Appeal No. A3/2020/1787(Y)

1 March 2021

IN THE COURT OF APPEAL
ON APPEAL FROM THE HIGH COURT OF JUSTICE (MARCUS SMITH J)

IN THE MATTER OF LB HOLDINGS INTERMEDIATE 2 LIMITED (in administration)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN

LEHMAN BROTHERS HOLDINGS SCOTTISH LP3

Appellant

and

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

Respondents

DEUTSCHE BANK AG (LONDON BRANCH) LBHI2 APPEAL REPLACEMENT RESPONDENT SKELETON ARGUMENT

This is Deutsche Bank's replacement respondent skeleton argument with updated bundle references filed and served on 29 March 2021 in accordance with the directions of Newey LJ of 19 December 2020. Bundle references "CB" are to the Core Bundle and "SB" are to the Supplementary Bundle. References are to bundle/volume/tab/page number. References to paragraphs in the judgment of Mr Justice Marcus Smith (CB/2/22/330-479) are in the form [J##].

INTRODUCTION

1. Deutsche Bank is the second respondent to the appeal of SLP3 against the declaration made in paragraph 1 of the Order of Marcus Smith J dated 24 July 2020 (the "**Trial**

Order")[1]. The Trial Order was made on an application for directions by the Joint Administrators of LB Holdings Intermediate 2 Limited ("**LBHI2**" and the "**LBHI2 Application**").[2]

2. By way of brief background:

(1) The LBHI2 Application concerns the relative priority of LBHI2's subordinated liabilities for distributions in its administration; these liabilities can be categorised into two groups.

(2) The first group (referred to by the Judge as "**Claim A**") comprises LBHI2's liabilities to PLC under three subordinated loan facility agreements dated 1 November 2006, which are in materially identical terms. These facility agreements were referred to at trial as the "**LBHI2 Sub-Debt**". Deutsche Bank has an economic interest in PLC's recoveries under Claim A.

(3) The second group (referred to by the Judge as "**Claim B**") comprises LBHI2's liabilities to SLP3 under floating rate subordinated notes issued under an offering circular dated 26 April 2007. These notes were referred to at trial as the "**LBHI2 Sub-Notes**".

(4) The terms of the LBHI2 Sub-Notes were amended on 3 September 2008 (the "**2008 Amendments**").

(5) The Judge concluded, in summary, that:

[1] [CB/2/23,24/480-487]

[2] The LBHI2 Application was heard at the same time as a related application in the administration made by the Joint Administrators of Lehman Brothers Holdings PLC ("**PLC**" and the "**PLC Application**"). The Judge's conclusions on the PLC Application are the subject of the joined appeal with reference A3/2020/1810 and 1811(Y), in which Deutsche Bank is an appellant.

a) Claim A ranks in priority to Claim B for distributions in LBHI2's administration.[3]

b) SLP3's claim for rectification of the 2008 Amendments failed on the facts;[4] and

c) If it had been relevant (which it was not given the Judge's conclusion on the rectification claim), the Judge would have concluded that Claim B would rank in priority to Claim A for distributions on the terms of the LBHI2 Sub-Notes absent the 2008 Amendments.[5]

3. On 19 December 2020 Newey LJ gave directions granting Deutsche Bank permission to file a skeleton argument on the basis that it would not duplicate the submissions made on behalf of PLC[6], the first respondent to this appeal with whom Deutsche Bank shares a common interest. Deutsche Bank agrees that SLP3's appeal should be dismissed for the reasons given by PLC, and adopts PLC's submissions in this regard. In the circumstances, this skeleton argument is limited to addressing certain aspects of the following issues, and in a manner that supplements the submissions of PLC:

(1) Pre-amendment ranking: Deutsche Bank submits that even if the Court were to accept SLP3's submissions that it should either (a) apply the Judge's conclusions as to the effect of the terms of the LBHI2 Sub-Debt to the terms of the LBHI2 Sub-Notes or (ii) have regard to the wider commercial context in which the LBHI2 Sub-Notes were issued, Claim A would still rank in priority to Claim B on either approach; and

(2) Rectification: Deutsche Bank submits that even if the Court were to accept SLP3's case as to the evidence, there was no rectifiable mistake on the facts.

[3] [J378(2)(a)-(c)]

[4] [J378(2)(d)]

[5] [J378(1)]

[6] [CB/2/29/495 and 501]

PRE-AMENDMENT RANKING

4. The terms of the LBHI2 Sub-Debt and LBHI2 Sub-Notes should be construed as amended, and principally by reference to the language used. However, in common with PLC, Deutsche Bank's position is that even prior to the 2008 Amendments, Claim A ranked in priority to Claim B. This is significant both because it demonstrates that the factual premise of SLP3's claim for rectification is wrong and because it makes SLP3's claim to rectify the 2008 Amendments pointless.

5. SLP3's claim for rectification is premised on the proposition that the 2008 Amendments changed the relative ranking from Claim B ranking *pari passu* with Claim A to a position where Claim A ranks in priority. SLP3's case is that there was an absence of an intention to effect this change and that such absence of intention constitutes the requisite common mistake necessitating rectification.[7] It is therefore fatal to SLP3's claim for rectification that even prior to the 2008 Amendments, Claim A ranked in priority to Claim B.

6. The ranking of LBHI2's subordinated debts is clear on the face of the relevant (unamended) contracts and (for the reasons given by PLC), any appeal in respect of the LBHI2 Application can be determined without having to rely on the commercial context in which the contracts were formed in order to reach the conclusion that Claim A is senior to Claim B. In particular, there is no persuasive answer (and SLP3 has offered no answer) to the fact that clause 3(a) of the LBHI2 Sub-Notes makes clear that (a) Claim B cannot be paid unless LBHI2 is "*able to pay its debts as they fall due*"[8], and (b) that, accordingly, in the circumstances of LBHI2's insolvency where LBHI2 is unable to pay Claim A in full (i.e. Claim A being one of its "*debts*"), distributions in respect of Claim B must by necessity be subordinated to distributions in respect of Claim A.

7. SLP3 seeks to avoid these consequences of the express terms of the pre-amendment LBHI2 Sub-Notes by relying principally on two alternative approaches:

   (1) First, SLP3 contends that the Judge's own reasoning, correctly applied, should have led him to conclude that the express terms of the LBHI2 Sub-Notes and the LBHI2 Sub-Debt give rise to a meaningless circularity whereby each of Claim A

[7] SLP3 Skeleton, ¶69 [CB/1/7/81-82]

[8] Limb (i) of the definition of "*solvency*" in clause 3(b) of the LBHI2 Sub-Notes [CB/3/41/723]

and Claim B purports to subordinate itself to the other. Therefore, SLP3 asserts that the subordination provisions for the purpose of determining the relative ranking of Claims A and B should be disregarded, resulting in (what is said to be) a default to "*pari passu*" ranking (i.e., the same conclusion that the Judge reached in relation to Claims C and D, which are the subject of the PLC Application);[9] and

(2) Secondly (and in the alternative), SLP3 contends that the Judge ought to have concluded that Claim A and Claim B rank *pari passu* as a matter of "*construction*" because: (a) that is said to be the "*the default legal position*"; and (b) that is what is said to be indicated by the "*applicable factual matrix*".[10]

8. Both of these approaches are flawed for the reasons given by PLC. In particular:

(1) The submission that a "*pari passu*" ranking is the legal default applying to creditors entitled to prove at the same time in an insolvency is pure assertion. It simply begs the question of whether, as a matter of contract, SLP3 and PLC are entitled to prove for Claim A and Claim B respectively at the same time (and in what amount), or whether one has agreed to prove after the other (and in respect of what amount). The alleged "*legal default*" thus sheds no light on the relative priority of Claim A and Claim B in this case;

(2) It is impermissible to rely on the alleged "*factual matrix*" in the manner that SLP3 seeks to do in order to undermine the clear effect of the express terms of the LBHI2 Sub-Notes, for the reasons given by PLC; and

(3) The Judge's conclusions in relation to the priority dispute between Claim C and Claim D under the terms of the PLC Sub-Debt and the PLC Sub-Notes (the terms of which are similar), and his conclusions in relation to Claims A(i), A(ii) and A(iii) under the three tranches of the LBHI2 Sub-Debt (the relevant terms of which are identical), cannot be applied to the issues arising under the materially different terms of the LBHI2 Sub-Notes. The same issues do not arise in light of

[9] SLP3 Skeleton, ¶¶37-44 [CB/1/7/69-71]

[10] SLP3 Skeleton, ¶¶45-54 [CB/1/7/71-75]

the different language used, and the solutions used by the Judge to solve those different issues do not justify approaching the question of construction of the LBHI2 Sub-Debt and the LBHI2 Sub-Notes in any manner other than that adopted by the Judge.

9. In short, this is not a case in which the admissible factual matrix should have any impact on the result, which is largely (if not wholly) a matter of contextual analysis of the language used in the documents. However, even if the Court were to have regard to the wider factual matrix said by SLP3 to be relevant and admissible, Deutsche Bank maintains that the relevant facts in any event point strongly to Claim A ranking in priority to Claim B.

10. In particular, if, as SLP3 contends, "*the factual matrix in this case is made up of the knowledge reasonably available to the centralised decision-makers within the Lehman Group*"[11], then it must follow that the factual matrix would include the commercial incentives operating on LBHI, as the ultimate holding company of the Group and the entity ultimately in control of PLC, LBHI2 and SLP3. These commercial incentives included ensuring that PLC could be paid in priority to SLP3, in order to avoid triggering an undertaking, known as the "Dividend Stopper", given by LBHI in connection with the issuance of certain securities (the ECAPS) held by Deutsche Bank, among others. By the Dividend Stopper, LBHI undertook not to pay any dividends or repurchase its shares for a period of 2 years if any sum due under the ECAPs was not paid when scheduled. This created a strong commercial incentive for LBHI to ensure that Claim A could be paid in priority to Claim B, of which the parties to the LBHI2 Sub-Debt and the LBHI2 Sub-Notes would have been aware.

11. An explanation of the relevance of the Dividend Stopper to the structure of the Lehman Group's subordinated debts is set out in paragraphs 41 to 52 of Deutsche Bank's appellant's skeleton argument in the appeal relating to the PLC Application (A3/2020/1810(Y)) [CB/1/18/266-269], and is not duplicated here. By way of brief summary:

[11] SLP3 Skeleton, ¶50 [CB/1/7/74]

(1) As the Judge accepted, the commercial purpose of the Dividend Stopper was "*to create a commercial incentive on LBHI to ensure that PLC could pay*" its liabilities to the issuers of the ECAPS under the PLC Sub-Notes.[12]

(2) PLC's ability to pay distributions on the PLC Sub-Notes in full is directly dependent on the sufficiency of its assets:

a) First, in order to make any payment to the ECAPS issuers under the PLC Sub-Notes, PLC had to be able to satisfy the solvency condition to payment in the PLC Sub-Notes, which in turn required it to have sufficient assets to pay its Senior Liabilities in full[13].

b) Second, even if this condition were satisfied, the existence of any competing *pari-passu* debt could prevent PLC being able to pay the ECAPS issuers in full unless PLC had sufficient assets to pay all competing *pari-passu* debt in full, having first paid any Senior Liabilities.

(3) It follows that the commercial incentive on LBHI identified by the Judge (to ensure that PLC "*could pay*") extended to ensuring that PLC at all times had sufficient assets to be able to pay the PLC Sub-Notes. It further follows that LBHI, and by extension the Lehman group, would have had strong commercial incentives to avoid creating competing *pari-passu* debt with either the LBHI2 Sub-Debt or the PLC Sub-Notes.

12. As SLP3 identifies, the purpose of issuing the LBHI2 Sub-Notes was to refinance the majority (but not all) of the LBHI2 Sub-Debt into a more tax-efficient form of borrowing.[14] However, SLP3 draws the wrong conclusions from this, suggesting that it "*overwhelmingly*" supports *a pari passu* ranking.[15] That is wrong:

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[12] [J366(6)]

[13] Condition 3 of the PLC Sub-Notes, which for these purposes is materially identical to the solvency condition in the LBHI2 Sub-Debt [CB/3/49/866-867]

[14] SLP3 Skeleton, ¶¶14 [CB/1/7/60], 52 [CB/1/7/74-75]; [J12]-[J13]

[15] SLP3 Skeleton, ¶52 [CB/1/7/74-75]

(1) It assumes what it needs to prove, without in any way identifying why the purpose of refinancing the LBHI2 Sub-Debt with the LBHI2 Sub-Notes informs the question of ranking *inter se*.

(2) Moreover, SLP3's approach ignores the fact that, although the LBHI2 Sub-Notes were a more tax efficient form of borrowing for LBHI2 and the Lehman Group than the pre-existing LBHI2 Sub-Debt, it was decided not to refinance the totality of the LBHI2 Sub-Debt.[16] Instead, a balance of the LBHI2 Sub-Debt remained outstanding and owing to PLC in an amount that approximated to the amount owed by PLC under the PLC Sub-Notes.[17]At the time that the LBHI2 Sub-Notes were issued, any relevant "*central decision makers*" would therefore have known that:

    (a) LBHI2 would continue to have a pre-existing subordinated liability to PLC in an amount corresponding the PLC Sub-Notes, which could be relied upon by PLC to make payments under the PLC Sub-Notes; and

    (b) It was commercially important for the Lehman group as a whole as a result of the Dividend Stopper that PLC would always have sufficient assets to be able to pay the PLC Sub-Notes.

(3) Against that commercial background, any reasonable person would conclude that the purpose of refinancing only a part of the LBHI2 Sub-Debt owed to PLC with the more tax efficient LBHI2 Sub-Notes was to give effect to the commercial imperative that PLC would always have sufficient assets to be able to make payments under the PLC Sub-Notes. The same conclusion would also require that LBHI2's existing liabilities to PLC under the PLC Sub-Debt be prioritised over its new liabilities to SLP3 under the LBHI2 Sub-Notes, because otherwise the far larger liability to SLP3 would compete with its ability to pay PLC under the LBHI2 Sub-Debt, and that would be likely to increase the likelihood of the Dividend Stopper being triggered.

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[16] [J13]

[17] [F4/2286] [SB/2/22/413]

13. As noted above, Deutsche Bank does not consider it necessary for the Court to have regard to the wider commercial context in which the LBHI2 Sub-Notes were issued. However, if the Court is minded to go down that route at the urging of SLP3 then, far from supporting a *pari passu* ranking, the wider commercial context strongly suggests that an objective commercial decision maker in the Lehman Group would have prioritised LBHI2's debt to PLC over its debt to SLP3. This is entirely consistent with the terms of the instruments and explains why, for example, the LBHI2 Sub-Notes are expressly payable only if LBHI2 can pay *all* its other debts (including its debts to PLC) as they fall due.

RECTIFICATION

14. Deutsche Bank agrees with PLC that SLP3's appeal on rectification for common mistake is bound to fail, and adopts PLC's submissions. As PLC submitted at trial[18], SLP3's claim for rectification is highly unusual. It is a claim to rectify quoted Eurobonds listed on the Channel Islands Stock Exchange which was raised for the first time in SLP3's Reply Position Paper dated 22 March 2019, and therefore almost 12 years after the 2008 Amendments were made. This was also long after the terms of the 2008 Amendments had been made public and the dispute as to the effect of the 2008 Amendments had been ventilated in these proceedings. The following limited supplemental points are made in support of PLC's position that this claim for rectification should be refused.

15. Even if it were open to SLP3 to challenge the Judge's findings of fact as to the absence of any discernible common intention that might support a case of rectification (which it is not), and even if SLP3 were able to overcome the other substantial difficulties with its case identified by PLC, such as the absence of any evidence from key decision makers (which it cannot), SLP3's appeal would be bound to fail on its own terms. This is because the evidence SLP3 led at trial would support a conclusion that the 2008 Amendments in the terms that they were adopted achieved precisely what they were intended to do.

16. SLP3 relies heavily on what it refers to as the "*Rectification Chronology*"[19]. However, this "*Chronology*" omits the crucial steps which explain how the initial intention to

[18] PLC Trial Skeleton, ¶¶185-188 [SB/1/10/264-265]
[19] SLP3 Skeleton, ¶¶80-88 [CB/1/7/85-87]

permit the deferral of interest under the LBHI2 Notes resulted in amendments that went materially beyond only permitting the deferral of interest. In particular:

(1) The first draft of the amendments simply allowed the Issuer to defer the settlement of interest[20]. However, in the course of reviewing the amendments, the A&O tax department identified an issue with the tax deductibility of the interest[21]. The Lehman Group was informed about the tax issue[22];

(2) In order to address this tax concern, the view was taken that it was necessary to remove the solvency condition to payment in a winding-up, and a draft was produced on this basis.[23] This change was, as Mr Grant accepted, an intentional and deliberate piece of drafting;[24]

(3) It was then identified that this change would be problematic because the LBHI2 Sub-Notes would lose their Lower Tier 2 debt regulatory status.[25] The proposed amendments had always been considered subject to the requirement that the debt remained LT2 status debt;[26]

(4) The final terms of the amendments were the proposed solution that would (a) achieve a tax benefit by deferring interest; (b) preserve the regulatory status of the LBHI2 Sub-Notes; and (c) deal with the tax deductibility issue. Specifically, the conditional subordination mechanism was replaced in a winding-up with a subordination mechanism which quantified the sums payable under the LBHI2 Sub-Notes by reference to what would be payable on a hypothetical preference

[20] See Grant cross-examination Day 2 page 101 line 20 onwards. [SB/2/51/544]

[21] [J206]-[J207]

[22] [J208]

[23] [J211]; [F5/2722-2732] [SB/2/27/433-443] and Grant cross-examination (Day 2, pages 113:10 to 114:2) [SB/2/51/547]

[24] [J211]; Grant cross-examination (Day 2, pages 98:18 to 99:4) [SB/2/51/543]

[25] [J213]; Grant cross-examination (Day 2, pages 116:4 to 117:25) [SB/2/51/547-548]

[26] [J213]; Dolby cross-examination (Day 3, page 90: 5-21) [SB/2/54/562]

share[27]. That addressed the conditionality concern that had been identified as threatening the tax treatment of the notes and ensured that they would remain LT2 status debt;[28]

(5) This careful drafting was designed to meet the purposes of (i) permitting deferred settlement of interest (ii) maintaining tax deductibility and (iii) maintaining regulatory status as LT2 debt[29], and the drafting was sent by Mr Grant to Ms Dolby and Ms Dave by email of 12 June 2008, and ultimately approved.[30]

17. In other words, the evidence (as far as it went) showed that there was a deliberate decision to make amendments to the effect that, in a winding up, the claims of the Noteholders would rank as if they were a form of preference share, and that this was the intended solution to an identified tax issue.

18. Thus, on analysis, far from showing a mistake, SLP3's case amounts at its highest to a complaint that there were commercial consequences to the 2008 Amendments that were not appreciated at the time. But even if SLP3 could make good that case on the evidence, a "*mistake*" of that nature has never been a basis for rectification: FSHC Group Holdings Ltd v GLAS Trust Corporation Ltd [2019] EWCA Civ 1361, [179]-[181].

19. Therefore, even if SLP3 could establish on the part of the relevant decision makers a common failure to appreciate the wider commercial consequences of the LBHI2 Sub-

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[27] The subordination provision thus quantified any claim by reference to a hypothetical preference share (the "Reference Share") that ranked above an equally hypothetical notional preference share (the "Notional Share"), which in turn ranked above actual issued shares ("Issued Shares"). i.e. giving a hypothetical hierarchy of (1) Reference Share (2) Notional Share (3) Issued shares. They remain creditor claims, but with claims quantified by reference to a return on a notional type of share and as such would rank below debt claims such as those of Claim A.

[28] Grant 1 at [38] and [41] [SB/1/1/16]; Grant cross-examination (Day 2, page 118:1 to page 121:3) [SB/2/51/548-549]

[29] [J262(2)]

[30] [J212]; [F5/2839-2856] [SB/2/31/448-465]

Notes ranking as a form of preference share[31], there would still be no common mistake as to the terms of the amendments themselves. The amendments achieved their intended purpose, and did exactly what they were meant to do.

20. Whether or not there was an intention to "*change the ranking*" of the LBHI2 Sub-Notes relative to any other debt, there was plainly an intention that the sums payable in a winding-up under the LBHI2 Sub-Notes would be quantified by reference to what would be payable on a hypothetical preference share. That necessarily led to a change in ranking if it is assumed (wrongly) that the LBHI2 Sub-Notes and LBHI2 Sub-Debt had ranked *pari passu* prior to the 2008 Amendments.

21. In this regard it may be helpful to consider what the position would be if the LBHI2 Sub-Debt had been issued after the LBHI2 Sub-Notes were amended. If the LBHI2 Sub-Notes were the only subordinated debt of LBHI2 in 2008, the legal effect of the 2008 Amendments would be the same, but the commercial consequences of that legal effect would be different. There would not have been any "*change in ranking*", but only because LBHI2 would not have had any other subordinated debt. If LBHI2 had thereafter issued the LBHI2 Sub-Debt, it would plainly have ranked senior to the LBHI2 Sub-Notes. That is a consequence of the language used in both instruments. However, a failure to appreciate the economic consequences of the amendments in a winding-up, and, to the extent established, the absence of any positive intention to change the ranking of the LBHI2 Sub-Notes relative to the LBHI2 Sub-Debt, is not a basis for rectification for the reasons set out at length by PLC.

22. It is also relevant to note that, if the LBHI2 Sub-Notes were rectified in the manner now sought by SLP3, the remaining balance of the amendments would not deal with the tax issues that the amendments were intended to address. SLP3 may not now care about those tax issues, but simply deleting the substance of the amendments to condition 3 would ignore (and be inconsistent with) the clear evidence as to the rationale for those amendments. In and of itself, this demonstrates that the SLP3 claim for rectification is unsustainable: there cannot be rectification of a contract in terms which would undermine

[31] Which, as noted in paragraphs 4 to 13 above, it cannot, not least because the amendments did not change the ranking of the pre-amended LBHI2 Sub-Notes, which were always subordinated to the LBHI2 Sub-Debt.

what was intended (here which would not give effect the intended method of dealing with the tax issues).

Sonia Tolaney QC

Richard Fisher QC

Tim Goldfarb

1 March 2021