**Waterfall III Application**

**IN THE HIGH COURT OF JUSTICE** **No. 7942 of 2008**
**CHANCERY DIVISION**
**COMPANIES COURT**

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

**AND IN THE MATTER OF THE INSOLVENCY ACT 1986**

**BETWEEN**

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

**Respondents**

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**POSITION PAPER ON BEHALF OF THE JOINT ADMINISTRATORS OF THE THIRD RESPONDENT ("LBEL")**

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## A. Introduction and Overview

1. The Waterfall III Application is concerned with fourteen issues, in respect of which the Joint Administrators of Lehman Brothers International (Europe) (in administration) (the "**LBIE Administrators**" and "**LBIE**") seek directions from the Court pursuant to paragraph 63 of Schedule B1 to the Insolvency Act 1986 (the "**IA 1986**"). The issues relate, in summary, to:

1.1. **Issues 1 to 4:** claims of LBIE against Lehman Brothers Limited (in administration) ("**LBL**") and/or LB Holdings Intermediate 2 Limited (in administration) ("**LBHI2**"), the registered shareholders of LBIE, under section 74 of the IA 1986 (a "**Contribution Claim**") to contribute to the assets of LBIE to the extent necessary to enable LBIE to pay sums owed to LBHI2 pursuant to three subordinated loan agreements entered into on 1 November 2006 between LBHI2 and LBIE (the "**Sub-Debt**");

1.2. **Issues 5 and 6:** the operation of insolvency set-off in a future distributing administration or liquidation of LBL and/or LBHI2 in respect of any cross-claims between those companies and LBIE and/or LBEL, in circumstances where insolvency set-off in the administrations of LBIE and LBEL took effect, respectively, on 4 December 2009 and 11 July 2012 (the "**Set-off Issue**");

1.3. **Issues 7, 8 and 13:** issues relating purely to the contribution and indemnity liabilities of LBL and LBHI2 in their capacity as registered shareholders of LBIE (including an issue as to the rectification of the share register of LBIE);

1.4. **Issues 9 (including the Issue 9 Preliminary Issue)[1] and 11:** LBL's alleged entitlement to recover three categories of sums from LBIE and/or LBEL, being (i) sums paid or payable by it to LBIE in respect of a Contribution Claim (the "**Contribution Claim Recharge**"), (ii) sums claimed by LBL from insolvent members of the Lehman Brothers group of companies (the "**Lehman Group**"), which were not ultimately recovered by LBL from such companies (the "**Bad Debt Claims Recharge**"), and (iii) certain (and if so, which) expenses of LBL's administration (the "**Administration Expenses Recharge**"; together, the "**Recharges**");

1.5. **Issue 12:** to the extent that LBL does have an entitlement to be paid the Contribution Claim Recharge, the Bad Debt Claims Recharge and/or the Administration Expenses Recharge, the impact of any set-off occurring in LBIE's administration as between (i)

[1] In the terms set out in paragraph 4 of the Order of Mr. Justice Hildyard dated 4 November 2016 (the "**4 November Order**"). The terms of the 4 November Order have, as at the time of writing, been agreed between all parties except the LBL Administrators.

the Contribution Claim, and (ii) provable claims of LBL against LBIE, on LBL's alleged entitlement to recover the amount of the Contribution Claim from LBEL;

1.6. **Issue 10:** to the extent that LBL does have an entitlement to be paid the Recharges in respect of a Contribution Claim, the priority ranking as between LBL's Recharge claim against LBIE in respect of the Sub-Debt Contribution Claim and LBHI2's claim in respect of the Sub-Debt; and

1.7. **Issue 14**:[2] LBL's alleged entitlement to recover the Contribution Claim Recharge from Lehman Brothers Holdings Plc (in administration) ("**LBH**").

2. On 14 March 2000 LBEL was incorporated as an English limited company. On 23 September 2008 LBEL entered into administration. The current Joint Administrators of LBEL are Dan Yoram Schwarzmann, Anthony Victor Lomas, Steven Anthony Pearson and Julian Guy Parr (the "**LBEL Administrators**").

3. LBEL carried on the principal activity of the provision of investment banking and corporate finance services. It was authorised and regulated by the Financial Services Authority, and it also arranged derivatives transactions as agent for other members of the Lehman Group of companies.

4. LBEL's participation in the proceedings is limited to those issues in which it has a direct interest, being:

4.1. the Set-Off Issue (Issue 6), insofar as it relates to insolvency set-off in a future distributing administration or liquidation of LBL (and in respect of cross-claims between LBL and LBEL), in circumstances where insolvency set-off in LBEL's administration took effect on 11 July 2012;

4.2. the alleged Recharges as claimed by LBL against LBEL (Issue 11); and

[2] In the terms set out in paragraph 7 of the 4 November Order.

4.3. to the extent that LBL is entitled to be paid the Recharges, the impact on LBL's Contribution Claim Recharge against LBEL of any set-off occurring in LBIE's administration as between the Contribution Claim and provable claims of LBL against LBIE (Issue 12) (together with Issue 11, the "**LBEL/LBL Recharge Issue**").

5. LBEL may, however, be indirectly impacted by the outcomes of a number of the other issues arising in the Waterfall III Application. To avoid unnecessary duplication, no arguments are advanced in this Position Paper in relation to such issues. LBEL reserves the right to advance arguments in relation to such issues if and insofar as the parties to which such issues directly relate fail comprehensively to do so.

6. The Set-off and the LBEL/LBL Recharge Issues have significant economic import from the perspective of the LBEL administration, as a result of the facts and matters set out in the following paragraphs. (The relevant facts pertaining to the other parties to the proceedings will be addressed by those other parties, and this Position Paper seeks to avoid any unnecessary duplication in relation to the facts underlying the Waterfall III Application).

7. Following three interim dividends paid to the creditors of LBEL on, respectively, 9 November 2012, 13 November 2013 and 24 September 2014, the admitted creditors of LBEL received dividends totalling 100 pence in the pound.

8. The present position is that the LBEL Administrators are in possession of a surplus in the sum of approximately £275 million (the "**LBEL Surplus**"), which would, in the absence of the matters described below, be paid in the first instance, to discharge the statutory interest entitlements of creditors holding admitted, unsecured claims (currently estimated to amount to approximately £36 million), with the balance being distributed to LBEL's sole shareholder (LBH). As a result, the issues raised in this application are the only matters that are currently preventing the LBEL Administrators from concluding distributions to creditors.

9. However:

9.1. on 31 August 2012, LBL submitted a proof of debt in LBEL's estate in the sum of around £243 million, in respect of the intercompany balance between LBL and LBEL

as at 15 September 2008 and the recharge of certain matters not included in the intercompany balance (the "**Original Proof of Debt**");

9.2. on 9 September 2014, LBEL also submitted a proof of debt in LBL's estate in the sum of around £447 million, reflecting LBEL's assessment of the net balance owed to it by LBL following the reversal of certain inter-company debts (the "**LBEL Proof of Debt**"). The claims made in the Original Proof of Debt and in the LBEL Proof of Debt are not the subject of the Waterfall III Application, and are currently the subject of discussion between the LBEL Administrators and the LBL Administrators;

9.3. on 31 October 2014, LBIE submitted a claim for £10.4 billion in LBL's administration. This claim includes the LBIE Administrators' estimation of LBL's contingent liability under the Contribution Claim;

9.4. on 23 September 2015, LBL requested leave of the LBEL Administrators to amend its proof of debt to around £4.9 billion (the "**Revised Proof of Debt**") to claim a recharge of, amongst other things:

9.4.1. LBIE's estimated Contribution Claim Recharge against LBL in the sum of £10 billion, the alleged recharge to LBEL being valued at £4.5 billion;

9.4.2. the Bad Debt Claim Recharge valued at £399 million, in respect of the unrecovered balance of claims made by LBL in the insolvent estates of other entities within the Lehman Group, where a dividend of less than 100 pence in the pound is anticipated to be received by LBL; and

9.4.3. administration expenses incurred by LBL, in the amount of £22 million (the "**Administration Expenses Claim**")

10. On 12 November 2015, the LBEL Administrators consented to LBL's request to amend the Original Proof of Debt. LBL's Revised Proof of Debt has not, however, been adjudicated upon by the LBEL Administrators, pending a resolution of the issues raised by this application. The result has been that the LBEL Surplus cannot be distributed to the unsecured creditors or shareholder of LBEL until the issues identified above have been resolved.

11. The LBEL Proof of Debt also remains to be adjudicated upon by the LBL Administrators.

12. LBL's additional Recharge claims in the Revised Proof of Debt were said by LBL to be based, in summary, on the alleged operation of an agreement which pre-dated the entry of LBEL and LBL into administration. It was said that under the alleged agreement LBL would recharge certain expenses (applying a 10 per cent. uplift) to LBIE, LBEL and other entities within the Lehman Group, with around 55 per cent. being recharged to LBIE and around 41 per cent. being recharged to LBEL. It is on the basis of those proportions that the Recharges have been claimed in the Revised Proof of Debt. However, LBL now appears, in LBL's Position Paper dated 30 September 2016 (the "**LBL Position Paper**"), also to assert an entitlement to recharges against LBH, in an unnamed proportion, and without any indication of its alleged effect on the Recharges claimed against LBEL.

13. It is LBL's assertion that it is entitled to claim the Recharges from LBEL which gives rise to the primary issue of dispute between LBEL and LBL in the Waterfall III Application. For the reasons summarised below (which will be developed in submissions at trial), LBEL's position is that LBL has no such entitlement as a matter of contract, whether on the bases alleged by LBL or otherwise.

14. This position paper addresses the three issues which concern LBEL in two separate sections:

    14.1. Section I: the "Part A Issues", being those issues directed to be heard in the Part A Trial by the 4 November Order.

    14.2. Section II: the "Part B Issues", being those issues directed to be heard in the Part B Trial by the 4 November Order.

15. For brevity, references to the LBEL Administrators' position in this Position Paper will be made by reference to LBEL's position.

## Section I

## Part A Trial

### B. Issue 6: the Set-off Issue

16. This issue raises a narrow point of legal principle, in respect of which LBL's position is set out in the LBL Position Paper at paragraphs 128 to 132.

17. It concerns the impact of insolvency set-off (if any) in LBL's administration (which took effect on 8 July 2014), on the cross-claims between LBL and LBEL, in circumstances where insolvency set-off took effect in LBEL's administration on the earlier date of 11 July 2012.

18. As a result of the insolvency set-off occurring in LBEL's administration prior to the date on which it occurred in LBL's administration, the question of what impact the subsequent insolvency set-off (in LBL's administration) will have on the parties' cross-claims will arise in circumstances in which:

    18.1. such claims as are to be admitted in LBEL's estate under the Revised Proof of Debt (of LBL, against LBEL) and LBEL's cross-claims against LBL (being those currently identified in the LBEL Proof of Debt in LBL's estate), were the subject of the mandatory insolvency set-off in the LBEL administration under rule 2.85 of the Insolvency Rules 1986 (the "**IR 1986**") (which took effect on 11 July 2012); and

    18.2. in the distributing administration of LBL, the LBL Administrators are required to adjudicate upon any claims of LBEL against LBL (whether under the LBEL Proof of Debt, or otherwise).

19. This Issue also assumes that the Revised Proof of Debt encompasses all the alleged claims of LBL against LBEL (the existence of the claims under the Recharges being denied by LBEL, for the reasons set out in Section II below).

20. It is perhaps useful to consider two alternative scenarios:

20.1. Scenario A: if the statutory balance gives rise to a claim against LBL, the LBEL Administrators will continue to prove in respect of the net claim in any subsequent distributing administration or liquidation of LBL (the "**LBEL Net Claim**") (on the assumption that its cross-claims which were the subject of the set-off occurring on 11 July 2012 already encompass all other claims which would be lodged in LBL's estate);

20.2. Scenario B: if, however, the statutory balance is such that LBL is a net creditor of LBEL, then any provable claims of LBEL against LBL will have been discharged in the LBEL administration, such that LBEL will possess no subsisting cross-claim against LBL. In that scenario, no issue of set-off will arise in any subsequent distributing administration or liquidation of LBL.

21. The prior insolvency set-off in the administration of LBEL (giving rise to the LBL Net Claim) is automatic and self-executing: see *Stein v Blake* [1996] AC 243.

22. In Scenario A, it is clear that:

22.1. the LBEL Administrators will be entitled to prove only in respect of the LBEL Net Claim in LBL's estate, and

22.2. the LBL Administrators will be precluded from setting-off against the LBEL Net Claim, LBL's alleged claims against LBEL, as those claims will already have been discharged in full by the operation of insolvency set-off in LBEL's estate on 11 July 2012.

23. It is therefore LBEL's position that the operation of insolvency set-off in LBEL's administration, to the extent that it gives rise to a statutory balance as between LBEL's claims against, and liabilities to, LBL (the "**LBEL Set-off**"), has the effect that the subsequent operation of insolvency set-off in LBL's administration cannot alter or disturb the impact of the LBEL Set-off on the underlying claims of LBEL against LBL and the underlying claims of LBL against LBEL.

24. Paragraph 130 of the LBL Position Paper is not understood. In particular, it is not clear whether LBL agrees or disagrees with LBEL's position as set out above, in relation to

    24.1. the possible discharge by the LBEL Set-off of part or all of LBL's underlying claims against LBEL, and

    24.2. the possible discharge by the LBEL Set-off of part or all of LBEL's underlying claims against LBL.

25. Further, in relation to the points made in paragraph 131 of the LBL Position Paper, these are correct statements of law, but have relevance only to insolvency set-off in the administration of LBEL, which took effect prior to the insolvency set-off in LBL's administration.

26. To the extent that information becomes available to the LBEL Administrators requiring them to revise the quantum of any estimated debt applied for the purposes of insolvency set-off, this constitutes an action required to be taken by the *LBEL* Administrators in the *LBEL* administration, and has no import on the operation of insolvency set-off in LBL's estate.

## C. Issue 12: the impact of set-off in LBIE's administration on the LBEL/LBL Contribution Claim Recharge

27. This issue also raises a point of legal principle as to whether LBL's Contribution Claim Recharge against LBEL is affected by the operation of insolvency set-off in LBIE's administration, in respect of which LBL's position is set out at paragraphs 137 to 140 of the LBL Position Paper.

28. This issue is premised on the existence (contrary to LBEL's case) of LBL's entitlement to be paid the Contribution Claim Recharge (i) from both LBIE and LBEL, and (ii) in identified proportions as between, *inter alia,* LBIE and LBEL (whether on the 55 per cent./41 per cent. allocation applied by LBL in its revised proofs of debt, or otherwise).

29. It arises in circumstances where (i) on the one hand, the Contribution Claim (amongst other claims by LBIE against LBL),[3] and (ii) on the other hand, provable claims of LBL against LBIE, including the Contribution Claim Recharge, were subject to the operation of insolvency set-off on 4 December 2009 in LBIE's estate. (LBEL's case is that the stating of this issue indicates how unlikely is LBL's Contribution Claim Recharge, because of its circular nature.)

30. This issue gives rise to the question whether, to the extent that LBL's *gross* claim under the Contribution Claim Recharge is discharged by set-off in LBIE's estate, and where LBIE's cross-claims comprise and/or include its Contribution Claim against LBL, a corresponding reduction ought to apply in the amount of the Contribution Claim Recharge (allegedly) payable by LBEL.

31. It is LBEL's case that no such reduction ought to apply, such that this issue should be answered in the negative. The existence (if any) of set-off in LBIE's administration in respect of LBL's Contribution Claim Recharge, is irrelevant to the question of whether LBEL is required to reimburse LBL in respect of the Contribution Claim.

32. It appears likely that there will be no dispute between LBL and LBEL in relation to this issue.[4]

[3] On 31 October 2014, LBIE submitted a claim for £10.4 billion in LBL's administration, of which the Contribution Claim represents £10 billion.

[4] As was foreshadowed in the letter from Linklaters LLP dated 8 June 2016 on behalf of the Joint Administrators of LBEL, paragraph 3.4.

## Section II

## Part B Trial

### D. Issue 11: the LBEL/LBL Recharge Issue

33. This issue raises disputed issues of fact and law, in respect of which LBL's position is set out, primarily, at paragraphs 78 to 95 of the LBL Position Paper.

#### (a) The Facts

34. The facts can be summarised simply. There are no written agreements between LBEL and LBL that can be said to support LBL's contention that it is entitled to claim the Recharges from LBEL. The following paragraphs constitute a very brief summary of the relevant facts which will be developed in evidence.

35. Prior to its entry into administration on 15 September 2008, LBL acted as the service company for the European entities within the Lehman Group (each, a "**Lehman OpCo**"). It incurred costs relating to the supply of property, staff, IT, security and other business services to the Lehman OpCos (the "**Business Services**"). The arrangements under which LBL was permitted to be reimbursed for the costs and expenses of providing the Business Services to LBEL prior to LBL's (and LBEL's) insolvency were as follows.

#### (i) The LBEL Service Agreement

36. By a Service Agreement dated 22 August 2000, certain costs and expenses in respect of certain, defined services provided to or for the benefit of LBEL were recharged by LBL directly to LBEL:

36.1. LBL agreed to provide certain *"administrative and operational support services"* to LBEL (Clause 1);

36.2. in consideration for which LBEL was required to pay a fee calculated on the basis of *"the total cost of such services plus a mark up of ten per cent (10%) or such other basis of calculation which may be agreed from time to time between the parties"* (Clause 4).

37. The relevant costs were stated as being *"Compensation and Benefits", "Technology & Communications", "Business Development Expenses", "Occupancy", "Professional Fees", "Brokerage & clearance"* and *"Other miscellaneous expenses"* (Appendix A) relating to the administrative and operational support services which were covered by the Service Agreement (by clause 1).

38. By clause 6, the Service Agreement could only be amended by the agreement of both parties in writing.

39. By a Service Agreement dated 20 May 2004 between LBEL and LBL, the above provisions were restated in materially identical terms, save that it was an express term of that agreement that no payment was to be made by LBEL to LBL in the event of regulatory capital constraints on the part of LBEL, insofar as such regulatory capital constraints continued (clause 4) (together with the Service Agreement dated 22 August 2000, the "**LBEL Service Agreement**").

40. The 10 per cent. uplift paid to LBL under the LBEL Service Agreement was held by LBL as retained profits or paid up as dividends to its parent company (being LBH).

**(ii) The LBEL Secondment Agreement**

41. By a Secondment Agreement dated 22 August 2000 (the "**LBEL Secondment Agreement**"), LBL agreed to supply investment banking staff to LBEL as required by LBEL from time to time (clause 2), in consideration for which certain indemnity provisions ensured that LBEL would reimburse LBL for the costs associated with the LBL secondees (clauses 3 and 4).

**(iii) The Proportion of costs allocated to LBEL**

42. LBL entered into a number of identical and/or similar service agreements with other Lehman OpCos. In relation to (typically) costs incurred by LBL in respect of services

provided to or for the benefit of the entire Lehman Group (and where it was not possible to identify a single beneficiary of the service provided, such as the payment of rent charges relating to business premises occupied by several Lehman OpCos), such costs were apportioned as between certain Lehman OpCos.

43. In addition to LBIE and LBEL, the relevant Lehman OpCos included, at different times: Lehman Brothers Asset Management (Europe) Limited ("**LBAM**"); Lehman Brothers Bankhaus AG ("**Bankhaus**"); Lehman Brothers Inc ("**LBI**")); Lehman Brothers Holdings Inc ("**LBHI**").

44. The proportionate share allocated to each Lehman OpCo varied at different times between 2000 and 2008, taking into account a number of different factors (which included, without limitation, profitability and employee headcount). The respective proportionate shares of such recharges between 2000 and 2008 will be addressed in evidence.

**(iv) The categories of costs recharged by LBL to LBEL**

45. The LBL Position Paper identifies at Appendix 3 a number of categories of costs which were allegedly recharged to one or more of the (unidentified) Lehman Group entities at unidentified times prior to their insolvency.

46. LBL is put to proof as to whether such costs were recharged to and paid by LBEL, and to what line items such costs related. No admission is made by the LBEL Administrators in this respect.

47. If and insofar as LBL alleges and proves that a particular, identified category of costs in Appendix 3 was recharged to LBEL, it is LBEL's case that (on a proper construction of the LBEL Service Agreement and the LBEL Secondment Agreement) those costs fell within the LBEL Service Agreement or the LBEL Secondment Agreement.

48. Further, if and insofar as LBL alleges and proves that a particular, identified category of costs in Appendix 3 was recharged to LBEL and that it did not fall within the LBEL Service Agreement or the LBEL Secondment Agreement (which is not admitted), it is LBEL's position that any such payment was made by or on behalf of LBEL either:

48.1. By way of an *ex gratia* payment to LBL, which was not made pursuant to any pre-existing contractual obligation to make such payment.

48.2. Alternatively, by means of an *ad hoc* and *ex post facto* agreement between LBL and LBEL at the time of entry of the particular debit or credit in the accounts of LBL and/or LBEL. Such payment was not made pursuant to any pre-existing contractual obligation, and was made in relation to a specifically identified cost incurred and/or known at that time to be incurred by LBL.

48.3. Alternatively, as a mistaken payment, in respect of which all of LBEL's rights as against LBL are reserved.

**(v) The Cost Recharge Agreement**

49. On or around 23 December 2008 the Cost Recharge Agreement was entered into between LBIE, LBEL, LBL and certain other Lehman Group entities, making provision for the basis on which each party to the agreement would pay the costs incurred by any other party in future providing *"Services"* to that entity. The services (as defined by the Cost Recharge Agreement) related only to (i) "*Building, Occupancy and Operational Costs*" and (ii) "*Payroll Costs*". On or around 31 May 2013 the Cost Recharge Agreement was terminated by the Cost Recharge Termination Agreement.

50. The Cost Recharge Agreement was a new, post-administration agreement between the Lehman companies and it did not extend to the Recharges claimed by LBL in the Revised Proof of Debt.

51. The Cost Recharge Agreement is not relied upon by LBL in asserting its rights of payment to the Recharges.

52. Further, LBEL understands LBL's case to be that its right to the Recharges against LBEL arises under the LBEL Service Agreement and/or under an *"agreement made initially by conduct and subsequently recorded, in part, in writing"* by the LBEL Service Agreement. LBEL does not understand LBL's case to be that its right to the Recharges as against LBEL is founded on any right accruing, or by reason of any service provided to or for the benefit of LBEL, after 23 December 2008.

53. If and to the extent that LBL asserts that its right to payment of the Recharges against LBEL is founded on a right accruing, or by reason of any service provided to or for the benefit of LBEL, after 23 December 2008, then LBEL's rights on this issue are reserved. In particular, LBEL reserves the right to submit that the LBEL Service Agreement was terminated as at or by the entry by LBEL and LBL, amongst others, into the Cost Recharge Agreement and/or the Cost Recharge Termination Agreement.

**(b) LBL's position**

54. LBL's case is that:

54.1. an agreement existed between LBL and each of LBIE, LBEL and *"various other companies in the Lehman Group ... to whom it provided services"*, which was *"made initially by conduct"* and *"subsequently recorded, in part, in writing"*, under which LBL recharged *"all costs, expenses and liabilities that it incurred"* (the "**Alleged Recharge Agreement**");[5]

54.2. under the Alleged Recharge Agreement, LBL claims that the *"scope of services provided and recharged by LBL"* was *"extensive"*, and that it *"included the various types of administrative costs recharged and set out in Appendix 3"* (the "**Appendix 3 Costs**");[6]

54.3. prior to 2000, the Alleged Recharge Agreement was *"evidenced by a course of consistent conduct over an extended period and embedded in the accounting arrangements for the group"*;[7]

54.4. under the LBEL Service Agreement, *"part of the arrangements that were already the subject of the* [Alleged Recharge Agreement]*"* were *"recorded"*; however, the LBEL Service Agreement did not *"replace, limit or affect the terms of the Recharge*

[5] LBL Position Paper, paragraph 80.
[6] LBL Position Paper, paragraph 82.
[7] LBL Position Paper, paragraph 83.

*Agreement already in place but were consistent with that agreement in respect of the particular matters that* [the LBEL Service Agreement] *addressed"*;[8] and

54.5. under the Alleged Recharge Agreement, *"other costs, liabilities and expenses"* beyond those covered by the LBEL Service Agreement were recharged to the other Lehman Group entities which were party to it.[9]

**(c) LBEL's position**

55. It is LBEL's case that LBL has no entitlement to claim the Recharges against LBEL as a matter of contract, whether on the bases alleged by LBL or otherwise, for the reasons set out in the following paragraphs (which will be developed in submissions at trial).

56. In summary, in order to establish that LBEL is liable to pay the Recharges to LBL, LBL must demonstrate that the Recharges fell within the ambit of the LBEL Service Agreement or the LBEL Secondment Agreement. For the reasons set out below, it is plain that the Recharges fall outside the scope of application of those agreements.

**(i) The LBEL Service Agreement and the LBEL Secondment Agreement**

57. It is denied that LBEL is liable to pay the Recharges to LBL pursuant to the LBEL Services Agreement or the LBEL Secondment Agreement:

57.1. On the proper construction of the LBEL Service Agreement, not one of the Recharges falls within the ambit of that agreement, being neither (i) costs specifically identified in Appendix A to the LBEL Service Agreement nor (ii) costs incurred by the provision of *"administrative and operational support services"* (or indeed costs incurred in the provision of any services at all, to LBEL).

57.2. On the proper construction of the LBEL Secondment Agreement, not one of the Recharges falls within the ambit of that agreement, not being costs incurred in relation to the supply of investment banking employees to LBEL.

[8] LBL Position Paper, paragraph 86.
[9] LBL Position Paper, paragraph 89.

57.3. Rather, the Recharges constitute costs arising by reason of the insolvency of LBL and/other entities within the Lehman Group. The costs which were the subject matter of the LBEL Service Agreement and the LBEL Secondment Agreement related to the *operation* of LBEL's business, and were therefore entirely different in nature to the Recharges.

57.4. The Recharges do not constitute the costs of providing any identified services to LBEL (or any other Lehman Group entity), nor do they relate to the secondment of any employee. They constitute liabilities incurred by LBL unrelated to its provision of services to LBEL.

58. Further or alternatively, if (which is denied) the Recharges fall within the ambit of the LBEL Service Agreement and/or the LBEL Second Agreement, LBL is in any event contractually time-barred from making any claim in respect of the Recharges against LBEL under either agreement: see clause 2.7.4 and the definitions of "Claims", "Services" and "Termination Date" in clause 1.1 of the Cost Recharge Termination Agreement.

59. Further or alternatively, it is denied that any agreement existed between LBEL and LBL pursuant to which LBEL agreed to pay the Recharges to LBL, notwithstanding that such costs fell outside the ambit of the LBEL Service Agreement and/or the LBEL Secondment Agreement:

59.1. The Contribution Claim Recharge, the Bad Debts Claim Recharge and the Administration Expenses Recharge all constitute costs which, by definition, could only arise upon the liquidation of LBIE and/or the insolvency of LBEL or other Lehman Group entities. By their very nature, it is impossible for any such agreement to have been made by LBEL (or even by the Lehman Group) prior to insolvency in respect of the Recharges (and nor has LBL referred to any evidence that such an agreement was made).

59.2. The existence of the LBEL Service Agreement and the LBEL Secondment Agreement is inconsistent with LBL's claim that the alleged agreement extended to

*"all costs, expenses and liabilities that it incurred"*. It was not the case that *"all costs, expenses and liabilities that* [LBL] *incurred"* were to be recharged under the LBEL Service Agreement or the LBEL Secondment Agreement.

59.3. By way of example, in relation to the LBEL Service Agreement, that agreement suspended payment insofar as there were any regulatory capital constraints (clause 4). The agreement therefore expressly contemplated the situation in which LBEL would not meet certain of the costs which LBL incurred in its provision of services to the Lehman Group.

**(ii) Agreement by conduct**

60. It is denied that any implied contract giving rise to the Recharges now claimed by LBL has at any time existed, for the reasons summarised in the following paragraphs.

61. LBEL was formed on 14 March 2000. Thus, it could not have been party to any *"agreement made initially by conduct and subsequently recorded* [by the LBEL Service Agreement]"[10] which pre-dated 14 March 2000 (which was only five months prior to its entry into the Service Agreement dated 22 August 2000). It could also not have been a party *"Prior to 2000"* to any *"course of consistent conduct over an extended period and embedded in the accounting arrangements for the group"*.[11]

62. Further or alternatively:

62.1. No implied contract in the form of the Alleged Recharge Agreement, or at all, existed between the parties in relation to the Recharges. There was no relevant course of conduct between LBL and LBEL (from 14 March 2000 onwards).

62.2. In particular, LBL has failed to identify (i) the particular conduct giving rise to the alleged course of dealing between LBEL and LBL, (ii) the other Lehman Group entities which are said to be party to the Alleged Recharge Agreement, (iii) the alleged nature of each of the categories of costs identified in Appendix 3, (iv) the

[10] LBL Position Paper, paragraph 81.
[11] LBL Position Paper, paragraph 83.

dates on which each category of costs identified in Appendix 3 were recharged to each such Lehman Group entity (including LBEL), and (v) the proportions in which the costs identified in Appendix 3 were allegedly recharged to each such entity.

62.3. As a result, it cannot be said that any implied contract exists. In this respect it is well established by authority that:

62.3.1. a party asserting an implied contract inferred from conduct must show the necessity for implying it. Contracts are not to be lightly implied.[12] The burden for demonstrating such necessity lies with that party: *Modahl v British Athletic Federation*.[13] The existence of the LBEL Service Agreement and the LBEL Secondment Agreement (neither of which extends to the Recharges) demonstrates that no such necessity can be said to have existed (and in fact, by clause 6, the LBEL Service Agreement could only be amended by the agreement of both parties in writing). Further, there is no other basis, as a matter of fact, on which the Alleged Recharge Agreement can be said to have been necessary;

62.3.2. the proponent of an implied contract must demonstrate that the parties intended to create the particular legal relationship alleged,[14] in respect of which the courts will ordinarily apply an objective test;[15] In particular, to the extent that the Recharges could be said to fall within the ambit of the Appendix 3 Costs (which, as set out above, is not accepted), the existence of historic recharge arrangements does not, of itself, provide any ground for the implication of a contract giving rise to the Recharges at any future point in time. The points made in paragraphs 45 to 48 above are repeated;

62.3.3. for an implied agreement to be held to exist, its terms must also be sufficiently certain such that a definite meaning may be given to it: see, in particular, in the financial context, *Bear Stearns, op. cit.*; *Barbudev v Eurocom Cable*

[12] *Blackpool and Fylde Aero Club Ltd v Blackpool Borough Council* [1990] 1 WLR 1195, 1202 (CA), *per* Bingham LJ.
[13] [2002] 1 WLR 1192 at [102] *per* Mance LJ.
[14] See, in particular: *Blackpool and Fylde Aero Club Ltd v Blackpool Borough Council*, *op. cit.,* at 1202 *per* Bingham LJ; *Modahl, op. cit.; Baird Textile Holdings Ltd v Marks & Spencer Plc* [2011] EWCA Civ 274 at [20], [21] and [30]; *Re MF Global UK Ltd (in special administration)* [2015] Pens. LR 405 at [56] to [58].
[15] See, in the financial context, *Bear Stearns Bank Plc v Forum Global Equity Ltd* [2007] EWHC 1576, at [171].

*Management Bulgari Food.*[16] For the reasons identified above, LBL's case fails to identify sufficiently certain terms which can be said, as a matter of law, to found an implied contract giving rise to its alleged entitlement to the Recharges.

62.4. It is clear from paragraph 81 of the LBL Position Paper that LBL cannot identify the terms of the alleged contract from any consistent prior course of conduct. For example, from paragraphs 81.3 to 81.5, it is evident that LBL can only assert that "*certain*" liabilities were dealt with in some ways (for example with an uplift) and other liabilities were dealt with in other ways (for example at cost, or "*using a combination of the methods*"). There was no consistent course of conduct which LBL can identify. Nor can LBL identify the parties to which any particular recharge was made, let alone that it was the basis for any course of conduct.

62.5. The points made in paragraph 59 above are repeated. The Contribution Claim Recharge, Bad Debts Claim Recharge and the Administration Expenses Recharge have never previously been recharged to LBEL. It is plain that not one of the three categories of Recharges claimed in the Revised Proof of Debt falls within the ambit of the Appendix 3 costs.

63. Further or alternatively, insofar as the Contribution Claim is said to arise out of LBL's alleged nominee holding of the LBIE share and the purported benefit to LBIE of having two statutory shareholders, it is specifically denied that any implied contract giving rise to the Contribution Claim Recharge against LBEL exists:

63.1. This is a matter that does not concern LBEL and cannot give rise to any claim against LBEL (as opposed to LBIE). The holding of the LBIE share was, on LBL's case, a service provided to or for the benefit of, alternatively, LBIE and/or LBH and/or LBHI2.

63.2. If and to the extent that it is LBL's case that the holding of the LBIE share constituted a service provided to or for the benefit of LBEL (which in any event, is

[16] [2012] EWCA Civ 548, at [47] *et seq.*

inconsistent with LBL's case against LBIE and/or LBH and/or LBHI2), this is denied:

63.2.1. There is no basis on which LBL can allege that it constituted a service provided to or for the benefit of LBEL, and therefore no basis on which (on either party's case) LBEL has a contractual liability to pay the Contribution Claim Recharge to LBL;

63.2.2. Further, LBEL was not formed until (some five and a half years) after the allotment of the LBIE share to LBL (being on or around 23 November 1994). It is therefore plain that the holding of the LBIE share did not constitute a service provided to or for the benefit of LBEL.

63.3. The alleged connection between the Contribution Claim Recharge and LBIE, LBH, and/or LBHI2 is inconsistent with a claim that there was at the same time a recharge agreement with LBEL which is capable of covering the same liability.

63.4. In any event, the only costs or liability that arose in relation to the share prior to administration was that of paying up the share (i.e. US$1). LBL has provided no evidence that this cost was paid by LBL nor, more importantly, that even if the cost of paying up the share was paid by LBL, it was subsequently recharged to LBEL. LBEL has seen no evidence that any recharge of this cost took place. There was therefore no course of conduct in relation to the liabilities associated with the share prior to LBL's administration upon which it can rely.

64. Further, in any event, there is no justifiable basis for charging LBEL with the Bad Debt Claims. LBL has not attempted to assert that under the Alleged Recharge Agreement (or otherwise prior to 15 September 2008), there existed any course of conduct by which LBL was entitled to claim from one Lehman OpCo an unsatisfied recharge debt otherwise payable by a different Lehman OpCo. The Bad Debt Claims Recharge is an artificial construct which is not supported by LBL's own case. Moreover, the Bad Debt Claims relate to no service provided by LBL to LBEL. Indeed, it is not suggested by LBL that in the event that it recovers any statutory interest in respect of claims lodged in the estates of

other Lehman Group entities, that statutory interest should be repaid to LBEL (or any other Lehman Group entities).

65. Further, in any event, there is no justifiable basis for charging LBEL with the expenses of the administration of LBL:

65.1. This also relates to no services provided by LBL to LBEL.

65.2. Moreover, the costs of or arising in connection with operating a distributing administration do not constitute costs of the company (LBL) in providing an administrative or operational service to any third party (whether as a pre-administration service or as a post-administration service). Rather, such costs are those of or arising in connection with the getting in and distribution of the assets of the company.

65.3. In addition, in the light of the post-administration Cost Recharge Agreement between the administrators of LBL and LBEL (and others), there is no room for any further contract or agreement in relation to matters that all, by definition, arose after administration. To the extent that LBL specifically identifies the basis on which specific categories of administration expenses are said to fall within the scope of the Appendix 3 Costs and/or otherwise fall within the scope of a pre-administration course of conduct, LBEL's position is reserved.

66. Further, in any event, even if (which is denied) any of the Recharges can as a matter of principle be recharged to LBEL, LBL is unable to identify with sufficient certainty the basis for determining what percentage of any costs should be allocated to LBEL. Even on LBL's case, it cannot be said that there was any consistent proportionate share according to which recharges were made to LBEL. Taking the figure of 41%, being the last figure historically applied, has no proper basis in law (or fact).

67. Further, if (which is denied) the Recharges or any of them can properly be said to have arisen in connection with the provision of services, LBL has not yet identified the time period(s) in which such services are alleged to have been provided. If and insofar as any Recharge is capable of being made to LBEL (which is denied), LBL would only be

entitled at most to the agreed percentage in relation to the time period in which the relevant service was provided.

**(iii) Agreement by custom**

68. LBL alleges in the alternative that there was an "*agreement by custom (and/or ... 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.*"[17]

69. It is denied that any such "agreement by custom" existed. The LBEL Service Agreement governed precisely such recharges. In any event, there was no "benefit" accruing to LBEL in relation to the Contribution Claim Recharge, the Bad Debt Claims Recharge or the Administration Expenses Recharge, for the reasons set out above.

70. It is presumed that LBL in fact intends to assert usage, as opposed to custom, custom being an immutable rule with the force of law, having existed since time immemorial (*Dashwood v. Magniac*;[18] *Lac Minerals v. International Corona Resources Ltd*[19]).

71. LBL has not identified any financial or trade custom or usage on which it relies, and simply refers to the parties' alleged historic recharge arrangements. On its own case (as set out by its reliance on *Durham v BAI (Run Off) Ltd*[20]*)* any such alleged usage is required to be *"certain, notorious, and universal"* (*Durham v BAI (Run Off) Ltd*, at [181]; see also, in the financial context, *Bear Stearns Bank Plc v Forum Global Equity Ltd, op. cit.* at [145]). For the reasons identified above in this Position Paper, even if LBL's purported reliance on a "custom" or "usage" was apposite in the present case, it would fail to satisfy (amongst other things) that test.

72. Its reliance on the following cases is therefore flawed:

[17] LBL Position Paper, paragraph 93.
[18] [1891] 2 Ch 306, 370.
[19] (1989) 16 IPR 27.
[20] [2009] 2 All ER 26, *per* Burton J.

72.1. *Hutton v Warren*:[21] that decision was concerned with the admissibility of extrinsic evidence of a particular custom or usage, for the purpose of annexing terms to a contract (i.e. the implication of the relevant terms, by reference to the relevant custom or usage). Insofar as LBL relies on the decision in *Hutton v Warren* in support of an implied contract and/or an implied term, that is dealt with elsewhere in this Position Paper.

72.2. *Durham v BAI (Run Off) Ltd*:[22] that decision also considered, insofar as LBL appears to contend is relevant, the impact of a particular custom or usage on the contract.

72.3. LBL's reliance on the House of Lords' decision in *Liverpool City Council v Irwin*[23] is also misconceived. The case was concerned with the test to be applied in relation to an implied term of a contract (in the context of a contract which was incomplete). Insofar as LBL's case is to assert an implied term of the contract, that is dealt with below.

**(iv) Implied term**

73. LBL alleges in the further alternative that there was an implied term of the LBEL Service Agreement 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 LBEL,"* having *"received the benefit of such services upon the terms set out therein"*.[24]

74. It is LBEL's position that such a term does not fall to be implied in the LBEL Service Agreement:

74.1. It is well established by authority that the implication of a term will be found in two situations: first, where it is necessary to give business efficacy to the contract (i.e. whether the term is necessary, in a business sense, to give efficacy to the contract)[25]

[21] (1836) 1 M & W 466.
[22] *Op. cit.*.
[23] [1977] AC 239.
[24] LBL Position Paper, paragraph 94.
[25] *The Moorcock* (1889) 14 P.D. 64, 68 *per* Bowen LJ; see, more recently, the Supreme Court's decision in *Aberdeen City Council v Stewart Milne Group Ltd* [2012] SLT 205, *per* Lord Clarke.

or so obvious that it goes without saying,[26] and second, where the term implied represents the obvious, but unexpressed, intention of the parties (but still such that it is necessary to give effect to the reasonable expectations of the parties).[27]

74.2. The Supreme Court has recently clarified the proposition stated by Lord Hoffmann in *Attorney-General of Belize v Belize Telecom Ltd*[28] (relied on at paragraph 94 of the LBL Position Paper), emphasising that there has been no dilution of the requirements which have to be satisfied before a term will be implied, and as such, no dilution of the test of necessity: *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* at [23] and [24].[29]

74.3. There is no basis for any assertion that the alleged implied term is required to give business efficacy to the LBEL Service Agreement, nor that such a term is necessary to give effect to the reasonable expectations of LBEL and LBL under that agreement. The scope of application of the LBEL Service Agreement was expressly limited to making provision for the cost of *"administrative and operational support services"* provided by LBL to LBEL. There can consequently be no basis on which the LBEL Services Agreement might be said to extend to *"all services provided by LBL in the capacity of a service company,"* and such a term cannot therefore be necessary to give effect to the LBEL Services Agreement. Indeed, a term of such width and imprecision as asserted by LBL would be manifestly contradictory to the existing, express terms of the LBEL Service Agreement.

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[26] *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] 3 WLR 1843 *per* Lord Neuberger (with whom Lord Sumption and Lord Hodge agreed).

[27] *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408, 459; *Attorney-General of Belize v Belize Telecom Ltd, op. cit.,* at [23].

[28] [2009] 1 WLR 1988, at [21] *et seq.* Lord Hoffmann's statement was subsequently applied by the Court of Appeal in a number of cases, including in *Crema v Cenkos Securities Plc* [2011] 1 WLR 2066 in the context of an agreement that is partly oral and partly in writing (that case being relied on in the LBL Position Paper, but which predates the decision in *Marks and Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd, op. cit.*).

[29] *Op. cit.,* at [23] to [24], *per* Lord Neuberger (on this point, unanimously): *"the notion that a term will be implied if a reasonable reader of the contract, knowing all its provisions and the surrounding circumstances, would understand it to be implied is quite acceptable, provided that (i) the reasonable reader is treated as reading the contract at the time it was made and (ii) he would consider the term to be so obvious as to go without saying or to be necessary for business efficacy... The first proviso emphasises that the question whether a term is implied is to be judged at the date the contract is made"*.

74.4. It has also been held that a term will not be implied unless it is capable of being clearly formulated and satisfies the requirement of certainty. It has been emphasised at first instance that *"clarity, certainty and predictability of interpretation are always important factors when considering whether a term should be implied into an arm's length commercial agreement",* and that *"the proposed implied term must be capable of being defined with sufficient precision to give reasonable certainty of operation".*[30] For the reasons set out above, it is plain that the alleged implied term, which is contended to relate to *"all services"* provided by LBL to LBEL, fails to satisfy the requirement of certainty.

74.5. In any event, for the reasons set out above, neither the Contribution Claim Recharge, the Bad Debt Claims Recharge or the Administration Expenses Recharge, is based on a "service" provided to LBEL. Further, for the reasons set out above, there was no "benefit" to LBEL in relation to those claims.

75. In the circumstances, the alleged liability of LBEL to pay for the Recharges is denied.

**(d) Other matters**

76. To the extent that the Issue 9 Preliminary Issue is to be answered in the negative, LBEL's position as to LBEL's right of indemnification against LBIE is expressly reserved.

77. The Issue 9 Preliminary Issue concerns the question whether, as a matter of law, it is possible for a member of a company to enter into with that company an enforceable agreement which has the effect of enabling that member to avoid what would otherwise be its obligation to contribute to the assets of the company under section 74 of the 1986 Act in the event of the company's winding up or otherwise, to reverse the effect of that section.

78. The LBEL Administrators have no direct interest in the matters raised by the Issue 9 Preliminary Issue.

[30] In *Torre Asset Funding Ltd v The Royal Bank of Scotland Plc* [2013] EWHC 2670 (Ch) at [151] and [152].

79. However, if (i) it is held at trial that LBL has no entitlement to claim the Contribution Claim Recharge against LBIE on the basis that LBL is precluded as a matter of law from so claiming, and (ii) it is *also* held at trial that (contrary to the LBEL Administrators' case) LBL would otherwise have a contractual entitlement to a right of indemnity against both LBIE and LBEL under the Alleged Recharge Agreement in respect of the Contribution Claim Recharge in the proportions, respectively, of 55 per cent. and 41 per cent., then LBEL's position will be that:

    79.1. LBL was precluded as a matter of law from entering into the Alleged Recharge Agreement (insofar as its subject matter is the Contribution Claim Recharge), the effect of which is that LBEL can be subject to no liability under the Alleged Recharge Agreement.

    79.2. Further or alternatively, to the extent that LBEL remains liable to LBL under the Alleged Recharge Agreement (which is denied), all LBEL's rights to claim indemnification from LBIE in respect of the whole or part of its liability to pay the Contribution Claim Recharge to LBL are expressly reserved.

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**18 November 2016**

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