"**Subordinated Liabilities**" means all Liabilities to the Lender in respect of the Loan or each Advance made under this Agreement and all interest payable thereon.*"

€500,000 of Fixed / Floating Rate Subordinated Notes to LP3 on 22 February 2006.

36. The final relevant arrangement was the third tranche of PLC Sub-Notes, which were issued pursuant to an offering circular dated 20 February 2006. The terms are materially the same as the earlier PLC Sub-Notes.

Summary

37. For the purposes of the PLC Application, that is where the relevant background ceases.

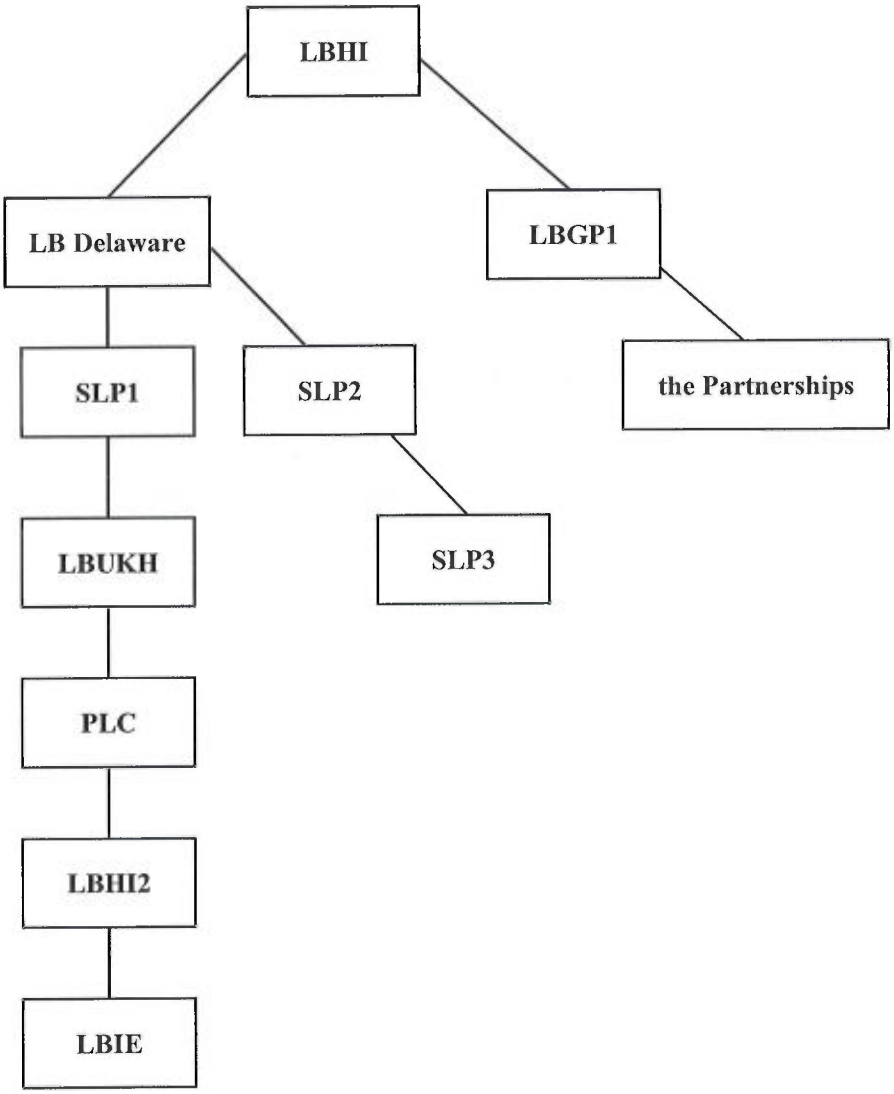
38. Later in 2006 and into 2007:

[21] Though, again, the prepayment provisions at clause 9 do not sit altogether happily with the guidance notes beneath

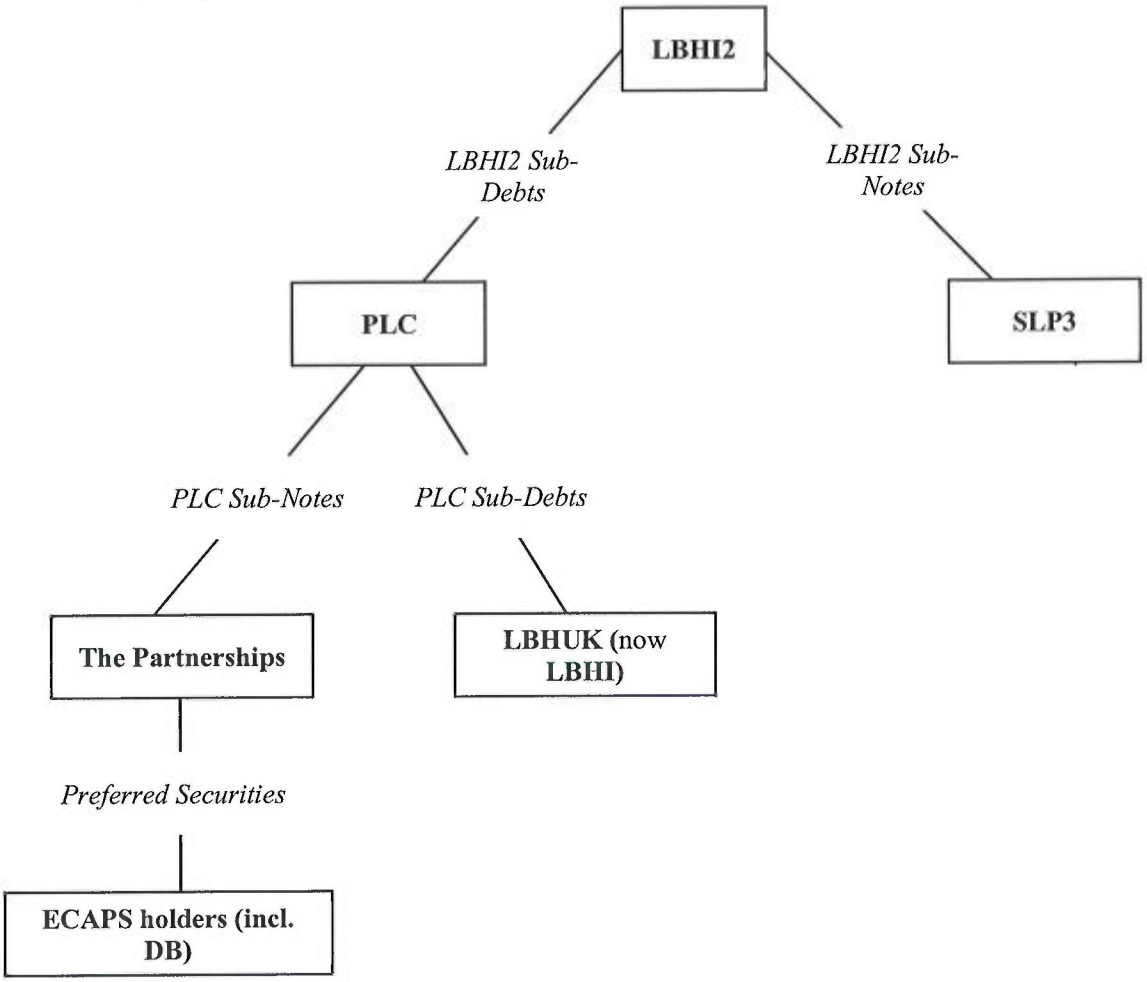
38.1 LBHI2 was interposed into the corporate structure (between PLC and LBIE), and the LBHI2 Sub-Debts created; and

38.2 SLP3 was created (under LB Delaware) and the LBHI2 Sub-Notes issued.

39. The relevant simplified corporate ownership structure thereafter was therefore:



40. The relevant debts at the conclusion of this reorganisation (with debts flowing downwards) can be stylised as follows:



41. When presented as set out above, it is obvious why the LBHI2 Application must be determined first: if it is determined that the LBHI2 Sub-Notes have priority, nothing will flow down the left hand side of the waterfall shown above – and the ranking between the PLC Sub-Debts and PLC Sub-Notes will be irrelevant.

42. The remainder of this paper therefore proceeds on the basis that PLC has succeeded in the LBHI2 Application.

IV. ISSUE 2: Whether LBHI's claims in respect of the PLC Sub-Debts rank for distribution before, *pari passu* with or after any of the claims of LBGP1 under the PLC Sub-Notes.

43. The JLs' position is that the PLC Sub-Notes rank ahead of the PLC Sub-Debts.

44. In circumstances where it is LBGP1's position that the ranking question is to be determined by construing the relevant agreements, it is convenient to set out at the outset of this section those subordination provisions.

Subordination provisions in the PLC Sub-Debts

45. The subordination provisions in the first two long-term PLC Sub-Debts are materially identical. The provisions in the third, short term, PLC Sub-Debt are almost – but not quite – the same.

46. Starting, then, with the two long term PLC Sub-Debts:

46.1 Paragraph 5(1) of the Standard Terms contains the subordination provision. It confirms that *"the rights of the Lender in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities."*

46.2 The relevant defined terms are set out in paragraph (1):

"Senior Liabilities" means all Liabilities except the Subordinated Liabilities and Excluded Liabilities."

""Subordinated Liabilities" means all Liabilities to the Lender in respect of each Advance made under this Agreement and all interest payable thereon."

""Excluded Liabilities" means Liabilities which are expressed to be and, in the opinion of the Insolvency Officer of the Borrower, do, rank junior to the Subordinated Liabilities in any Insolvency of the Borrower."

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

47. Payment of sums under the PLC Sub-Debts is subject to conditions set out at paragraphs 5(1)(a) and (b):

47.1 Paragraph 5(1)(a) applies where *"an order has not been made... for the Insolvency of the Borrower."* "Insolvency" includes administration, and LBH is in administration. This condition can therefore be disregarded.

47.2 The condition at paragraph 5(1)(b) is the relevant one:

> *"the Borrower being "solvent" at the time of, and immediately after, the payment by the Borrower and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that the Borrower could make such payment and still be "solvent""*

47.3 The meaning of "solvent" for these purposes is set out at paragraph 5(2):

> *"For the purposes of sub-paragraph (1)(b) above, the Borrower shall be "solvent" if it is able to pay its Liabilities (other than the Subordinated Liabilities) in full disregarding-*
>
> *(a) obligations which are not payable or capable of being established or determined in the insolvency of the Borrower, and*
>
> *(b) the Excluded Liabilities."*

48. The sole difference in these clauses as they appear in the third, short term, PLC Sub-Debt relates to the definition of "Subordinated Liabilities":

48.1 That term is defined in the third short-term PLC Sub-Debt as *"all Liabilities to the Lender in respect of the Loan or each Advance made under this Agreement and all interest payable thereon."*

48.2 In turn, "*"Loan" means the indebtedness of the Borrower to the Lender referred to in paragraph 2(1) as that indebtedness may be reduced from the to time by any repayment or prepayment permitted under this Agreement."*

48.3 Paragraph 2(1), in turn, reads: *"Where as indicated in the Variable Terms this Agreement is for a loan, the Borrower acknowledges its indebtedness to the Lender in the sum mentioned in the Variable terms as an unsecured loan upon and subject to the terms and conditions of this Agreement".*

48.4 Of course, the Variable Terms of the short term PLC Sub-Debt do not provide for a loan *per se*, but for a facility (dealt with in paragraph 2(2)).

48.5 Consequently, LPGP1's position is that the difference in the "Subordinated Loan" definition is of no consequence in the analysis.

49. It is convenient to pause here to address briefly the reference to the opinion of the Insolvency Officer in the context of the "Excluded Liabilities" definition. For the purposes of this analysis, LBGP1's position is that it is appropriate to assume (to the extent necessary) that the "Insolvency Officer" (i.e. PLC's administrators) will reach an opinion which mirrors the correct construction

of the PLC Sub-Notes and PLC Sub-Debts. For simplicity, express reference to this condition can be therefore be dispensed with.

50. It is also convenient – for completeness – to address in this context the fact that the final comma in the definition of "Excluded Liabilities" is in the wrong place. It should be after "rank". The concept of "ranking" is limited to the Insolvency Officer's opinion. So far as the position in fact is concerned, an Excluded Liability is one that is *"expressed to be... junior to the Subordinated Liabilities"*. The term "ranking" is not used. That is in contrast to the definition of "Subordinated Liabilities" in the context of the PLC Sub-Notes, set out below.

51. Returning to the subordination provisions of the PLC Sub-Debts, and amalgamating the concepts (though, for simplicity not embedding the "Liabilities" definition): each PLC Sub-Debt is subordinated as follows:

> *"the rights of the Lender in respect of all Liabilities to the Lender in respect of each Advance made under this Agreement are subordinated to all other Liabilities except Liabilities which are expressed to be junior to the Liabilities to the Lender in respect of each Advance made under this Agreement and all interest payable thereon."*

52. And this condition must be met:

> *"The Borrower being able to pay at the time of, and immediately after, the payment, its Liabilities (other than to the Lender in respect of each Advance made under this Agreement) in full, disregarding Liabilities which are expressed to be junior to all Liabilities to the Lender in respect of [the Loan or] each Advance made under this Agreement in any Insolvency of the Borrower."*

53. The advances under each PLC Sub-Debt were accordingly subordinated to *all* <u>other</u> liabilities, save for those which are expressed to be junior to the PLC Sub-Debts. That is because the "Senior Liabilities" are defined as everything *other* than the debts under the PLC Sub-Debts themselves (i.e. "Subordinated Liabilities") and debts expressed to be more junior ("the Excluded Liabilities").

54. LBHI is therefore wrong, for two reasons, to say (at §14(6) of its Position Paper) that, for the purposes of the PLC Sub-Debts, *"'Senior Liabilities' include subordinated 'Liabilities' that are not expressed to rank <u>nor do rank either</u> <u>pari passu</u> or junior to the 'Subordinated Liabilities'"* (emphasis added).

    54.1 First, nowhere in the PLC Sub-Debts are *pari passu* liabilities referred to: Senior Liabilities are all Liabilities except the Subordinated Liabilities and Excluded Liabilities; and neither of those two definitions refer to *pari passu* liabilities either. The drafting of the PLC Sub-Debts does not recognise or admit of the concept of a *pari passu* ranking with the debts that are being subordinated.

54.2 Second, on a point of detail (and as noted above), the issue is not whether the other debt is expressed to *rank* junior, but whether it is expressed to *be* junior.

55. LBHI further submits (§14(8)) that *"Where the terms of two subordinated debts subordinate them behind the same senior liabilities, they are entitled to prove at the same time and they rank* pari passu... *"*

56. True that may be, but that principle does not apply here. Each of the PLC Sub-Debts is subordinated – not to the *same* senior liabilities – but to different ones. Each is subordinated, on a literal interpretation of the clauses, to liabilities *which include the other PLC Sub-Debts.* That is because none of the other PLC Sub-Debts is expressed to be junior to any other.

57. An impasse arises, which is not easily analysed or resolved. Potential answers are that the first in time should rank ahead of the second in time and so forth, or vice-versa, or that (by some mechanism which LBHI does not articulate) they rank *pari passu* between themselves.

58. Fortunately, there is no need to provide a solution to this conundrum, if it be one, because it would appear to make no odds in circumstances where each of the PLC Sub-Debts is held by the same entity, LBHI.

Subordination provisions in the PLC Sub-Notes

59. The subordination provisions are in materially identical form to those in the PLC Sub-Debts, with one key difference – which means that an impasse as regards the internal ranking of the PLC Sub-Notes does not arise.

60. The difference is in the definition of "Subordinated Liabilities": *"all Liabilities to the Noteholders in respect of the Notes* ***and all other liabilities of the Issuer which rank or are expressed to rank*** **pari passu** ***with the Notes"*** (emphasis added).

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

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

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

62. Whilst none of the PLC Sub-Notes is expressed to rank *pari passu* with any other in terms, neither is any subordinated to any other on the literal interpretation of each set of PLC Sub-Notes. Accordingly, they are each subordinated to exactly the same things or level as each other, and

therefore rank *pari passu* with one another: Rule 14.12 of the 2016 Rules. On that point of logic and principle, LBGP1 agrees with LBHI.[22]

Ranking between Sub-Debts and Sub-Notes

63. The difference in the definition of "Subordinated Liabilities" is also key to the analysis of the ranking between the PLC Sub-Debts and PLC Sub-Notes.

64. In particular, LBHI is wrong to say that the PLC Sub-Debt and the PLC Sub-Notes are subordinated behind the same "Senior Liabilities", nor are their subordination provisions *"materially the same"*.[23] To recap, and by reason of the differing "Subordinated Liabilities" definition:

    64.1 The PLC Sub-Debts are subordinated to *everything* other than debts which are expressed to be junior. They are not *pari passu* with anything.

    64.2 The PLC Sub-Notes are subordinated to everything other than debts: (i) which are expressed to be, or (in fact) do, rank *pari passu*; or (ii) debts which are expressed to be junior to the PLC Sub-Notes.

65. Whilst the PLC Sub-Debts do not *refer* to the PLC Sub-Notes, on the proper construction of the PLC Sub-Debts (i.e. the fact that they rank behind everything other than debts which are expressed to be junior), the PLC Sub-Debts are *"expressed to"* be junior to the PLC Sub-Notes because the PLC Sub-Notes are not expressed to be junior to the PLC Sub-Debt. From the perspective of the PLC Sub-Notes, the PLC Sub-Debts are therefore Excluded Liabilities to which the PLC Sub-Notes do not subordinate themselves.

66. The converse is not true. From the perspective of the PLC Sub-Notes, they do not rank behind *everything*. They may rank *pari passu* with some debts. It follows that there are – conceptually - some debts to which they will not rank below, but will 'peg' with (e.g. other Sub-Notes) on a *pari passu* basis, and go no lower. Wherever that level is in the relative ranking, however, the terms of the PLC Sub-Debt are such that it will always go lower. It follows that the PLC Sub-Debts are subordinated to the PLC Sub-Notes.

67. To look at it another way; the form of subordination provision in the PLC Sub-Debts is such that the debt will always fall to the 'bottom of the pile', save in respect of debts which are expressed to be more junior still. The PLC Sub-Notes, on the other hand, due to the expanded definition of "Subordinated Liabilities", has a level on which they can sit on a *pari passu* basis with similarly

[22] LBHI Position Paper §15(8)
[23] §16 of LBHI's position paper

subordinated debt. The PLC Sub-Debts could never sit on that level; because it would *ipso facto* be alongside other debt that was not expressed to be junior.

68. LBHI submits that *"under the PLC Sub-Notes, LBHI, as Lender in respect of the PLC Sub-Debt, is a subordinated creditor whose claims "rank pari passu... with the Notes"* [under the definition of Subordinated Liabilities] *in respect of the PLC Sub-Notes."*[24]

69. Assuming that was true, however, all that would mean is that the PLC Sub-Debts would not be "Senior Liabilities" for the purposes of the PLC Sub-Notes, and therefore the PLC Sub-Notes would not be subordinated to them.

70. However, turning back to the PLC Sub-Debts, they do not recognise a *pari passu* ranking concept. The PLC Sub-Notes are not "Excluded Liabilities" as they are not expressed to be junior, nor are they "Subordinated Liabilities" because they are not liabilities which arise under the PLC Sub-Debt Agreements.

71. To explain the point a final way: the PLC Sub-Notes could (on their terms) accommodate the PLC Sub-Debt on a *pari passu* basis; but the PLC Sub-Debt could not (on its terms) occupy such a position, and must therefore be relegated in order of priority in favour of the PLC Sub-Notes.

72. To summarise, the PLC Sub-Notes' agreement to subordinate was only to the extent that others were subordinated at the same level as the PLC Sub-Notes or lower. As the PLC Sub-Debts agreed to be subordinate to all Liabilities and did not agree to subordinate at the same level as the PLC Sub-Notes, their ranking must be lower.

Revisiting the factual matrix

73. LBHI places great weight on the fact that the PLC Sub-Debts and PLC Sub-Notes were based upon the same FSA standard forms (or at least similar: it seems that forms 10.1, 10.6 and 10.7 were used from time to time). That such forms were used is correct, but it does not assist as an aid to construction of these agreements:

    73.1 The fact that the PLC Sub-Debts (to a lesser extent) and PLC Sub-Notes (to a greater extent) contained departures from the standard terms (despite the warning against that in guidance note 10.8) illustrates that the draftsperson did not intend to be wedded to the standard forms.

    73.2 The regulatory context was such that these forms *had* to be used (or a waiver obtained, which would no doubt have been easier the closer to the standard form the revised draft

[24] §16(3)

was). The fact that the same forms were used as the starting point of drafting is consistent with the regulatory constraint as to the starting point rather than an intention that the end point should be the same.

73.3 Differences in drafting between the two documents against a common regulatory background, point (as a matter of construction) to the conclusion that there should be a difference in outcome.

73.4 In particular, therefore, the addition of the words *"and all other liabilities of the Issuer which rank or are expressed to rank* pari passu *with the Notes"* to the template in the definition of "Subordinated Liabilities" is of significance. Those words must be given meaning.

73.5 The obvious meaning, is that – unlike the earlier versions of the term which envisaged the subordinated debt always falling to the bottom of the pile – a *pari passu* subordinated level was envisaged. In the context of the issue of PLC Sub-Notes (ultimately) funded by third party investors, and with further Note issues no doubt envisaged (as transpired), such a concept is of eminent commercial sense.

74. Nor is it anathema to that commercial sense for the existing, in some instances sloppily drafted, internal financing arrangements to be relegated to a lower rung than that third-party investment. Indeed, the issue of the PLC Sub-Notes and underlying ECAPS apparently *"generated a lot of positive noise for Lehman Brothers in the market."*[25] By contrast, LBGP1 notes in this context that LBHI is rather equivocal about the ultimate source of funding for the Sub-Debt – *"ultimately derived from a mixture of debt and equity issued to the market"*.[26]

75. In short, in the context of seeking to raise funds from the external markets, even by subordinated notes, there is nothing commercially absurd about that indebtedness: (i) ranking *pari passu* between all notes; and (ii) ranking ahead of intra-group lending.

Non-Applicability of the Argument to the Subordinated Guarantee

76. As a postscript, and notwithstanding the JLs' position on Issue 3 of the PLC Application (as outlined at paragraph 6.3 above), it may assist to explain briefly why the argument as to the ranking between the Sub-Notes and Sub-Debts in the PLC Application does not apply equally to the form of subordination wording in the Subordinated Guarantee. There are two main reasons:

[25] DAH2 p.328; LB Finance Committee presentation on 17 August 2005
[26] LBHI Position Paper §13(3)

76.1 First, the definition of "Senior Creditors" in paragraph 2.9(a) excludes (so far as relevant) liabilities *"expressed to rank* pari passu *with or junior to this Subordinated Guarantee."* It does not refer, unlike the PLC Sub-Notes, to liabilities which *in fact* so rank, despite what they express. The PLC Sub-Notes must therefore rank higher, applying the logic explained above.

76.2 Second, and more significantly perhaps, the Subordinated Guarantee does give an express – and fixed – statement of the position at which the Subordinated Guarantee should rank: *pari passu* with the "Parity Securities" (which include non-cumulative preference shares). As LBHI correctly notes at §§43(5) & (6) of its Position Paper, this is a deeper layer of subordination than either the PLC Sub-Notes or PLC Sub-Debt – such that the Subordinated Guarantee is expressed to be junior to both.

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22 February 2019

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