Waterfall III Application

No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:-

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

Applicants

-and-

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)

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

(3) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS EUROPE LIMITED (IN ADMINISTRATION)

Respondents

Position paper of the Joint Administrators of Lehman Brothers Limited (In Administration)

A) INTRODUCTION

1. In this paper the Joint Administrators of Lehman Brothers Limited (In Administration) (“**LBL**” and “**LBL Administrators**”) set out their position in respect of the various issues (“**Issues**”) raised by the application of the Joint Administrators of Lehman Brothers International (Europe) (“**LBIE**” and “**LBIE Administrators**”) dated 22 April 2016 (“**the Waterfall III application**”) on which the LBIE Administrators seek directions from the Court pursuant to paragraph 63 of Schedule B1 of the Insolvency Act 1986 (“**IA86**”).

2. The Issues arise in relation to the surplus in the LBIE administration following the judgments at first instance and in the Court of Appeal in the earlier application of the LBIE Administrators in the proceedings known as "Waterfall I"[1]. These Issues can be broadly grouped and summarised as follows:

2.1 Whether the liability of the registered shareholders of LBIE, being LBL and LB Holdings Intermediate 2 Limited ("**LBHI2**"), to contribute to LBIE's assets extends to a liability to contribute to the extent necessary to enable LBIE to pay the subordinated loan debt owed by LBIE to LBHI2 (**"Sub-Debt"**)(Issues 1-3);

2.2 How the rules of insolvency set-off operate where there are multiple administrations (Issues 4-6);

2.3 How the shareholding in LBIE of LBL and LBHI2 affects their respective liabilities to contribute to the assets of LBIE including by way of any contribution claims raised by LBIE under section 74 IA86 ("**Contribution Claim**") (Issues 7-8) ("**Adjustment Issue**");

2.4 Whether LBL is entitled to recharge the Contribution Claim and other liabilities and how such recharge would rank in the administrations of LBIE, Lehman Brothers Europe Limited (**"LBEL"**) and/or LBHI2 and whether this would be impacted by any set-off (Issues 9-12) (the "**Recharge Issues**"); and

2.5 Whether LBIE's share register ought to be rectified (Issue 13) (the "**Shareholding Issue**"), in particular so that LBL is not registered as a shareholder in LBIE, and/or LBL should not in any event have the liabilities of a member of LBIE.

3. The background to the Issues is set out below. The LBL Administrators then proceed to address the Shareholding, Recharge and Adjustment Issues since, if their position on those Issues is accepted by the Court, that will materially affect the position of LBL in relation to the remaining Issues – in particular since LBL will either have no liability to meet a Contribution Claim, or will be entitled to recharge, and so pass on, any such liability to other members of the Lehman Group, including LBIE, LBHI2, LBEL or Lehman Brothers Holdings Plc ("**LBH Plc**").

[1] They are therefore addressed in this paper subject to the final appeal hearing in respect of Waterfall I, to be heard by the Supreme Court from 17 October 2016.

4. The LBL Administrators' case as set out in this paper is to be the subject of further evidence and submissions in due course, and the LBL Administrators reserve their right to rely on such further materials and make such further arguments as may in due course become appropriate for the determination of the Issues.

B) THE FACTUAL CONTEXT

5. The factual context in which the Issues arise has been described in the judgments in Waterfall I of David Richards J. of 14 March 2014 ([2014] EWHC 704 (Ch), [2015] Ch 1), and the Court of Appeal of 14 May 2015 ([2015] EWCA Civ 485, [2016] Ch 50). The following is provided by way of summary only. For ease of reference a dramatis personae is also provided, at Appendix 1.

(i) The Parties

6. The Lehman Brothers group of companies (**"Lehman Group"**) provided financial services to corporations, governments and municipalities, institutional clients and high net worth individuals. Prior to September 2008, Lehman Brothers operated as one of the four biggest investment banks in the United States. The various companies within the Lehman Group appear to have operated principally as members of that group, and without always having due regard to their separate corporate identity.

7. LBL was incorporated on 27 April 1965 as H. Hentz & Co Limited and subsequently changed its name on several occasions before taking its present form in 1990. LBL was the service company which supported the operations of the various Lehman Group entities based in the UK, Europe and Middle East; its sole stated business function as recorded in its statutory accounts from December 1992 was "*to provide administrative services to fellow group companies with business operations in the UK*".

8. By reason of its operation as a service company LBL employed the personnel who worked within the Lehman Group entities operating in the UK, Europe and Middle East (many of which employees were seconded by LBL to entities within the Lehman Group), and sourced property/accommodation, pensions, information technology, tax, accounting and legal services for entities in the Lehman Group. In its role as a service company LBL was the head lessee for the UK Lehman Group's headquarters at 25

Bank Street, London, amongst other premises, the "*Group Paying Agent*" for the UK Lehman Corporation Tax Group, Representative Member for the UK Lehman VAT registration and the "*principal employer*" under the occupational pension scheme now known as the Lehman Brothers Pension Fund.

9. The costs incurred by LBL in providing such services were recharged to the various members of the Lehman Group who benefitted by virtue of a longstanding agreement within the group (as described further below).

10. The ultimate parent company of the Lehman Group was Lehman Brothers Holdings Inc. (**"LBHI"**), a company incorporated in the United States. Prior to 1990 the Lehman Group conducted its business operations in the UK and Europe through US incorporated entities. However, following concerns expressed by the Securities Investment Board that it was unable adequately to regulate a non-UK company, on 10 September 1990 LBIE was incorporated under the name Lehman Brothers International Limited. On 1 December 1990, the principal business operations of the Lehman Group in the UK (with the exception of international equities trading) were transferred to LBIE upon the express undertaking of LBHI given to the Securities Investment Board that it would take responsibility for the operations of LBIE.

(ii) Incorporation of LBIE/Capital Structure

11. LBIE was incorporated as a limited liability company with an authorised share capital of 100,000,000 $1 ordinary shares of which two shares were issued. One share was allotted to each of Alistair Bird (a solicitor at Simmons & Simmons, then solicitors retained by the Lehman Group) and Colleen Harney (a legal assistant at Simmons & Simmons).

12. On 5 October 1990 Ms Harney transferred her $1 ordinary share to LBH Plc, and Mr Bird his $1 ordinary share to Martin Cornish, the Company Secretary of LBIE. Thereafter, on 30 November 1990 (and so immediately prior to LBIE assuming the principal trading business of the Lehman Group in the UK) 59,999,998 $1 shares were issued and allotted to LBH Plc. Additionally, on 2 October 1991 Mr Cornish transferred his $1 ordinary share in LBIE to Peter Sherratt, when he took over the position of Company Secretary of LBIE.

(iii) Profitability Review

13. From about March 1992 a profitability review was undertaken by legal, tax and accounting personnel of the Lehman Group regarding its European operations in order to understand why the group was generating an "*abnormally high US tax charge*". This was because US federal income tax rules taxed profits of certain foreign subsidiaries of a US parent, in this case LBHI. On 22 September 1992 Mr Sherratt transferred his single share in LBIE to LBH Plc, the relevant stock transfer form recording that *"This is a transfer by a mere nominee who has at all times held the property on behalf of [LBH Plc]"* (**"Sherratt Stock Transfer Form"**) and, as at 22 September 1992 LBH Plc became the sole registered shareholder in LBIE. The Sherratt Stock Transfer Form incorrectly records the share transferred by Mr Sherratt to LBH Plc as being denominated in sterling when, at the time, LBIE did not have any authorised sterling denominated share capital.

14. The results of the profitability review were recorded in a memorandum dated 27th November 1992, which identified two main reasons for the high US tax charge: (i) growth in costs due to the expansion of the London based international business had given rise to losses being realised in UK entities, including LBIE, that could not be offset against US taxable profits for US tax purposes, and (ii) it was not possible to offset the losses of some UK companies against certain income of other UK companies for US tax purposes.

15. In order to address these issues a restructuring of the Lehman Group was proposed whereby:

15.1 A holding company for the UK Lehman Group, Shearson UK Holdings Limited ("**SHUKL**") would be converted into a dual UK and US incorporated/resident company, to ensure foreign tax credits of indirect subsidiaries were accessible for US tax purposes;

15.2 Ownership of two indirect subsidiaries of SHUKL, Lehman Brothers Gilts Limited ("**LBGL**") and Lehman Brothers Money Brokers Limited ("**LBMBL**") (each of which was profit making) would be transferred from LBH Plc to LBIE (which was loss making), to take advantage of the fact that US tax law permitted the netting off of a parent's losses against a subsidiary's profits under "chain deficit" rules; and

15.3 LBIE would be re-registered as an unlimited company and certain other amendments would be made to its memorandum and articles of association so that it would be treated for US purposes as a branch of LBH Plc thereby enabling losses in LBIE to be set off against profits of LBH Plc.[2]

16. Further to this review, in December 1992 SHUKL was converted into a dual incorporated/resident company and the following further steps were undertaken:

16.1 The transfer of the entire issued share capital of LBGL and LBMBL to LBIE was effected by:

16.1.1 LBIE increasing its authorised share capital to include 50,000,000 ordinary shares denominated in £ sterling; and

16.1.2 pursuant to an agreement dated 18 December 1992, the issue and allotment of 30,000,010 ordinary £ shares in LBIE to LBH Plc in return for the transfer to LBIE of the entire issued share capital of LBGL (20,000,000 ordinary shares of £1 each) and LBMBL (10,000,010 ordinary shares of £1 each);

16.2 Pursuant to the resolution of its shareholder, LBH Plc, passed on 18 December 1992, on 21 December 1992 LBIE was re-registered as an unlimited company. At the same time certain changes were made to the memorandum and articles of association of LBIE so that it would be regarded as a branch of LBH Plc for US tax purposes. In particular:

16.2.1 the name of Lehman Brothers International Limited was changed to "Lehman Brothers International (Europe)";

16.2.2 the limited liability of LBIE's members was removed;

16.2.3 LBIE's power to create new classes of shares was removed;

16.2.4 articles 3, 32, 34 and 35 of Table A of the Companies (Table A to F) (Amendment) Regulations 1985 (**"Model Articles"**) were disapplied (as

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[2] As set out at paragraph 10 of the judgment of Richards J in Waterfall 1.

required by Table E of the Companies (Table A to F) (Amendment) Regulations 1985 for unlimited companies);

16.2.5 pre-emption rights under section 89 of the Companies Act 1985 ("**CA85**") were applied to the allotment of shares;

16.2.6 LBIE's power to issue redeemable shares was removed;

16.2.7 the following decisions were required to be made by special resolution, rather than ordinary resolution:

16.2.7.1 increase in share capital;

16.2.7.2 consolidation or division of shares;

16.2.7.3 sub-division of shares;

16.2.7.4 cancellation of unissued shares;

16.2.7.5 reduction in share capital;

16.2.8 the transfer of any shares that resulted in LBIE having more than one member was prohibited;

16.2.9 a special resolution was required to be passed to approve LBIE having more than one member;

16.2.10 the quorum for a general meeting was reduced from two to one;

16.2.11 LBIE was allowed to appoint 'Special Directors', being employees or officers of LBIE with the word director in their title but who were not actually 'directors' of LBIE; and

16.2.12 the members of LBIE were required to wind the company up if LBH Plc ceased to be the sole member or itself was wound up.

17. The amendments set out in paragraphs 16.2.8, 16.2.9, 16.2.10 and 16.2.12 above were made notwithstanding the provisions of section 24(1) CA85 concerning the imposition of liability for the debts of LBIE upon LBH Plc in the absence of any other

registered shareholder. This reflected the fact that LBIE was to be represented as a branch of LBH Plc, for US tax purposes and it was intended that the ultimate responsibility for the debts of LBIE would be undertaken by LBHI, which had already taken such responsibility in respect of LBH Plc.

18. Thus following its re-registration as an unlimited company LBH Plc remained the sole registered member of LBIE. In accordance with section 24 CA85, from 21 June 1993 (being six months after becoming the sole member of an unlimited company) LBH Plc was jointly and severally liable with LBIE for LBIE's debts but with ultimate responsibility for such debts lying with LBHI.

19. Whilst no £ sterling Register of Members and Share Ledger for LBIE exists at present, that company only ever issued 35,250,010 sterling shares being, 30,000,010 shares allotted to LBH Plc as mentioned in paragraph 16.1 above and a further 5,250,000 shares allotted to LBH Plc following the allotment by LBGL of an equal number of shares in LBGL to LBIE on 23 September 1994. As set out below, all the sterling shares were redeemed to the sole benefit of LBH Plc on 1 May 1997. It appears that the decision of LBIE to issue sterling shares to acquire LBGL and LBMBL may have been for currency hedging purposes.

(iv) Amendment to Memorandum and Articles/Transfer of single share to LBL in 1994

20. As a result of a review of the shareholding position of LBIE it was (erroneously) believed that it was a mandatory requirement that there had to be a second registered shareholder of LBIE in addition to LBH Plc. In fact there was no such requirement. LBH Plc could remain as sole shareholder but it would then be liable for the debts of LBIE under section 24 CA85 but this was of little concern for the reasons set out in paragraph 18 above and as further explained in paragraph 23 below. As a result of this error the steps below were undertaken in November 1994.

21. On 23 November 1994 by written resolution of its member, LBIE resolved to make certain amendments to its memorandum and articles of association. The amendments included:

21.1 removing the restriction on transfers of shares that resulted in more than one member and replacing it with a requirement that all transfers require the prior written consent of all members;

21.2 removing the requirement that a special resolution be passed to allow LBIE to have more than one member; and

21.3 removing the requirement that the members wind-up LBIE if LBH Plc ceased to be the sole member or itself was wound up.

22. Subsequent to the amendment of the memorandum and articles of association of LBIE, on 23 November 1994:

22.1 the board of directors of LBH Plc resolved to transfer to LBL, as nominee, one ordinary share of its shareholding in LBIE;

22.2 the board of directors of LBL purportedly resolved to hold, as nominee for LBH Plc, one ordinary share in LBIE;

22.3 the board of LBIE resolved that the stock transfer form relating to the transfer of one ordinary share from LBH Plc to LBL be approved; and

22.4 a stock transfer form purportedly records the transfer of one ordinary share denominated in sterling to LBL as the nominee of LBH plc (**"LBL Stock Transfer Form"**). This may have been an error reflecting the fact that the standard form transfer has a sterling printed currency.

23. These arrangements were entered contemporaneously with steps to implement the restructuring of investments by LBH Plc in Platform Mortgages Limited (**"PML"**) whereby the latter company was to become an unlimited company and treated as a partnership between LBH Plc and LBL for US tax purposes, with LBL holding shares in PML along with LBH Plc. This was in contrast with the position of LBIE which was not to be treated as a partnership but as a branch of LBH Plc (for US tax purposes). This meant that although a second shareholder of PML was required so that PML could be treated as a partnership for US tax purposes this was not the case in relation to LBIE. The position in respect of LBIE remained as set out in paragraph 18 above and there was no reason to add LBL as a shareholder.

24. In entering into the transaction for the transfer of a share in LBIE from LBH Plc to LBL the same directors acted on behalf of both LBH Plc and LBL, namely Oliver Backhouse and C. Daniel Tyree. The contemporaneous records contain no reference to any separate consideration of the position of LBL or its interests by such directors when entering into such arrangements.

(v) Allotment of single share in 1997

25. As recorded in part in letters from LBL to HM Inspector of Taxes dated 11 January 1996 and 6 February 1997 certain regulatory changes enabled UK equities stock lending and money broking business and gilt-edged market maker businesses to be carried on in the same legal entity as other businesses trading on the London Stock Exchange. This led to the acquisition of the businesses of LBMBL and LBGL by LBIE between 1996 and 1997. Thereafter the entire issued share capital in each of LBMBL and LBGL were transferred to LBH Plc prior to the voluntary liquidation of those two subsidiary companies:

25.1 LBH Plc and LBIE resolved on 28 May 1996 and 1 May 1997 that LBH Plc purchase 10,000,010 ordinary £1 shares in LBMBL and 25,250,000 ordinary £1 shares in LBGL at par value;

25.2 On 1 May 1997 the board of LBIE, as well as LBH Plc and LBL as its members purported to resolve to cancel and extinguish the sterling share capital of LBIE being 35,250,009 shares of £1 each held by LBH Plc, one £ share held by LBL and 14,790,990 authorised but unissued shares of £1 each. This was ostensibly a means of extinguishing the intercompany liability from LBH Plc to LBIE created by the aforesaid transactions. No separate consideration was provided to LBL, reflecting the fact that its shareholding in LBIE had to be as a nominee for US tax purposes.

25.3 On 1 May 1997 it was further purportedly resolved by the board of LBIE to allot to 59,999,999 shares of $1 each to LBH Plc and one $1 share to LBL pursuant to purported resolutions and requests for such allotments from the boards of each of LBH Plc and LBL on the same date;

25.4 The directors of LBIE, LBH Plc and LBL who passed the aforesaid board resolutions for allotment were the same, namely Oliver Backhouse and Teresa South. The contemporaneous records contain no reference to any separate consideration of the position of LBL or its interests by such directors when entering into such arrangements.

26. Insofar as formal documents were prepared and executed for the allotment of a single share in LBIE to LBL as set out above, in the circumstances it can be inferred that this was a continuation of the original error made in November 1994 over the need for a second shareholder, when in fact there was no such need and the imposition of liability for the debts of LBIE upon LBH Plc that might result, under section 24 CA85, was consistent with the original tax purpose in LBIE being an unlimited liability company.

27. The lack of any consideration of the position of LBL as a shareholder and/or of any real intention for it to retain a shareholding in LBIE (other than for the mistaken purpose of satisfying an illusory formal requirement for there to be two shareholders on the register) was reflected in a document entitled "Lehman Brothers Gilts Limited Timetable to Liquidation" dated 12 March 1997 and drafted by Mr Backhouse and email correspondence of Mr Backhouse on 1 May 1997 notifying the relevant Lehman personnel that there had been a sale of the LBGL and LBMBL businesses to LBH Plc by the redemption of *"all 35,250,010 of its ordinary £1 shares held by [LBH Plc] and [the] issue [of] 60,000,000 ordinary $1 shares to [LBH Plc]"* even though the documents he had executed were reflected in LBIE's Register of Members and Share Ledger not as 60,000,000 ordinary $ shares being issued to LBH Plc but 59,999,999 with LBL being issued the remaining $1 share.

28. For reference, a schedule of the shareholders of LBIE is appended to this paper as Appendix 2.

(vi) APB 23

29. In 2000, Lehman Brothers made a tax accounting assertion under US GAAP known as an "APB 23" assertion with respect to LBL and LBEL.

30. Prior to the APB 23 assertion, deferred tax had been provided for on these entity's profits at the difference between the US and UK tax rates (35% and 30% respectively). The reason for the deferred tax was that foreign entities' profits were to be subject to the full rates of US tax once distributed, or deemed to be distributed, to the US. The APB 23 accounting assertion allowed an entity not to provide for the deferred tax liability on the basis that the profits would not be repatriated to the US and would be permanently reinvested in the UK Lehman Group.

31. According to an internal memorandum dated 28 April 1999, *"APB 23 permits entities that have the intent to permanently reinvest earnings overseas to accrue their tax provision at the local statutory rate. Lehman's ability to make this election for all or a portion of its UK operations could have a substantial financial statement benefit. The goal is to have a structure in place for the fiscal year beginning December 1, 1999."*

32. During the course of 2000, an APB 23 assertion was made for each of LBL and LBEL (**"APB 23 Project"**).

33. At the same time that the APB 23 Project was being implemented, the global Lehman Group policy on transfer pricing was being reviewed with the assistance of Ernst & Young (**"Global Transfer Pricing Review"**).

34. As part of the APB 23 Project and as well as a result of the Global Transfer Pricing Review, LBL's "mark up" / "uplift" on its intercompany recharges within the UK was increased from 1% to 10% in order to:

34.1.1 increase LBL's profits and therefore increase the benefit of the APB 23 assertion for the Lehman Group; and

34.1.2 increase the expenses booked to LBIE, as the more expenses that could be booked to LBIE the lower the overall tax charge for the Lehman Group;

34.1.3 ensure a consistent uplift percentage was applied across all companies for which LBL provided services.

35. On 22 August 2000, LBL entered into written agreements with LBIE and LBEL relating to the provision of administrative and operational support services and the supply of investment banking staff.

36. On 20 May 2004, LBL again entered into two written agreements, both titled "Service Agreement", directly with each of LBIE and LBEL. These agreements are, for present purposes, in materially the same terms as the agreements referred to in paragraph 35.

37. It is the case of LBL, as set out below, that all of the service and secondment agreements did not affect or alter the agreement already in place and continuing for the recharge of all expenses and liabilities incurred by LBL to those members of the Lehman Group who benefited. Rather they were created to document certain parts of the pre-existing recharge agreement (referred to further below) in order to satisfy various tax or regulatory authorities from time-to-time.

(vi) European Holding Company Restructure and LBIE Recapitalisation

38. Between 2006 and 2007, as a result of commercial, regulatory and US tax objectives, the Lehman Group restructured its European holding company and established two new UK companies, being LB Holdings Intermediate Limited 1 (**"LBH1"**) and LBHI2, which were interposed between LBH Plc and LBIE and recapitalised LBIE.

39. This project was referred to as the '*European Holding Company Restructure and LBIE Recapitalisation*'.

40. On 1 November 2006, agreements were implemented to interpose LBHI1 and LBHI2 between LBIE and LBH Plc. Also on that date a meeting of the directors of LBIE was held, at which:

    (a) it was reported that LBH Plc had executed stock transfer forms transferring the entire issued share capital of LBIE held by LBH Plc to LBHI1. Further, LBHI1 had subsequently transferred the entire issued share capital of LBIE held by LBHI1 to LBHI2; and

    (b) it was resolved that the transfer of the entire issued share capital of LBIE held by LBH Plc from LBH Plc to LBHI1 and the subsequent transfer of

the entire issue of LBIE held by LBHI1 to LBHI2 would be approved for registration.

(vii) Representations/treatment of shareholding

41. Representations by Lehman Group regarding 100% ownership of LBIE by LBH Plc were made during the restructuring, as described above. Further, after implementing the restructure, in a later application to the HM Revenue and Customs (**"HMRC"**) for clearance in relation to the avoidance involving arbitrage provisions, the Lehman Group described the shareholding of LBIE as follows:

"...LBH PLC in turns owns 100% of LB Holdings Intermediate 1 Ltd ("LB UK1") ... LB UK1 owns 100% of LB Holdings Intermediate 2 Ltd ("LB UK2") a UK holding company which is UK incorporated and UK tax resident, which in turn owns 100% of LBIE..."

42. This was consistent with the general manner in which LBL was held out and treated as if it was not in fact a shareholder in LBIE.

43. It was routinely represented, including to regulatory authorities such as the Financial Services Authority (**"FSA"**) and HMRC, that LBIE was a wholly owned subsidiary of LBH Plc, and/or, from 2006, LBHI2:

43.1 It was represented to the financial regulator that LBIE was wholly owned by LBH Plc, and / or LBHI2, including:

43.1.1 On 18 February 1998, in a letter to the Securities and Futures Authority Limited (**"SFA"**) identifying LBIE as "*a wholly owned subsidiary of* [*LBH Plc*] *which is ultimately 100% owned by* [LBHI]"; and

43.1.2 On 6 October 2006, an application for a change in controller was submitted to the FSA which stated that the shareholding of LBIE was intended to be 100% owned by LBHI1 and / or LBHI2. This application included a declaration signed by a director common to each of LBIE and LBL. The declaration included statements that:

43.1.2.1 it was understood that *"it is a criminal offence knowingly or recklessly to give the FSA information that is false, misleading or deceptive in a material particular"*; and

43.1.2.2 confirming that *"the information in this form is accurate and complete to the best of my knowledge and belief"*.

43.2 It was represented to HMRC that LBIE was wholly owned by LBH Plc and/or LBHI2. In particular:

43.2.1 On 30 April 1998, a letter to the Board of the Inland Revenue recorded that LBIE was a 100% subsidiary of LBH Plc and that all shares issued in LBIE were issued to LBH Plc;

43.2.2 On 5 December 2005, a letter to HM Inspector of Taxes regarding double tax relief for LBIE recorded that *"LBIE was incorporated in September 1990. It is a wholly owned subsidiary* of [*LBH Plc*]"; and

43.2.3 On 30 March 2007, a letter to HMRC represented that LBH Plc "*owns 100% of* [*LBHI1*]", which in turn *"owns 100% of* [*LBHI2*] ... *which in turns* [sic] *owns 100% of LBIE.*"

44. Professional advice was sought on the basis that LBH Plc and/or LBHI2 owned 100% of the equity and capital interests of LBIE, including:

44.1 On 26 October 2006, an email to Allen & Overy LLP, recorded that LBHI2 would have 100% beneficial ownership of LBIE and that LBH Plc, the existing shareholder of LBIE, would vote in accordance with LBHI2's wishes until legal ownership passed; and

44.2 On 31 October 2006, a letter to PricewaterhouseCoopers LLP represented and certified that "[*LBH Plc*] *owns 100% of the issued and outstanding stock of LBIE, a corporation organized and existing under the laws of the United Kingdom. [LBH Plc's] stock ownership represents 100% of the equity and capital interests in LBIE (including 100% of the value and all voting rights therein with respect to all classes of stock)*".

45. As regards the treatment of LBL as a shareholder, pursuant to LBIE's memorandum and articles of association and/or the CA85 as appropriate, LBL was *prima facie* entitled to statutory pre-emption rights, to receive notice of and vote at general meetings and to receive declared dividends.

46. These rights remained materially the same at all times save that, by amendment of LBIE's memorandum and articles of association dated 27 October 2006, statutory pre-emption rights were disapplied in respect of preference shares and, by amendment of LBIE's memorandum and articles of association dated 30 April 2007, rights were attached to Class B shares.

47. Notwithstanding these entitlements, no such rights or benefits were at any material time conferred upon LBL and LBL was not actually treated and/or considered as a shareholder in LBIE. In particular, but without limitation, insofar as the LBL Administrators are aware:

47.1 LBIE was required to hold an annual general meeting ("**AGM**") each year and, for each financial year, to lay before the company in general meeting its annual accounts and directors' report. LBL was entitled to 21 days' notice of the AGM and the annual accounts and directors' report should have been sent to LBL 21 days before AGM. However, the LBL Administrators have been unable to identify any evidence that between 1994 and 1999 LBIE held an AGM. Further, whilst from 2000 LBIE did hold AGMs on short notice, it did so without the written consent of LBL to the curtailment of the applicable notice period (as set out further below), and failed to provide LBIE's annual accounts and director's reports to LBL 21 days before the AGM as required by section 238(1) CA85;

47.2 LBL did not receive copies of LBIE's annual accounts and directors' reports;

47.3 Pursuant to 'Special Articles' 8, 24 and 25 of LBIE's articles of association and Article 38 of the Model Articles, having been incorporated into LBIE's articles of association, LBL was entitled to receive notice of general meetings either personally or by having the notice hand delivered or sent by prepaid letter to LBL's registered address as set out in the register of members, unless LBL had provided to LBIE a

waiver of this right in writing. Notwithstanding the foregoing, at no material time did LBL receive notice of extraordinary general meetings held by LBIE on the 21 April 1995, 23 June 1995, 28 November 1997, 23 December 1999, 9 October 2000, 29 November 2000, 5 November 2002, 28 November 2003, 30 April 2004, 6 September 2004 and 16 June 2005. Further, LBL did not receive notice of AGMs held by LBIE on each of 26 February 2001, 28 February 2002, 26 March 2003, 27 February 2004, 23 February 2005, 27 February 2006 and 26 February 2007. Nor did LBL waive its entitlement to notice of these meetings. In consequence of the failure to give LBL notice of the above meetings, LBL was deprived of any right to attend these meetings and to consider and vote on any proposed resolutions. This was so notwithstanding that at these meetings resolutions were passed (amongst other matters) (i) to increase LBIE's authorised share capital, (ii) to authorise LBIE's directors to allot the authorised but unissued share capital of the company, and (iii) to approve the amendment of LBIE's articles of association, with a consequential effect upon LBL's ostensible shareholding and purported interest in LBIE;

47.4 Pursuant to sections 378(3)(a) and 369(3)(b) CA85 and Article 38(b) of the Model Articles, a majority in number of the members having the right to attend and vote were required to approve a meeting being held on short notice; see too Re Ransomes Plc [1999] 1 B.C.L.C. Notwithstanding this, save for meetings held on 28 November 1997 and 29 November 2000, LBL did not sign a written consent authorising any of the meetings set out above to be held at short notice. On the occasions that LBL did not sign a written consent it was signed by LBH Plc only;

47.5 LBL was entitled to receive its proportional share of any dividend declared. However at no material time does it appear that LBL received a dividend in respect of its shareholding in LBIE; rather the full amount of dividends declared by LBIE (in the event and insofar as material, in respect of the financial years 1997 to 2000) were recorded as received by LBH Plc and the LBL financial statements for these years do not recognise any dividend payments from LBIE. The relevant dividend payments are as follows and were each paid solely to LBH Plc:

47.5.1 1997: Interim Dividend declared in the sum of $130,000,000: paid to LBH Plc;

47.5.2 1998: Interim Dividend declared in the sum of $140,000,000: paid to LBH Plc;

47.5.3 1999: Interim Dividend declared in the sum of $110,000,000: paid to LBH Plc;

47.5.4 1999: Year end Dividend declared in the sum of $60,000,000: paid to LBH Plc;

47.5.5 2000: Year end Dividend declared in the sum of $85,000,000: paid to LBH Plc;

47.6 LBL held (pursuant to section 89 CA85) statutory pre-emption rights to be offered "*a proportion of those securities* [being issued] *which is as nearly practicable equal to the proportion in nominal value held by*" LBL. These rights would have applied to entitle LBL to a further ordinary share in LBIE when on 24 May 1995, an allotment of 230,000,000 ordinary shares occurred. However, LBL was offered no such share and its statutory pre-emption rights were thus not afforded as required;

47.7 Shares in LBIE could not be transferred without the prior written consent of each of LBIE's members (at Special Article 7 of LBIE's articles of association). Notwithstanding that this afforded LBL the right to veto the insertion of LBHI2 as the immediate holding company of LBIE, the LBL Administrators have been unable to locate any documentation to show that this right was afforded to LBL during the course of the restructuring which occurred in 2006;

47.8 Further neither the statutory records of LBL or LBIE contain a share certificate evidencing LBL's ostensible share in LBIE;

47.9 No value was accorded to LBL's ostensible shareholding in LBIE in the Lehman Group general ledger (**"DBS"**) (which is available for the period between 2003 and 2008). Rather, the value of LBIE's shares was only recognised in LBH Plc. By contrast, minority shareholdings in other entities held by LBL, including PML, were recorded in DBS;

47.10 LBL was not recorded as holding any interest in LBIE in LBL's financial statements for each of the years from 30 November 1994 to 2006.

(vii) Entry into Administration

48. On 15 September 2008 LBHI commenced Chapter 11 bankruptcy proceedings in the United States Bankruptcy Court for the Southern District of New York. On the same date both LBL and LBIE went into administration. LBEL went into administration on 23 September 2008, and LBHI2 on 14 January 2009.

49. On 14 February 2013 the Joint Administrators of (i) LBIE, (ii) LBL, and (iii) LBHI2 issued the "Waterfall I" proceedings, seeking various directions, among other things, in relation to the position that might arise if the administration of LBIE was immediately followed by a liquidation, including as to the payment of statutory interest and the potential liability of a contributory under section 74 IA86.

50. On 14 March 2014 the Judgment of David Richards J. (**"Waterfall I Judgment"**) was handed down, determining (amongst other matters) as a matter of principle, whether the shareholders of LBIE were potentially liable to contribute to any shortfall in the assets of LBIE in the event that a contribution claim is made by a liquidator under section 74(1) IA86. The Waterfall I Judgment concluded that LBIE, acting by its administrators, is potentially entitled to prove in an administration or liquidation of LBL or LBHI2 for any contingent liability arising in a liquidation of LBIE under section 74(1) IA86. The contingency of LBIE entering into liquidation is solely at the election of the LBIE Administrators, as noted by Briggs LJ in the Court of Appeal judgment referred to below.

51. That decision of David Richards J. was upheld by the Court of Appeal, and is part of the appeal to be heard by the Supreme Court in October 2016 (in which LBL has participated, upon an express reservation as to whether it is in fact properly to be considered a shareholder in LBIE[3]).

52. Following the Waterfall I Judgment, on 31 October 2014 the LBIE Administrators submitted a claim for £10.4bn in LBL's administration. Of this sum £10bn related to the LBIE Administrators' assessment of the contingent liability of LBL to LBIE which might arise by way of Contribution Claim in any liquidation of LBIE, with such contribution expressly stated in LBIE's statement of claim dated 31 October

[3] See, in particular, the Written Case of the LBL Joint Administrators on the Statutory Interest Issue, at paragraph 9(3).

2014 to have been assessed on a "*pessimistic approach (i.e. low surplus, high creditor claim)*" having regard to the total of LBIE's estimated unpaid liabilities, both provable and non-provable, including unpaid interest.

53. On 7 November 2014 the LBIE Administrators submitted a proof of debt for £10bn in LBHI2's administration in respect of a like contingent Contribution Claim.

54. Subsequently, on 23 September 2015 the LBL Administrators:

54.1 requested leave of the LBIE Administrators to amend LBL's proof of debt (filed on 21 December 2011 in the sum of £363m.) to £10.934bn. to incorporate a recharge element in respect of the Contribution Claim, (as explained further below) to reflect the fact that LBL always operated as a service company and recharged all of the costs it incurred in providing such services to the various Lehman Group entities that benefitted from them. On 6 April 2016 the LBIE Administrators confirmed their consent to the LBL Administrators' request to amend its proof of debt;

54.2 submitted a proof of debt in LBHI2's estate in the sum of £10bn; and

54.3 requested leave of the LBEL administrators to amend LBL's proof of debt (filed on 31 August 2012 in the sum of £243m.) to £4.9bn., again to incorporate a recharge element in respect of the contingent Contribution Claim, as set out further below. On 12 November 2015 LBEL consented to the LBL Administrators' request to amend its proof.

55. These claims have naturally focused attention upon the question of who is to be considered a shareholder of LBIE and/or the liabilities which might flow from this.

C) <u>THE ISSUES</u>

56. As mentioned above, the LBL Administrators address the Shareholding, Recharge and Adjustment Issues first since, if their position on those Issues is correct, that will affect the approach on the remaining outstanding matters.

(1) Issue 13: the Shareholding Issue

57. By Issue 13 the LBIE Administrators have asked the Court to determine "*Whether the share register of LBIE ought to be rectified: a) on the basis that LBL did not hold a share in LBIE; or b) any other basis; or LBL should, on any other basis, not have the liabilities of a member of LBIE, notwithstanding its holding of a LBIE share*".

(i)Mistake

58. As to this the LBL Administrators' principal position is that the acquisition of a share by LBL in LBIE was the result of a mistake and the register ought to be rectified accordingly:

58.1 The original purpose in forming LBIE as an unlimited company was to gain US tax benefits from treating LBIE as a branch of LBH Plc. For that purpose it was necessary for LBIE to be wholly owned by LBH Plc and the creation of a further shareholding was likely to impede this objective; hence on conversion to an unlimited company LBH Plc became the sole registered shareholder. The existence of liability for debts of LBIE under CA85 made no difference to this approach since it was anticipated that LBH Plc (and thereby LBHI as ultimate holding company) would need to be responsible for the debts of LBIE in any event as a result of regulatory requirements in the United Kingdom. LBHI also expressly guaranteed the liabilities and obligations of LBIE, including latterly by way of corporate resolution dated 9 June 2005;

58.2 A change from the above initial position only occurred as a result of a mistake by which the boards of LBL, LBH Plc and LBIE incorrectly believed that CA85 made the requirement for two shareholders in LBIE mandatory, with there being no option to continue with one shareholder lawfully. This was erroneous. Under section 24 CA85, an unlimited liability company may continue to have a single shareholder albeit that, after six months of trading, that sole shareholder may be liable for the company's debts;

58.3 As a result of this mistake LBL became the holder of a single share in LBIE, as nominee for LBH Plc, in November 1994 and then acquired a substitute share in the same capacity as nominee for LBH Plc in May 1997. Absent there being some formal legal requirement no such shareholding would have been created, in circumstances

where LBIE's treatment as a branch for US tax purposes would have been put at risk and there would have been no practical benefit whatever for LBL or the Lehman Group (as reflected by the fact that LBH Plc and subsequently LBHI2, after reorganisation, were generally treated as if they were the sole shareholder in LBIE);

58.4 Applying Kleinwort Benson Ltd v Lincoln City Council [1999] 2 A.C. 349 and Brennan v Bolt Burdon [2005] Q.B. 303 this was a case of common mistake as to a matter fundamental to the contract for the transfer of a share in LBIE to LBL and rendered the transaction void. The register of LBIE should be rectified accordingly.

(ii) Lack of Authority/Breach of Duty

59. Alternatively, LBL acquired and held a share in LBIE only as a result of acts of directors of LBL that were unauthorised. In summary the position is as follows:

59.1 The directors of LBL had no actual authority to act in breach of fiduciary duty and contrary to the interests of LBL;

59.2 It was not in LBL's interest to hold, whether as a nominee or otherwise, a share in LBIE which carried any liability let alone unlimited liability and there was no discernible advantage to the Lehman Group that could have warranted it doing so;

59.3 In breach of their fiduciary duties to LBL the directors of LBL agreed in 1994 and 1997 to hold a share in LBIE without exercising any independent judgment as to whether this was in LBL's best interests and/or for improper purposes, namely in order to promote the interests of LBIE and other members of the Lehman Group as opposed to those of LBL, and/or acted in circumstances in which their duty to LBL conflicted with their duties to LBIE and/or LBH Plc;

59.4 These breaches of duty and thereby lack of authority were known to the directors of LBIE and LBH Plc, who were the self-same individuals as acted on the board of LBL for the purposes of the relevant transactions, as already outlined above.

60. As set out in Bowstead & Reynolds on Agency (20th Edn.), para.3-008, an agent is only authorised to act for his principal's benefit. As a result, actions of a company director or other agent that are in breach of fiduciary duty are not within the scope of that agent or directors' actual authority, especially so where they are for the benefit of

another (see Lysaght v Falk Bros & Co Ltd (1905) 2 C.L.R. 421 at 430, per Griffiths CJ; Architects of Wine Ltd v Barclays Bank Plc [2006] EWHC 1648 (QB); [2007] 1 Lloyd's Rep. 55, reversed on other grounds [2007] EWCA Civ 239; [2007] 2 All E.R. (Comm) 285; Parti v Al Sabah [2007] EWHC 1869 (Ch) at [50]; Flexirent Capital Pty Ltd v EBS Consulting Pty Ltd [2007] VSC 158 at [166]).

61. Whilst apparent authority to so act might arise in a particular case, this could not be so where the agent for the principal is also the representative of the third party for the purposes of the relevant transaction. In those circumstances the knowledge of the agent would be attributed to the third party and prevent reliance upon any representation of authority (see Bowstead & Reynolds, *supra*, Article 95).

62. The directors of LBL owed a fiduciary duty to exercise their powers after using independent judgment (as opposed to deferring to the decisions or judgment of others). This duty encompassed an obligation both properly to consider decisions taken on behalf of the company, and not unreasonably to delegate powers; see Re Westmid Packing Services Ltd [1998] 2 BCLC 646 at 653 to 654 per Lord Woolf MR, and Lexi Holdings Plc v Luqman [2009] EWCA Civ 117, [2009] 2 BCLC, 1 CA. As summarised by Jonathan Parker J. in Re Barings Plc (No. 5) [1999] 1 BCLC 433 at 489:

> "(i) *Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors.*
>
> *(ii) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.*
>
> *(iii) No rule of universal application can be formulated as to the duty referred to in (ii) above. The extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company*";

63. In this instance, there is no evidence that the directors of LBL considered or applied their minds to the consequences for LBL of taking a share in an unlimited company such as LBIE. In so far as any consideration whatever was given to the transaction in 1997 under which LBL acquired a $1 share, the factors that affected the approach of the directors were entirely bound up with the re-organisation of the businesses of LBGL and LBMBL and their amalgamation into the business of LBIE (as set out at paragraph 25 above). Such matters did not affect LBL and should not have led to the acquisition of a shareholding in LBIE. Had the matter been properly considered, the board ought to have concluded that there were no benefits whatever in LBL acquiring such a share and indeed no benefit to the Lehman Group given the desire for LBIE to be a branch of LBH Plc for US tax purposes and the lack of any difficulty arising under section 24 CA85 (given the liability already undertaken by LBH Plc as a member and the arrangements made with the United Kingdom regulatory authorities for LBHI to undertake responsibility for the debts of LBH Plc). Further or alternatively to the principal case, if the share was not acquired by LBL as nominee, there would have been no benefit either to LBL, or to the Lehman Group (assuming this had been relevant). There would in fact potentially have been adverse tax consequences for the Lehman Group as the US tax objective that LBIE be treated as a branch of LBH Plc may have been undermined.

64. In addition to the above, at all material times each of the directors of LBL owed a fiduciary duty, among other things, to exercise their powers for proper purposes. As explained in Madoff Securities International Ltd v Raven [2013] EWHC (Comm) [195-196]: "*A director owes a fiduciary duty to exercise the powers conferred on him by the constitution for the purposes for which they were conferred. The duty is now enshrined in s. 171(b) of the Companies Act 2006 . Although the duty often overlaps with the duty to act in what is honestly considered to be the interests of the company, the duties are distinct. A power may be exercised for an improper purpose notwithstanding that the directors bona fide believe it is being exercised in the company's best interests. That was held to be the position in Hogg v Cramphorn Ltd [1967] 1 Ch 254 , 266G-269A.*

196 The court will apply a four stage test (see Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 , 835F-H; Extrasure Travel Insurances v Scattergood [2003] 1

BCLC 598 at [92]), which involves identifying (1) the power whose exercise is in question, (2) the proper purpose for which such power was conferred (3) the substantial purpose for which the power was exercised in the instant case and (4) whether that purpose was proper".

65. For this purpose it is important to consider the exercise of the power by reference to the company in respect of which the director is appointed and not the corporate group within which that company exists (see W & M Roith Ltd, Re [1967] 1 WLR 432). As stated in Charterbridge Corp v Lloyds Bank [1970] Ch 62, per Pennycuick J, "*Each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company. This becomes apparent when one considers the case where the particular company has separate creditors. The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company...*" (at 74). See too Extrasure Travel Insurances Ltd v Scattergood [2003] 1 BCLC 598 at [91] and Gower & Davies 9th ed. at 19-75, "*...the core duty of loyalty does not recognise a duty "to the group" or to other companies in the group. It insists that the main focus of directors must be on the interests of their subsidiary, even if it accepts that the interests of the subsidiary are in many cases intimately related to the continuing existence of the group. Directors in corporate groups must guard against their inevitable inclinations to promote the interests of the group as a whole (or some part of it).*"

66. In this instance the board of LBL also acted in breach of this duty in acquiring a share in LBIE in 1994 and in 1997. There was no benefit to LBL in doing so and the only justifications for accepting the share transfer / applying for the allotment of a share were extraneous considerations concerning other members of the Lehman Group, but on analysis, these group interests were illusory for the reasons already set out above.

67. Further, the directors of LBL were obliged to avoid a conflict of interest between their own interests, or those of others whom they represented and to whom they owed duties, and their duties to LBL (see Bristol and West Building Society v Mothew

[1998] Ch 1 at 18: "*A fiduciary... may not act for his own benefit or the benefit of a third person without the informed consent of his principal..*").

68. In this instance there was strong potential conflict of duty in so far as there was any real interest on the part of LBIE or LBH Plc in having LBL acquire a shareholding in LBIE in 1994 or 1997. There was no such interest on the part of LBL and the matter required independent consideration by board members who were not also members of the board of LBH Plc and LBIE. This did not occur with the result that no proper consideration was given to the position or interests of LBL. Had the directors of LBL acted in accordance with their fiduciary obligations, the directors of LBL ought to have concluded that it was not in LBL's interests to take up a shareholding in an unlimited company and they should not exercise their powers to further this given that:

68.1 this would result in LBL being potentially exposed to claims by any liquidator of LBIE;

68.2 no consideration was being provided to LBL for taking on such exposure;

68.3 LBL could not transfer the share acquired without the consent of LBH Plc and/or LBHI2 once it was held; and

68.4 although LBL might seek indemnification in respect of such exposure from those for whose benefit the shareholding had been taken up, namely LBIE or LBH Plc and/LBHI2, any such right of indemnification might well be of no or little value in the context of a liquidation of LBIE (being the circumstance in which such right might be called upon).

69. Further each of the steps of the directors of LBL ostensibly to acquire a share in LBIE were taken in circumstances in which there was no apparent authority, the absence of actual authority being a matter of which all other parties transacting were aware. In particular:

69.1 As set out above, the board meetings of LBH Plc and LBL of 23 November 1994 at which the £ ordinary share was transferred to LBL as nominee for LBH Plc were attended by the same personnel: Oliver Backhouse, C. Daniel Tyree and Margaret

Smith, and similarly each of the board meetings which occurred on 1 May 1997, whether purportedly for LBL, LBIE or LBH Plc, was attended by Oliver Backhouse and Teresa South. Consequently, the allotment of the share to LBL was approved by Oliver Backhouse and Teresa South on behalf of LBIE, having regard to an application apparently made on behalf of LBL by Teresa South, purportedly by resolution of LBL passed by Oliver Backhouse and Teresa South. At the same time, an application made for shares by LBH Plc, approved by resolution of LBH Plc passed by Oliver Backhouse and Teresa South and made by way of letter signed by Oliver Backhouse, was granted by LBIE, by resolution passed by Oliver Backhouse and Teresa South.

69.2 The overlap between the boards of LBL, LBIE and LBH Plc set out above gave rise to a conflict of interest, as set out above, but also meant that LBIE and LBH Plc were fully aware of the breach of duty and of the lack of authority.

70. Where the directors of a company have acted without authority the relevant transaction will be void and of no effect; see Hogg v Cramphorn (supra.), and Guinness v Saunders [1990] 2 AC 663; where authorised but exercised for improper purpose the act will be liable to be set aside; Gower & Davies, Principles of Modern Company Law at 16-52 to 16-53 and see too Hely-Hutchinson v Brayhead Ltd [1968] 1 QB 549, and Hunter v Senate Support Services Ltd [2005] 1 BCLC 175. Applying these principles the acquisition of a share in LBIE by LBL should be treated as void or be set aside and the register of LBIE be rectified accordingly.

71. Indeed in all of these circumstances, the LBL Administrators' position on Issue 13 is that the share register of LBIE should be rectified on the basis that:

71.1 LBL did not hold a share in LBIE by virtue of any effective or authorised transaction and the transfer of a share and then allotment of the share were each void;

71.2 Further or alternatively, each of the transactions resulting in the acquisition of a shareholding in LBIE by LBL including the allotment of the share were carried out in breach of duty and should be set aside.

(iv) Rectification of the Register

72. The jurisdiction to rectify the register is contained in s.125(a) of the Companies Act 2006 (**"CA06"**), where the applicant's name has been entered into the share register without sufficient cause, and pursuant to which the court has a broad discretion, as set out in s.125(3) to decide "*any question relating to the title of a person who is a party to the application to have his name entered in or omitted from the register, whether the question arises between members or alleged members, or between members or alleged members on the one hand and the company on the other hand, and generally may decide any question necessary or expedient to be decided for rectification of the register*".

73. The Court may also rectify the register where a list of potential contributories is drawn up (section 148(1) IA86, and see too section 160(1)(b) and 160(2) IA86).

74. The circumstances in which a share register will be rectified are unlimited, but include cases such as the present, in which the shares ought never to have been registered in the name of the relevant applicant, including because the purported transfer to that applicant was void or irregular. See, by way of example, Portuguese Consolidated Copper Mines Ltd (1889) 42 Ch D 160, Re Homer District Consolidated Gold Mines (1889) 39 Ch D 546, Re Transatlantic Life Assurance Co Ltd [1980] 1 WLR 79; International Credit and Investment Co (Overseas) Ltd v Adham [1994] 1 BCLC 66; Avenue Road Developments Limited v Reggiesco Limited [2012] EWHC 1625 (Ch).

75. Further, the Court's power to rectify the register has retrospective effect, where the Court is satisfied that a person has never been a member; Barbor v Middleton (1988) 4 BCC 681.

(v) Indemnity

76. Even if, contrary to the above, LBL is rightly registered as a shareholder in LBIE, then the LBL Administrators contend that LBL is not to bear the liabilities of a member of LBIE including in respect of the Contribution Claim having regard to:

76.1 The fact that at all material times LBL held a single share in LBIE simply as nominee for LBH Plc and/or, from November 2006, LBHI2. This was consistently the position

throughout the entire period from 1994 onwards (the 1997 allotment being clearly intended simply to correct the transfer of a £ share in 1994, and not to change the capacity in which LBL ostensibly held a share in LBIE) and is reflected in (a) the manner in which LBL was not treated as a shareholder having any rights independent of LBH Plc or LBHI2 and (b) the way in which LBIE was repeatedly represented to be a wholly owned subsidiary of LBH Plc and LBHI2, as explained in paragraphs 41 to 47 above;

76.2 The fact that LBL was, as a result, entitled, either by virtue of implied contract or in restitution, to indemnification in respect of all such costs and expenses incurred as a shareholder in LBIE (see Re Overend, Gurney & Co. (Musgrave and Hart's case) [1867-68] LR 5 Eq 193 (at 206-207) and see generally Goff & Jones, The Law of Unjust Enrichment 8th ed. 19-16 - 19-21, Duncan, Fox & Co v North and South Wales Bank (1880) 6 App. Cas. 1 at 10 and Niru Battery Manufacturing Co v Milestone Trading Ltd (No.2) [2004] 2 All E.R. (Comm) 289); and/or

76.3 The contractual rights of LBL to recover and obtain indemnification in respect of all costs and liabilities incurred in the course of its business from other entities within the Lehman Group, which (LBL contends) includes an entitlement to indemnification in respect of all costs and liabilities associated with the shareholding in LBIE held by LBL and any Contribution Claim now raised. This matter is addressed further below, in respect of the Recharge Issues.

77. Such an indemnity is consistent with section 148(3) IA86, which provides that in settling the list of contributories the court "*shall distinguish between persons who are contributories in their own right and persons who are contributories as being representatives of or liable for the debts of others*".

(2) Issues 9 and 11: the Recharge Issues

78. Similarly, if, contrary to its principal case, LBL does hold a share in LBIE so as to be potentially liable in respect of any Contribution Claim raised, then the position of the LBL Administrators is that LBL has a right to be indemnified for and / or to recharge any such liability arising, pursuant to an agreement between itself and other Lehman Group entities discussed further below. This entitlement extends to bad debts (**"Bad**

Debt Claim") and expenses incurred in the administration of LBL (**"Administration Expenses"**) (as expressly raised by Issues 9 and 11).

79. As summarised above, at all material times LBL operated as a service company, providing administrative services to the members of the Lehman Group operating in the UK, Europe and Middle East. The provision of such services was identified as LBL's principal business activity in its audited accounts for all years from 1987 to 2006 (the last year for which audited accounts were prepared).

80. By agreement made initially by conduct and subsequently recorded, in part, in writing between LBL and each of LBIE and LBEL, as well as various other companies in the Lehman Group to whom it provided services ("**the Recharge Agreement**"), LBL recharged all costs, expenses and liabilities that it incurred.

81. All costs, expenses and liabilities were, at all material times, recharged by LBL in the following ways:

81.1 Where a cost, expense or liability was incurred on behalf of a specific entity, that amount was recharged to that entity by LBL, at cost;

81.2 Where a service was provided to a specific entity, all costs expenses and liabilities incurred as a result of the provision of that service were recharged to that entity by LBL, at cost;

81.3 Where a service was provided and shared between multiple Lehman Group entities, all costs expenses and liabilities incurred as a result of the provision of that service were recharged by LBL by apportioning the amount incurred, plus uplift, across a number of entities;

81.4 Where certain types of liabilities were incurred (for example net interest on intercompany accounts), those liabilities were recharged by apportioning the amount incurred, with no uplift, across a number of entities;

81.5 Where certain costs, expenses and liabilities were incurred (for example in connection with the 'Lehman Brothers Pension Fund') those amounts were recharged using a combination of the methods.

82. The scope of services provided and recharged by LBL was extensive, and included the various types of administrative costs recharged are set out in Appendix 3.

83. Prior to 2000, the Recharge Agreement was not recorded in writing, but was evidenced by a course of consistent conduct over an extended period and embedded in the accounting arrangements for the group.

84. However, as set out in paragraphs 29 to 35 above, during the course of 1999 and 2000, the Lehman Group considered making an assertion under US accountancy rule known as APB 23 for LBL and LBEL.

85. As part of the considerations in respect of the APB23 Project and the Global Transfer Pricing Review, it was recognised that it would be beneficial to:

85.1 increase the profitability of LBL by increasing the uplift from 1% to 10%;

85.2 to book as much cost as viable to LBIE (for which no APB23 election was to be made), so as to reduce the overall current year tax charge for the Lehman Group;

85.3 ensure a consistent uplift percentage was applied across all companies for which LBL provided services; and

85.4 document parts of the Recharge Agreement to assist in the obtaining of tax benefits as set out above.

86. Accordingly, each of the service agreements recorded part of the arrangements that were already the subject of the Recharge Agreement and were created for the purpose of providing evidence to enquiring tax or regulatory authorities. Consequently, they provided for the recharge of costs relating to certain categories of services being: compensation and benefits, technology and communications, business development expenses, occupancy, professional fees, brokerage and clearance and other miscellaneous expenses. The service agreements did not and were not intended to replace, limit or affect the terms of the Recharge Agreement already in place but were consistent with that agreement in respect of the particular matters that such service agreements addressed.

87. On 20 May 2004 an amended service agreement was entered into between LBL and LBIE, and also LBL and LBEL, with effect from 1 April 2004, for the purpose of deferring payment in relation to services provided by LBL, if necessary.

88. In addition to the above, to support the APB23 assertion, in relation to employees of LBL who were seconded to other entities within the Lehman Group, written secondment agreements were entered into by LBL and LBIE effective from 1 December 1999. Materially identical secondment agreements were entered into by LBL with LBEL. As in the case of the service agreements these documents did not and were not intended to replace, limit or affect the terms of the Recharge Agreement already in place but were consistent with that agreement in respect of the particular matters that such secondment agreements addressed.

89. Pursuant to the Recharge Agreement costs, liabilities and expenditure incurred by LBL continued to be recharged to the other Lehman Group companies that were party to the agreement and who received the benefit of such services (principally LBIE and LBEL). These costs, liabilities and expenditure related to services including those expressly identified in the service agreements entered into in 2000 and 2004 (such as compensation and benefits, and professional fees) but also included other costs, liabilities and expenses.

90. The recharge of costs for the provision of such services were calculated as they had been prior to the service and/or secondment agreements, but subject to a 10% uplift and with amendments to the exact proportions of recharges between service recipients being made periodically but always on the basis that the total cost was recharged.

91. Very substantial sums were recharged by LBL pursuant to the Recharge Agreement. In the year immediately prior to administration, LBL recharged significantly in excess of £1bn. to those other entities within the Lehman Group who were party to the Recharge Agreement and had benefitted from the services LBL provided.

92. In these circumstances, and having regard to Issues 9 and 11, it is LBL's position that it is now entitled to recharge on the basis set out above any costs, expenses or liabilities incurred by it as a member of LBIE (including any Contribution Claim), Bad Debt Claims and/or Administration Expenses. Without limitation:

92.1 This is consistent with the operation of LBL as a service company, the purpose of which was merely to provide operational, administrative and support services to other entities within the Lehman Group. LBL never bore the cost of the provision of such services, and indeed did not have the resources to do so;

92.2 The Recharge Agreement provided for the recharge of all costs, expenses and liabilities incurred by LBL in providing its services, to the Lehman Group entity who received the benefit of such services, together with an uplift of, prior to December 1999, 1%, and thereafter 10%, on certain services. This is partly recorded in the various service agreements and secondment agreements set out above;

93. Further or alternatively, by reason of the arrangements set out above, there was an agreement by custom (and/or, where applicable, collateral contract) whereby LBL is entitled to recharge all costs that it incurs by reason of its provision of services to the Lehman Group entity deriving benefit from the same; see further Hutton v Warren (1836) 1 M & W 466 at 475; Liverpool City Council v Irwin [1977] AC 239 at 253; Durham v BAI (Run Off) Ltd [2009] 2 All ER, per Burton J. at 86 (unchallenged on this point on appeal), so that it may now recharge any Contribution Claim raised by LBIE and/or recover from LBIE and/or LBEL and/or other Lehman Group entities as appropriate, the Bad Debt Claim and Administration Expenses; and/or

94. As a further alternative, it was an implied term of the service agreements and secondment agreements that all services provided by LBL not expressly therein identified but provided by LBL in the capacity of a service company, were to be recharged to the Lehman Group entity with whom such agreements had been entered into and who received the benefit of such services upon the terms set out therein. Such an implied term is necessary to give effect to the intention of the parties or to achieve the parties' objective in entering into the contract; see further A-G of Belize v Belize Telecom Ltd [2009] UKPC 10, [2009] 1 WLR 1988; " … *in every case in which it is said that some provision ought to be implied in an instrument, the question for the court is whether such provision would spell out in express words what the instrument read against the relevant background, would reasonably be understood to mean*" per Lord Hoffmann at [21]. See too Crema v Cenkos Securities Plc [2010] EWCA Civ 1444; Bus LR 943.

95. Further:

95.1 There is no reason to depart from the Recharge Agreement simply by reason of LBL's entry into administration and/or (if appropriate) liquidation; and

95.2 LBL's entitlement to recharge under the Recharge Agreement includes:

95.2.1 any liability incurred by LBL as a shareholder in LBIE and thus by way of Contribution Claim; in the circumstances set out above, it appears that LBL was nominated as shareholder in LBIE not for its own benefit but ostensibly to meet a perceived statutory requirement that LBIE have two shareholders and/or for other reasons of benefit to LBIE, LBH Plc and LBHI2 and/or other entities within the Lehman Group;

95.2.2 Bad Debt Claims (including on the basis that terminal and other specific losses were amongst the costs recharged by LBL); and

95.2.3 Administration Expenses.

(3)Issue 7: the Adjustment Issue

96. Issue 7, raises the question whether, in light of the fact that LBL is only registered as owning a single share in LBIE, and LBHI2 owns 2 million 5% redeemable Class A preference shares of $1000 each, 5.1 million 5% redeemable Class B shares of $1000 each, and 6,237,113,999 ordinary shares of $1 each, there is to be an adjustment of rights as between LBL and LBHI2, or LBH Plc, in respect of any Contribution Claim made.

97. When considering this issue it is relevant to take into consideration not merely the fact that LBL is registered as holding a de minimis shareholding but also that fact that this was without the benefit of shareholder entitlements that went with that shareholding, as explained in paragraphs 45 to 47 above.

98. The general obligation of contributories to contribute is set out in section 74(1) IA86, which provides that *"When a company is wound up, every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of*

the contributories among themselves"[4]; that obligation is qualified in a number of respects, set out in section 74(2) IA86, including to provide that "*nothing in the Companies Act or this Act invalidates any provision contained in a policy of insurance of other contract whereby the liability of individual members on the policy or other contract is restricted, or whereby the funds of the company are alone made liable in respect of the policy or contract*";

98.1 Section 148(1) IA86 further provides that "*As soon as may be after making a winding-up order, the court shall settle a list of contributories, with power to rectify the register of members in all cases where rectification is required, and shall cause the company's assets to be collected, and applied in discharge of its liabilities.*" As set out above, it is expressly provided by section 148(3) IA86 that in settling the list, the court shall distinguish between persons who are contributories in their own right and persons who are contributories as being representatives of or liable for the debts of others;

98.2 Section 150(1) IA86 then applies so that, "*The court <u>may</u>, at any time after making a winding-up order; and either before or after it has ascertained the sufficiency of the company's assets, make calls on all or any of the contributories for the time being settled on the list of contributories to the extent of their liability, for payment of any money <u>which the court considers necessary</u> to satisfy the company's debts and liabilities, and the expenses of the winding up, and for the adjustment of the rights of the contributories amongst themselves, and make an order for payment of any calls so made*" (emphasis added), and by section 150(2) that "*In making a call the court may take into consideration the probability that some of the contributories may partly or wholly fail to pay for it*".

99. The powers conferred by section 148 IA86 are, by section 160 IA86, delegated to the liquidator (save that the liquidator may rectify the register only with the leave of the court, and make a call upon contributories only either with special leave of the court or the sanction of the liquidation committee).

100. However, it is submitted that any such contributions are to be rateable to the members' shareholding and to have regard to whether the shareholding was merely as

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[4] The scope of section 74 is a matter for consideration by the Supreme Court in Waterfall I.

a nominee and the shareholder was accorded the rights held by other shareholders since:

100.1 The ability of the court (delegated to the liquidator) is, under section 150(1) IA86 discretionary, and the calls extend to such sums as the court considers may be necessary to pay the company's debts and liabilities;

100.2 The statutory scheme plainly envisages that not all contributories will meet calls made; section 150(2) IA86, such that there can be no requirement that contributories make equal payments to meet the company's debts and liabilities;

100.3 Where a surplus is generated (whether by reason of a call or otherwise) it is to be distributed to the company's members "*according to their rights and interest in the company*" (except as otherwise provided by the company's articles) (s.107 IA86). It would create an obvious imbalance if the right to a distribution accords with the extent of a member's interest in the company, but the liability to contribute to a call does not.

101. Accordingly, the position of the LBL Administrators is that if, contrary to its principal case, LBL does hold the share, then having regard to the fact that its shareholding is de minimis, the nominee status of LBL for LBHI2 and/or LBH Plc and the lack of rights accorded to LBL:

101.1 LBL should not be responsible for any part of the Contribution Claim and such claim should be met by LBHI2 alone, or otherwise LBHI2 and LBH Plc;

101.2 Alternatively the obligations of LBL and LBHI2 to meet a Contribution Claim should be rateable to their shareholdings in LBIE; and

101.3 Further or alternatively, insofar as the obligations of LBL and LBHI2 to meet a Contribution Claim are not rateable to their shareholdings in LBIE, then:

101.3.1 LBHI2 and/or LBH Plc is obliged to contribute to LBL, alternatively to LBIE, in respect of any payments required to be made by LBL pursuant to the Contribution Claim so that the obligations of LBL and LBHI2 to meet the Contribution Claim are rateable to their shareholdings in LBIE;

101.3.2 LBHI2 and/or LBH Plc is to indemnify LBL in respect of its obligation to make payments to LBIE in respect of the Contribution Claim, save insofar as LBL holds the share; and/or

101.3.3 There is to be an adjustment as between LBL and LBH Plc and/or LBHI2, the effect of which is to be that their contributions to LBIE in respect of a Contribution Claim are proportionate to their shareholdings in LBIE.

102. As a further alternative to the above, in all of the circumstances, any liquidators of LBIE are to be directed to assert any Contribution Claim as against LBHI2 and/or LBH Plc, and if as against LBL then only to the extent that it holds the share.

(4)Further Issues Arising for Determination

103. In the event that LBL is not properly considered a shareholder in LBIE and/or has no liability as such, then its position in respect of the remaining Issues falling for determination may well be redundant. The remaining Issues are therefore addressed in turn, entirely without prejudice to the principal case made by LBL as set out above.

(a)Issue 1

104. Issue one concerns whether the obligations of LBHI2 and/or LBL as members to contribute to the assets of LBIE pursuant to a Contribution Claim include an obligation to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay sums owed to LBHI2 pursuant to the three subordinated loan agreements entered into on 1 November 2006 between LBHI2 (as Lender) and LBIE (as Borrower) (**"Sub-Debt"**).

105. By way of proof of debt submitted on 24 April 2012, LBHI2 has sought to prove in the administration of LBIE for the Sub-Debt in the sum of £1,254,165,598.48. On a "*pessimistic*" assessment, the LBIE Administrators have assessed the potential value of the Sub-Debt claim at £3bn, including interest, for the purposes of proofs of debt filed by the LBIE Administrations in the administrations of LBL and LBHI2 by way of Contribution Claim incorporating the Sub-Debt.

106. These proofs were filed by LBIE following the Waterfall I Judgment, that the Sub-Debt is a provable debt, ranking in priority of distribution below the payment of the

statutory interest and currency conversion claims. That decision was upheld by the Court of Appeal [at 39, 57, 62 and 121], but is presently the subject of appeal to the Supreme Court.

107. LBIE has not yet adjudicated upon LBHI2's proof of debt (see Downs 9th witness statement, paragraph 33(b)) and, at the present time, the Sub-Debt is a purely contingent claim, with its proof to be valued at zero pending payment of the statutory interest and currency conversion claims (see judgment of the Court of Appeal at [38, 41]).

108. Furthermore, whilst determining that the Sub-Debt is a provable debt, neither the Court of Appeal nor David Richards J. ruled upon whether the Sub-Debt is in fact payable, in particular by funds raised by way of Contribution Claim. On a correct analysis of the applicable statutory provisions and interpretation or application of the relevant loan agreements, it is not.

109. The formulation of LBIE's Contribution Claim in its proof of debt filed in LBL's administration, dated 31 October 2014, suggests the following financial position in respect of LBIE (all amounts are in £billions):

Estimated surplus:	5
Claims for interest:	(10)
Currency conversion claims	(2)
Shortfall:	(7)
Subordinated debt (including interest)	(3)
Unpaid liabilities	(10).

110. The sums claimed by LBIE may, of course, change upon appeal of the Waterfall I proceedings to the Supreme Court, which appeal includes the applicability of claims for statutory interest and also currency conversion claims. If these claims fall away, LBIE will be able to pay the Sub-Debt from its own estimated surplus. Otherwise, however, LBIE will be insolvent such that, properly considered, the Sub-Debt is not payable, and can form no part of any Contribution Claim raised against LBL and/or LBHI2.

(i) Does a Contribution Claim extend to the Sub-Debt

111. Although section 74(1) IA86 contains a general provision that *"every present and past member is liable to contribute to its assets to any amount sufficient for payment of its debts and liabilities, and the expenses of the winding up"*; that obligation is qualified in a number of respects. In particular in connection with an unlimited company section 74(2)(e) provides that *"nothing in the Companies Acts or this Act invalidates any provision contained in a policy of insurance or other contract whereby the liability of individual members on the policy or contract is restricted, or whereby the funds of the company are alone made liable in respect of the policy or contract"* (emphasis added). This provision (or its predecessor provisions[5]) have been given effect to on a proper construction of the relevant contractual documentation; see in particular In Re Athenaeum Life Assurance Company, ex p. Prince of Wales Life Assurance Company 44 ER 1423 and 70 ER 216; Re Accidental Death Co (1878) 7 Ch. D. 568; Re Great Britain Mutual Life Assurance Society (1880) 16 Ch D 246, and also Lathbridge v Adams Ex p. Liquidator of the International Life Assurance Society (1872) LR 13 Eq 547.

112. When considered in their commercial context[6], on the true interpretation of the facility agreements under which the Sub-Debt was created, the funds of LBIE alone were to be resorted to for the purpose of meeting this liability, and there was to be no recourse to the members of LBIE. Alternatively, there was an implied term of the

[5] Section 74(2)(e) can be traced back to the Joint Stock Companies Act 1848, s. 57. The form of wording now found in s.74(2)(e) first appeared in the Companies Act 1862, and has since appeared in almost identical form as s.123(1)(vi) of the Companies (Consolidation) Act 1908, s. 157(f) of the Companies Act 1929, s. 212(f) of the Companies Act 1948, and s.502 of the Companies Act 1985, before it was consolidated into the Insolvency Act 1986 in its current form. Like provision may be found in s.426(1)(f) of the Companies Act 1956 (India), s.207(1)(f) Companies Act 1963, s.1278 Companies Act 2014 (Ireland) and s.526 Corporations Act (Australia).
[6] As to the importance of the commercial context in construing provisions of the type in issue.
see Rainy Sky SA v Kookmin Bank [2011] 1 W.L.R. 2900, at [21] (per Lord Clarke): *"The language used by the parties will often have more than one potential meaning. I would accept the submission made on behalf of the appellants that the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other"*; see too Arnold v Britton [2015] UKSC 36, at [15] and [108-110].

relevant facility agreements to this effect[7]. As a result a Contribution Claim under section 74(1) cannot be advanced in respect of the Sub-Debt against LBL.

113. The following factors support the above construction or existence of such an implied term:

113.1 It makes no commercial sense for there to be recourse to assets beyond those of LBIE itself in this case. As set out above, the member with the vast majority of the shares in LBIE was the same person who is the lender in respect of the Sub-Debt, namely LBHI2, whereas LBL was registered as holding the single share. Even assuming for the purposes of this argument that such registration was correct, for the reasons already set out above any such membership would have been provided by LBL as a service and as a nominee or pursuant to rights of indemnity against LBIE and/or LBHI2. It would make no commercial sense for there to be rights of recourse to assets beyond those of LBIE when this simply leads back to LBHI2 (the lender in respect of the Sub-Debt);

113.2 Even ignoring any right of indemnification of the type described above, the context still supports a construction limiting recourse to LBIE's own funds and not those of its members:

113.2.1 The Sub-Debt agreements were entered into so as to ensure compliance with regulatory capital requirements. As explained by David Richards J. in the Waterfall I Judgment, at [33]: "*Under capital rules made by regulators, banks and other financial institutions are required to hold capital of a certain amount, which depends in broad terms on the extent of their business and their risk exposures. The purpose of the capital adequacy rules is so far as possible to ensure that firms provide financial resources to protect their customers and other stakeholders against failure and enable them to withstand some level of loss*";

113.2.2 As further explained by David Richards J., both the first Basel Accord (International Convergence of Capital Measurement and Capital Standards (Basel I)) and the revised Basel Accord of 2006 (Basel II) (as implemented

[7] As to the significance of the commercial context when implying a term see Attorney General of Belize v Belize Telecom Ltd (supra.) at [16] to [27].

by the EU Directives 2006/48/EC and 2006/49/EC relating to credit institutions) provided that subordinated loan capital could only be included in the calculation of capital base *"if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled"*;

113.2.3 Such an objective would be achieved were no claim to be available against members of LBIE under section 74(1) IA86. However, it would not be achieved if there was to be such a claim or at least such a claim against LBL:

113.2.3.1 If the funding for payment of the Sub-Debt had to be provided by LBL as a result of a section 74 claim, this would carry with it the prospect that LBL would then have diminished resources with which to meet the claims of its own third party creditors;

113.2.3.2 Almost all of the creditors of LBL were in commercial reality persons providing services for the benefit of the Lehman Group, including LBIE. The fact that their contract was with LBL as service company to the Lehman Group did not detract from this fact;

113.2.3.3 It would be inimical to the objective of the regulatory capital requirements for the provider of the Sub-Debt (LBHI2) to receive payments so as to reduce that debt at the expense of such external creditors.

(ii) The Sub-Debt agreements

114. Further as described in the Waterfall I Judgment, the Sub-Debt was the subject of agreements that contained very similar wording. Key for present purposes were the clause 5 subordination provisions quoted at [53] of the judgment which include the requirement that the Sub-Debt is payable only where certain contingencies are met, including that LBIE is "solvent":

"Subordination

5(1) Notwithstanding the provisions of paragraph 4, the rights of the Lender in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities and accordingly payment of any amount (whether principal, interest or otherwise) of the Subordinated Liabilities is conditional upon:-

...

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

(2) For the purposes of sub-paragraph 1(b) above, the Borrower shall be "solvent" if it is able to pay the 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 [being any 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].*

...

(4) For the purposes of sub-paragraph 1(b) above, a report given at any relevant time as to the solvency of the Borrower by its Insolvency Officer, in form and substance acceptable to the FSA, shall in absence of proven error be treated and accepted by the FSA, the Lender and the Borrower as correct and sufficient evidence of the Borrower's solvency or insolvency".

115. Further:

115.1 Liabilities are defined as "*all present and future sums, liabilities and obligations payable or owing by [LBIE] (whether actual or contingent, jointly or severally or otherwise howsoever)*"; and

115.2 the Standard Terms continue to provide that where the Sub-Debt is paid where the aforesaid condition of solvency is not met, then "*Any sum... shall be received by the Lender upon trust to return it to the Borrower*" (at Standard Conditions 5(5) and (6)).

116. The significant issue of interpretation for present purposes arises in respect of the words in clause 5(2), which define the condition of solvency, namely that "*the Borrower shall be "solvent" if it is able to pay the Liabilities (other than the Subordinated Liabilities) in full*". Is the condition of ability to pay "*Liabilities*" to be treated as referring to payment from LBIE's own funds or does it encompass payment from LBIE's own funds and also from the funds of members through a claim by a liquidator under section 74 IA86? In the light of the commercial context described above the answer is the former and payment must be possible from LBIE's own funds without reference to a section 74 claim against members IA86[8].

(b)Issue 2

117. The second Issue arising is whether any claim made by LBIE against LBHI2 and/or LBL under section 74 in respect of the Sub-Debt (a "**Sub-Debt Contribution Claim**") is to be included in the insolvency set-off account in LBIE's administration as against the provable claims of LBHI2 and/or LBL.

118. As matters stand, it is hard to see any basis upon which a Contribution Claim raised in respect of the Sub-Debt should not in principle be included in the insolvency set-off account; it has already been determined that the Sub-Debt is a provable debt, that the liability of LBL and LBHI2 as contributories extends to provable debts, and moreover that the Contribution Claim in respect of the non-provable debts could be included in the insolvency set-off (Appeal Judgment at [38-42] and see too [121])[9].

[8] This result must also follow in the event that LHI2's appeal to the Supreme Court on the scope of the s.74 liability succeeds (so that any s.74 liability is restricted to provable debts).
[9] Applying s.80 of the Insolvency Act 1986 and rr.2.85 and 13.12 of the Insolvency Rules.

119. However, for the reasons set out below, the Sub-Debt Contribution Claim is not to be afforded any value for this purpose. If it was to be given value there would be no basis for the LBIE Administrators to value the Sub-Debt Contribution Claim at full value whilst valuing the claim of LBHI2 regarding the Sub-Debt at zero. This would potentially create a scenario where LBHI2 would be funding the payment of its Sub-Debt with no assurance that the funds would be used by the LBIE Administrators to discharge that Sub-Debt.

(c)Issue 3

120. The ability to prove for a Contribution Claim in an administration is the subject of appeal to the Supreme Court in Waterfall I. However, assuming that the ability to prove is upheld, the third issue arising is what value should be afforded to any Sub-Debt Contribution Claim for the purposes of proof and set-off, and specifically whether the Sub-Debt Contribution Claim should be valued as (i) the full amount of the Sub-Debt; (ii) limited to the estimated value that is applied to LBHI2's claim for the Sub-Debt for the purposes of proof; or (iii) some other value.

121. For the purposes of proof and set-off, the Sub-Debt Contribution Claim has to be valued as a contingent claim, and thus estimated on a genuine and fair basis (since its amount is not certain), having regard to the likelihood of the relevant contingency occurring. There are multiple contingencies arising here:

121.1 LBIE may never go into liquidation and a Contribution Claim may never in fact be made;

121.2 Even if it goes into liquidation, LBIE may have sufficient assets in the surplus to pay all of its obligations including the Sub-Debt (in particular if the appeals in respect of statutory interest and currency conversion claims succeed) so as not to require its members to contribute to the Sub-Debt; and

121.3 Alternatively, LBIE may have insufficient assets to pay the prior claims made against its estate, so that the Sub-Debt never becomes payable, and LBIE therefore need not seek a contribution in respect of the same from its members.

122. Having regard to the contingent nature of the Sub-Debt itself the Court of Appeal determined that it should be afforded a nil value for the purposes of proof and set-off until such time as the statutory interest and currency conversion claims have been met; see Appeal Judgment at [41].

123. It cannot be the case that, notwithstanding this, the Sub-Debt Contribution Claim ought to be afforded real value for the purpose of proof and set-off. It is a more remote contingency than the Sub-Debt claim itself, and the result would be that LBIE would make recoveries by way of the Sub-Debt Contribution Claim where presently the underlying debt is not due, and is not to be accorded any value at all.

(d) Issue 4

124. The fourth Issue arising is, to the extent that insolvency set-off has already taken effect then, in the administration of LBIE, as between LBHI2's claim in respect of the Sub-Debt and LBIE's Sub Debt Contribution Claim (if any) against LBHI2, what effect (if any) does set-off have on LBIE's ability to make a Sub-Debt Contribution Claim against LBL.

125. For present purposes, in administration and prior to payment of the statutory interest claims and currency conversion claims, the value of each of the Sub-Debt and the Sub-Debt Contribution Claim is to be zero, and the question of its set-off is irrelevant to the adjustment of claims *inter se*.

126. However, if LBIE is put into liquidation then to the extent that any Sub-Debt Contribution Claim is made by LBIE it will be the subject of mandatory set off as against LBHI2's claim to the Sub-Debt.

127. In such circumstances it must follow that any Sub-Debt Contribution Claim raised against LBL is to be adjusted; otherwise LBIE would benefit twice from the Sub-Debt Contribution Claim, once as regards LBHI2 (as against whom the Sub-Debt Contribution Claim is set off as against the Sub-Debt Claim), and once as regards LBL. Moreover, it appears to be accepted by LBIE that it will not be entitled to double recovery in this way; see the First Appendix to Downs 9th witness statement at paragraph 8.

(e)Issues 5 and 6

128. Issues 5 and 6 fall to be considered together; they are:

128.1 In circumstances where insolvency set-off in LBIE's administration took effect on 4 December 2009 is insolvency set-off in a subsequent distributing administration of LBHI2 and/or LBL of any application in respect of those companies' claims against, and liabilities to, LBIE; and/or

128.2 In circumstances where insolvency set-off in the administration of LBEL took effect on 11 July 2012, is insolvency set-off in a subsequent distributing administration or liquidation of LBL of any application in respect of LBL's claims against and liabilities to, LBEL.

129. The above issues fall to be determined together, and concern the effect of set-off where multiple companies enter distributing administration on different dates.

130. LBL understands from Linklaters' letter of 3 December 2015 that LBIE's position is that once set-off has occurred in LBIE's estate (i.e. as at 4 December 2009) insolvency set-off can have no relevance or effect in the estates of LBL and/or LBHI2. This cannot be right. The fact that insolvency set-off has occurred in LBIE's estate cannot preclude insolvency set-off occurring in the separate estate of LBL (or LBHI2) when it subsequently enters into distributing administration. Insolvency set off must then take place in the ordinary way in LBL's estate.

131. Furthermore, it is LBL's position that the balances arising in the administrations of LBIE, LBHI2 and/or LBL can be re-drawn at a later date by the adjustment of any rights of set-off that arise as between the parties:

131.1 This accords with the hindsight principle as explained by Lord Hoffman in MS Fashions v BCCI [1993] CH 425, that it should be possible to redraw the balances between the parties at a later point if circumstances change and/or new information becomes available;

131.2 It accords too with the analysis contained in Bank of Credit & Commerce International (Overseas) Ltd v Habib Bank Ltd [1998] 2 BCLC 459, in which it was held that under Insolvency Rule 4.90, the Court was required to take into account the

fact that debts owed to the creditor at the date of liquidation had subsequently been paid by third parties; and

131.3 It is consistent with the provisions of rules 2.81, 4.84 and 4.86 of the Insolvency Rules permitting the revision of estimates of contingent debts in light of further information (and see Lomas v Burlington Loan Management [2015] EWHC 2269 (Ch)) and the fact that a creditor may lodge an additional proof out of time for the balance due on a crystallised contingency (see Re Danka Business Systems [2013] Ch. 506).

132. Further and for the avoidance of doubt, there is nothing to prevent, and significant support in principle, for notices of distribution to permit an adjustment of rights as between parties on an ongoing basis, prior to the conclusion of the insolvency process, in particular where the same parties have proved and/or are receiving interim payments, which might permit adjustments to take into account any over or underpayments made.

(f)Issue 8

133. By Issue 8 the Court is invited to direct how, if at all, any claim for contribution or indemnity as referred to in paragraph 7(ii) of the Waterfall III application and/or any adjustment as referred to in paragraph 7(iii) of the same would be affected by the rule against double-proof in circumstances where LBIE has not yet been paid in full in respect of the Contribution Claim.

134. It is submitted that the questions raised simply do not arise in the context of LBL's position under Issue 7 as addressed above. LBL's position in connection with Issue 7 is that any Contribution Claim against it would be nil or de minimis on a proper application of the applicable statutory provisions.

(g)Issue 10

135. By Issue 10 the LBIE Administrators ask the Court to determine whether, to the extent that LBL is entitled to recover by way of recharge from LBIE sums paid or payable in respect of a Contribution Claim, LBL's recharge against LBIE in respect of

the Sub-Debt Contribution Claim and LBHI2's claim in respect of the Sub-Debt are to be paid *pari passu* and, if not, in what order of priority.

136. As already set out above the primary case of LBL is that the Sub-Debt could not be claimed against LBL at all. The issue posited would therefore not arise. If Sub-Debt did arise as an item that could be the subject of a claim against LBL and which then had to be recharged it is submitted that it is most likely that LBHI2's and LBL's claims would be addressed by way of set-off against the contribution claim made against them respectively and as a result there would be no ranking of claims required.

(h)Issue 12

137. Issue 12 arises in the event that LBL is entitled to recharge any liability incurred as a shareholder in LBIE, and is whether, where such recharge would otherwise be permitted, is it impacted (and if so, to what extent) by any set-off occurring in LBIE's administration as between (i) the Contribution Claim; and (ii) provable claims of LBL against LBIE.

138. This Issue is further posited in Appendix 1 to Downs 9th Witness Statement (paragraph 20) as follows:

138.1 LBIE Makes a Contribution Claim of £1bn against LBL;

138.2 LBL successfully asserts that the Contribution Claim is capable of recharge to LBIE and LBEL in the following proportions £600m (being 60% of the Contribution Claim) to LBIE and £400m (being 40% of the Contribution Claim) to LBEL;

138.3 Insolvency set-off is applied between LBIE's Contribution Claim and LBL's recharge of that claim, extinguishing the two gross claims and resulting in a net claim in favour of LBIE in the sum of £400m;

138.4 in these circumstances is LBL's claim against LBEL reduced to a recharge of 40% of the net claim from LBIE; or

138.5 does LBL remain able to claim 40% of the gross claim (in other words without having to take account of the insolvency set off in LBIE's administration) against LBEL.

139. The above scenario appears to contain a misapprehension, that LBIE's claim against LBL is being reduced by the set-off of LBL's recharge claim as against LBIE rather than, as in fact occurs, discharged by set off.

140. The fact that part of LBL's claims are discharged by LBIE does not affect any liability of LBEL in respect of any claims raised by LBL against it; 40% of LBL's claim against LBEL is still £400m, and LBEL is required to pay that sum.

Philip Marshall QC

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Appendix 1 - DRAMATIS PERSONAE

NAME	DESCRIPTION
CORPORATE ENTITIES	
Lehman Brothers Limited (In Administration) ("**LBL**")	LBL was the administrative service company supporting the operations of the Lehman Group in the UK, Europe and Middle East. Incorporated on 27 April 1965. Previous names: 27 April 1965 – 25 February 1977 H. Hentz & Co Limited 25 February 1977 – 20 December 1979 Shearson Hayden Stone Limited 20 December 1979 – 23 October 1981 Shearson Loeb Rhoades Limited 23 October 1981 - 6 July 1984 Shearson/American Express Limited 6 July 1984 – 15 March 1985 Shearson Lehman/American Express Limited 15 March 1985 - 20 March 1989 Shearson Lehman Brothers Limited 20 March 1989 - 1 August 1990 Shearson Lehman Hutton Limited
Lehman Brothers International (Europe) (In Administration) ("**LBIE**")	LBIE was the principal trading company within the European Lehman Group. Incorporated on 10 September 1990. Re-registered as an unlimited company on 21 December 1992. Previous names: 10 September 1990 – 21 December 1992 Lehman Brothers International Limited
Lehman Brothers Holdings Inc ("**LBHI**")	The ultimate parent company for the Lehman Group. Incorporated in the United States of America.

NAME	DESCRIPTION
Lehman Brothers UK Holdings Limited (“**SHUKL**”)	A holding company for the whole of the UK Lehman Group. Incorporated in the UK on 17 November 1986 and dual incorporated in the US on 29 December 1993. Previous names: 11 December 1987 - 2 August 1993 Shearson UK Holdings Limited 17 November 1986 - 11 December 1987 Flushsharp Limited
Lehman Brothers Holdings Plc (In Administration) (“**LBH Plc**”)	A holding company for a number of entities in the Lehman Group incorporated in England and Wales. Incorporated on 11 October 1984. Previous names: 1 August 1990 – 2 August 1993 Shearson Lehman Brothers Holdings Plc 5 April 1988 - 1 August 1990 Shearson Lehman Hutton Holdings Plc 8 January 1987 – 5 April 1988 Shearson Lehman Brothers Holdings Plc 7 August 1986 – 8 January 1987 Shearson Lehman Plc 11 October 1984 – 7 August 1986 Shearson Lehman UK Holdings Limited
LB Holdings Intermediate 1 Limited (“**LBHI1**”)	A wholly owned subsidiary of LBH Plc and shareholder of LBHI2. Incorporated on 5 October 2006.
LB Holdings Intermediate 2 Limited (In Administration) (“**LBHI2**”)	A wholly owned subsidiary of LBHI1 and shareholder of LBIE. Incorporated on 5 October 2006.
Lehman Brothers Europe Limited (In Administration) (“**LBEL**”)	A UK trading company within the Lehman Group. Incorporated on 14 March 2000.

NAME	DESCRIPTION
Lehman Brothers Gilts Limited ("**LBGL**")	A UK trading company within the Lehman Group, now dissolved. It was a broker and dealer in UK government securities. Incorporated 12 June 1986. Dissolved on 3 July 1998.
Lehman Brothers Money Brokers Limited ("**LBMBL**")	A UK trading company within the Lehman Group, now dissolved. It acted as a money broker in the London markers. Incorporated on 16 April 1984. Dissolved on 23 April 1998.
Platform Mortgage ("**PML**")	PML was acquired by LBH Plc in 1993, now dissolved. It was the holder of sundry mortgages. Incorporated on 4 January 1988. Re-registered as an unlimited company on 24 November 1994. Dissolved on 22 December 2009.

NAME	DESCRIPTION
INDIVIDUALS **(Names appear in alphabetical order by Surname)**	
Backhouse, Oliver (now deceased)	Occupation: Executive Director Regulatory Appointed an alternate director of McHugh, Daniel of the following companies: LBIE from 22/02/1991 to 15/02/1996 LBL from 13/02/1990 to 15/02/1996 LB UK Holdings from 22/12/1988 to 23/12/1993 Director of LBL from 15/02/1996 to 15/05/1999 Director of LBIE from 15/02/1996 to 15/05/1999 Director of LBH Plc from 22/12/1988 to 15/05/1999 Director of LB UK Holdings from 23/12/1993 to 15/05/1999 Secretary of LBIE from 13 March 1998 to 15 May 1999
Bird, Alistair	Occupation: Solicitor at Simmons & Simmons

NAME	DESCRIPTION
Cornish, Martin William	Occupation: Legal Counsel until 1992 Company Secretary of LBL from 17/08/1990 to 02/10/1991 Company Secretary of LBIE from 05/10/1990 to 07/08/1991 Company Secretary of LBH Plc from 17/08/1990 to 07/10/1991
Gamester, Peter	Occupation: Chartered Accountant Tax director/international tax director (Europe and Asia), July 1988 to June 2005 Director of LBL from 15/05/1999 to 12/04/2005 Director of LBIE from 15/05/1999 to 20/04/2005 Director of LBEL from 14/03/2000 to 20/04/2005 Director of LBH Plc from 15/05/1999 to 12/04/2005 Director of LB UK Holdings from 15/05/1999 to 02/02/2005
Harney, Colleen	Occupation: Legal assistant at Simmons & Simmons
Jackson, Marcus	Occupation: UK Financial Controller Director of LBIE from 10/05/2005 to 05/05/2008 Director of LBL from 12/04/2005 to 05/05/2008 Directors of LBH Plc from 12/04/2005 to 05/05/2008 Director of LBEL from 10/05/2005 to 05/05/2008 Director of LBHI1 from 05/10/2006 to 05/05/2008 Director of LBHI2 from 05/10/2006 to 05/05/2008 Director of LB UK Holdings from 12/04/2005 to 05/05/2008
Sherratt, Peter Robert	Occupation: Legal Director Chief Legal Officer (Europe & Asia), October 1986 – September 2008 Company Secretary of LBL from 02/10/1991 to 05/01/2000 Company Secretary of LBIE from 07/10/1991 to 05/01/2000 Company Secretary of LBH Plc from 07/10/1991 to 05/01/2000 Director of LBL from 28/07/1995 to 06/10/2008 Director of LBIE from 21/04/1995 to 06/10/2008 Director of LBEL from 05/04/2000 to 06/10/2008 Director of LBH Plc from 21/04/1995 to 05/01/2000 Director of LB UK Holdings from 19/04/1995 to 05/01/2000

NAME	DESCRIPTION
Smith, Margaret	Occupation: Legal counsel (Europe), December 1991 – current Company Secretary of LBL from 05/01/2000 to 25/01/2010 Company Secretary of LBIE from 05/01/2000 to 25/01/2010 Company Secretary of LBH Plc from 05/01/2000 to 25/01/2010 Company Secretary of LBL, LBIE and LBH Plc
South, Teresa	Occupation: Attorney Director of LBL from 13/01/1997 to 13/03/1998 Director of LBIE from 25/02/1997 to 13/03/1998 Director of LBH Plc from 25/02/1997 to 13/03/1998 Director of LB UK Holdings from 25/02/1997 to 13/03/1998
Troup, Edward	Occupation: Partner, Simmons & Simmons
Tyree, Charles Daniel	Occupation: Managing Partner - Europe Director of LBL from 30/07/1992 to 15/02/1995 Director of LBIE from 31/07/1992 to 15/02/1995 Director of LBH Plc from 31/07/1992 to 15/02/1995 Director of LB UK Holdings from 23/09/1992 to 15/02/1995

APPENDIX 2 – SCHEDULE OF SHAREHOLDERS

	LBIE shareholders and their respective holdings of ordinary shares on the dates that LBIE shares were transferred									
	10/09/90	5/10/90	02/10/91	22/09/92	23/11/94	01/05/97	24/05/02	11/11/02	01/11/06	15/09/08
Alistair Bird	1	-1								
Colleen Harney	1	-1								
Martin Cornish		1	-1							
Lehman Brothers Plc		1	1	110,000,000	225,000,000 (US$) 35,250,009 (£)	589,999,999 (US)	929,999,999	1,028,113,999	-4,098,113,999	
Peter Sherratt			1	-1						

	LBIE shareholders and their respective holdings of ordinary shares on the dates that LBIE shares were transferred									
	10/09/9 0	5/10/9 0	02/10/9 1	22/09/92	23/11/94	01/05/97	24/05/02	11/11/02	01/11/06	15/09/08
Lehman Brothers Limited					1(£)	1(US)	1	1	1	1
Lehman Brothers Holdings Inc							48,114,000	-48,114,00		
LB Holdings Intermediat e 1 Limited									4,098,113,99 9 - 4,098,113,99 9	
LB Holdings Intermediat e 2 Limited									4,098,113,99 9	6,273,113,99 9

APPENDIX 3 – TYPES OF ADMINISTRATIVE COSTS RECHARGED

1. Depreciation
2. Profit on disposal of fixed assets
3. Loss on disposal of fixed assets
4. Production commission
5. Brokerage and clearance fees
6. Exchange dues
7. Legal settlements
8. Deferred compensation
9. Salaries
10. Annual bonus (including contingent stock awards)
11. Salaries & Bonus (excluding CSA)
12. Contingent Stock Awards
13. Recharges of CSA cost to group companies
14. Recharge of pension costs to group companies
15. Retirement pension contributions
16. Medical and life cover
17. Payroll taxes
18. Recruitment costs
19. Relocation
20. Severance payments
21. Temporary staff
22. Employee training
23. Ex-pat housing, relocation etc
24. Other employee benefits
25. Telephone

26. Telex

27. Communications

28. Postage

29. Air express and messengers

30. Stationery & supplies

31. Subscriptions

32. Leasing income of plant & machinery (charged to other group companies)

33. *Net Broadgate Schedule "A" analysis:*

    33.1. Office rent

    33.2. Building service charge

    33.3. (Released from) reserves

    33.4. Office cleaning & maintenance

    33.5. General and water rates

    33.6. Utilities & guard service

    33.7. Other costs (including building insurance)

34. NON BROADGATE (WAREHOUSE - 1994):

    34.1. Office rent

    34.2. Office cleaning & maintenance

    34.3. General and water rates

    34.4. Utilities & guard service

    34.5. Occupancy - other

    34.6. Occupancy - broadgate

    34.7. Storage costs

35. Other office rent

36. Equipment - reproduction and related expenses

37. Equipment - rental expenses

38. Equipment - repairs & maintenance

39. System software

40. Capitalised software

41. Advertising

42. Travel & lodgings

43. Entertaining

44. Seminars & conventions

45. Public relations

46. Taxi & limo services

47. Dues & memberships

48. Professional services

49. Charitable contributions

50. Insurance

51. Non-recoverable UK VAT

52. Repayment (supplement)/expense

53. Interest income allocation

54. Foreign exchange (gain)/loss

55. Miscellaneous

56. Charitable donation - charges on income

57. General reserve

58. Operations allocations

59. Safe custody recharge (inc 10% mark-up)

60. Tax equalisation costs

61. Reclassification to Operating Income

62. Release of VAT provision

63. Broadgate sub-lease obligations

64. Write-off investment in LBCL

65. Rental charge - HP Leases (LBL&F No1)

66. Rental charge - Operating Leases (LBL&F No1)

67. Other expenses

68. Inter-company allocation

69. Corporate allocations

<u>Professional services</u>

70. Accounting & Audit

71. Employee tax - outside advice

72. Pension Plan - EF Hutton

73. Corporation tax - outside advice

74. VAT - outside advice Tax advice

75. *Legal fees:*

    75.1. Specific business activities

    75.2. Office restack

    75.3. Rent review

    75.4. Employee matters

    75.5. General legal services

    75.6. Company liquidations/formations

    75.7. Broadgate sub-letting

    75.8. EMU

    75.9. Year 2000

    75.10. Advisory

    75.11. Regulatory

    75.12. Litigation

76. Outside systems consultants

77. Software - Licence & Maintenance

78. Software -Purchased packages

79. *Consultants etc:*

79.1. Systems software licence, maintenance etc

79.2. Data services software costs

79.3. Outside systems software consultants

79.4. EMU

79.5. Year 2000

79.6. Royal Blue

79.7. Trading Systems

79.8. GFS

79.9. Finance systems

79.10. FID Front-end systems

79.11. Operations systems

79.12. Equity Front-end systems

79.13. INF - Production services

79.14. Restack/Office moving

79.15. Gloss systems

79.16. Risk analysis systems

79.17. Other systems

79.18. General business matters

79.19. Advisory

79.20. Public Relations etc

80. Advisory:

80.1. Employee matters

80.2. General business matters

81. Other:

81.1. Office restack

81.2. Employee matters

81.3. Public Relations etc

81.4. Rent review

81.5. Communications review

81.6. Re-engineering

81.7. General business matters

81.8. Payroll

81.9. Economics advisory