Wednesday, 6 October 2021

(10.30 am)

Submissions in reply by MR PHILLIPS (continued)

LORD JUSTICE LEWISON: Yes, Mr Phillips.

MR PHILLIPS: Good morning, my Lords, my Lady.

My Lords, I'm yielding to my learned friend Mr Beltrami's wish to address your Lordships in relation to an authority that your Lordship raised.

LORD JUSTICE LEWISON: I think it was a red herring in the end because it was unilateral mistake.

MR BELTRAMI: It was a unilateral mistake, my Lord. We dug it out, and I don't think it is going to --

MR PHILLIPS: That is what I was going to say about it. Thank you very much.

My Lords, my Lady, we have now had the opportunity to read the transcript of Mr Beltrami's submissions overnight and to consider some of your further questions that were raised.

To do this in a structured way I will adopt the same structure as the parties so far. So I will comment on the general approach, the amended notes, the unamended notes and rectification. And I will won't repeat the points that I made yesterday.

So if I may start with the general approach. Using my Lord, Lord Justice Lewison's words in our opening the

construction of each of the instruments requires approaching them as the reasonable reader would, giving effect to all the different parts of the agreement, reading them as a whole in a unitary manner and trying to avoid, where possible, an uncommercial result.

Central to the construction arguments you have heard prosecute both sides is the interrelationship between what we have called the definitional wording, which my learned friend calls the general principle of a statement of intent, and the conditionalities, which my learned friend called the mechanism.

My learned friend repeatedly said that the real issue for your Lordships is whether the conditionalities in these instruments amounted to an expression of juniority. If you need the page references it's on page 79, 23 to 25, and 49, 23-25.

We do not say that conditionality can never amount to an expression of juniority. But they don't in this case.

All parts of the subordination provisions are connected by the word "accordingly" to the definitional wording meaning "in consequence of" or "therefore", and you cannot read one without the other.

My learned friend Mr Beltrami necessarily assumes that the conditionalities have independent and

inconsistent effect to the definitional wording.

My learned friend also said that the first phrase is "just [and I'm quoting] a confirmation that the debt is subordinated debt". And he said that at page 35, lines 24 to 25. And he described it as a "general principle of subordination".

And with respect, that is not right. The statement is not an unqualified statement of subordination in the abstract. It is an agreement to subordinate one's rights to payment to defined senior liabilities for senior creditors. That is what the plain words say, and my learned friend's case in relation to the notes ignores it.

I then turn to the amended notes. In asking you to find that the judge was correct for all purposes in relation to the amended notes, my learned friend Mr Beltrami did not address two fundamental problems:

First, on the judge's reasoning the definition of senior creditors in the amended notes does not the define to whom the LBHI2 Sub-Notes are subordinated. Mr Beltrami said that the conditionalities could alter the legal characteristics of defined senior creditors because those characteristics were not set in stone.

And with respect, we disagree.

Take the amended notes. The definition of senior

creditors expressly envisages debts which are junior because they express themselves to be junior. SLP3 has not agreed to subordinate its notes to debts expressed to rank junior to them. However, outside of a winding up PLC say that no debt due can ever be junior because that is what the cash flow conditionality dictates, and inside a winding up PLC says that all debt ranks senior to the notes, save the notional holders, because that's what the further conditionality dictates.

In our submission, a reasonable reader would not conclude, having read the senior creditors' definition, that the notes subordinated themselves to everyone or almost everyone, although my learned friend said by reference to the judge's methodology that it was "uncomfortable", that was the word he used, to end up with potentially inconsistent subordination clauses. That is exactly where he ends up: with express definitions which are inconsistent with the conditionalities.

And we don't think that your Lordships need authority for the proposition that where parties provide that certain terms in a contract bear a certain meaning when defined in a definitions clause, the court will be very slow in departing from the express meaning. And if your Lordships wish to read T&N at paragraph 262.6 in

the bundles, it is authorities 128/523. I'm not suggesting turning it up now.

The second of these two fundamental problems is that on the judge's reasoning the effect of what we call the further conditionality is that all upper tier 2 debts rank ahead of the lower tier 2 LBHI2 Sub-Notes, save for the upper tier 2 debts that use the preference share mechanism.

My learned friend could not explain why, on his construction, upper tier 2 debt ranked higher than lower tier 2 debt. That does not sit comfortably with GENPRU. Your Lordships will recall the letter A&O wrote confirming the LT2 status of the notes in both amended and amended form. And as the judge found at paragraph 67, GENPRU only required subordination to unsubordinated debts both inside and outside a winding up. And your Lordships will recall that the express subordination to unsubordinated creditors is found in the definitions. It is not found in the preference share mechanism.

My learned friend has identified no sensible regulatory reason as to why, on his construction, the Sub-Notes were subordinated to absolutely everyone, including tiers of regulatory capital which sit below LT2.

How did it make sense for it to be impossible for LBHI2 to issue junior regulatory debt at any time? Which is the flexibility, my Lords, that your Lordships have seen in Mr Justice David Richards' judgment in particular in relation to issuing further junior debt which is excluded liabilities.

LORD JUSTICE LEWISON: Can I just ask about tier 2 capital.

MR PHILIPPS: Yes.

LORD JUSTICE LEWISON: That includes undated debt, I think, doesn't it?

MR PHILIPPS: No, it's dated -- oh, it does include undated.

LORD JUSTICE LEWISON: On Mr Beltrami's interpretation, the dated debt does take preference over undated upper tier 2 capital, doesn't it?

MR PHILIPPS: No, it doesn't.

LORD JUSTICE LEWISON: No?

MR PHILIPPS: No. And that's one of the problems, because on Mr Beltrami's construction it only takes priority over such upper tier 2 debt if it uses a notional holders mechanism. And that was the judge's decision.

The way I think of it, picking up my learned friend's Pink Floyd analogy, is that one has the brick in the wall, preference shares, and has the upper tier 2; one has the lower tier 2, and further up one has the seniors. So I can put four bricks, as it

were, in the wall. But that's the answer to your Lordship's question.

LORD JUSTICE LEWISON: So on Mr Beltrami's construction, the notes take priority over some but not all LT2 capital.

MR PHILIPPS: Precisely right, my Lord. Precisely right. And of course any debts that express themselves to be junior, unless they use that same notional shareholder mechanism, are senior.

My Lords, there are six specific points, if I may, in reply to the amended notes argument made by my learned friend. The first point is what we describe as the floor to ceiling point. Mr Beltrami said it was impossible and meaningless for there to be a floor but not a ceiling. And that is not right. The definitional wording defining who your senior creditors are, sets the ceiling, and the ceiling below whom the amended notes rank.

Interpreting the preference share mechanism as both a floor and a ceiling makes the definition of senior creditors entirely redundant. And one only makes sense of the whole clause on our case. The definitional wording tells you to whom you are subordinated, including, critically, the unsubordinated creditors. And the preference share mechanism describes the position in a winding up to make clear that this LT2

debt sits at LT2 level, above upper tier 2 debt.

In our submission the repeated references to over and above are more consistent with the conditionality being a floor than its being a ceiling. And we made the point yesterday that the notion preference share cannot sit in the well-known place my learned friend described, because there are creditors in the brick immediately above, which is the upper tier 2 creditors.

Second point: my learned friend's different regimes point. My learned friend Mr Beltrami said it was not unusual to have different tests inside and outside an insolvency. He said that you get that from the LBHI2 Sub-Debts standard form and you get it from the cases.

Two points:

First of all the LBHI2 Sub-Debts do not have two regimes operating inconsistently. That's not how they operate. Clause 5.1(a) is applicable outside a winding up. Clause 5.1(b) is applicable both inside and outside of an insolvency, and it effects subordination to the senior creditors in both scenarios.

Second point: my learned friend referred to Maxwell and Kaupthing. They do not support the different regime proposition. I won't go back to the cases, but your Lordships should note that they are cases where there was only subordination in an insolvency. That does not

mean that the subordination regimes provisions contain different regimes for where the debts ranked inside and outside of the insolvency. They were unsubordinated outside of the insolvency and they had agreed to subordinate themselves inside an insolvency, so that's very different.

The third point was the theoretical junior debt point. My learned friend Mr Beltrami refers to the possibility of the notional holders and the potential for juniority. But he then said that there were no notional holders and so the category below the debt is irrelevant.

We say that that does not follow when one is looking at the construction, especially when you consider that the definition of senior creditors expressly contemplates debts that rank junior to the notes.

I am sure I don't need to remind your Lordships of the words, but it does expressly contemplate there may be junior debt. That language suggests that they do not fall to the bottom of the pile or join at the end of the queue, which is the submission that my learned friend was making. They expressly contemplate that there will be debts which are, and are expressed to be, junior.

The fourth point is the confirmatory note point. My learned friend Mr Beltrami said we are bending the

construction of the notes to the confirmatory note.

That is, with respect, an unfair criticism. The notes sit in the lower tier 2 level above the equity and all the upper tier 2 debt, including preference shares and undated subordinated debt instruments.

My learned friend also sought to explain the confirmatory note by suggesting that the reference to any upper tier 2 security was in fact only a reference to the notional holders.

With respect, that construction is not open on the words of the confirmatory note. The wording states that "the notes are intended to rank above any upper tier 2 securities", ie all upper tier 2 securities. And on my learned friend's case any upper tier 2 undated debt that subordinated itself without a preference share mechanism would rank above the note. And the confirmatory note is inconsistent with that construction.

The fifth point is the proving for 100 per cent. My learned friend said that this means that notes proved as a debt but ranked as a preference share.

Two points: that is impossible. It does not rank as a preference share, because it is a debt. And the second point is, it proves for 100 per cent, which tells you that it can't be a share, but it also tells you it can't be a contingent debt, and it can't be a contingent

debt because no contingent debt can prove for 100 per cent. That would mean there's no contingency.

I know my learned friend said this is an arid debate, but we do say the categorisation and characterisation of the mechanisms is important. Even on my learned friend's case, the further conditionality does appear to be a form of simple contractual (inaudible word).

Sixth point, and the last point under this head: my learned friend did not attempt to justify the judge's analysis of the old and new regimes; in other words, the new regime being a completely different regime that starts with the conditionality, starting at phrase 8, whether or not you have numbered it.

Phrase 2, in other words subordinated to the senior creditors, is where you find the subordination to unsubordinated creditors as required by GENPRU. And that's the regulatory context of this debate. And it will be wrong to construe the subordination provision without reference to the clause that meets the regulatory requirement. And in our trial skeleton, just please make a note, SB18/135 and following, we explain --

LORD JUSTICE LEWISON: SB8 --

MR PHILIPPS: SB1, tab 8, 135 and following. What we have

done there is an analysis of the regulatory regime, because of course you will appreciate that GENPRU was in the UK implementing the regulation.

May I move on to the unamended. Just a very few points. The unamended notes. The big criticism we raised at my learned friend's construction was that when applied it left a very curious result, that under the definitional wording the notes rank after the senior creditors as specifically defined, but under the solvency conditionality they ranked behind all creditors.

My learned friend, with respect, had no answer to that point in his submissions.

Four specific points in reply:

First of all the tie-breaker point. My learned friend accepted that had the judge properly applied his approach to the notes on the definitional wording you would reach at least a pari passu ranking with the debt. And that's at page 75, line 12 of the transcript. He said that the insolvency conditions were then the tie-breaker. He accepted that the Sub-Debt has a form of category insolvency condition. Which is plainly right. We've seen it. The definition of liabilities is very broad. He said that you plug in the definitions -- and I am using my learned friend's phrase, "plug in" --

and there is no expression of juniority. That was page 76, lines 3 to 7.

He then turned to the notes. His argument was that when you come to the notes you do not plug in the defined terms, you read the cash flow solvency in isolation, and that is what is supposed to make all to the difference between the two solvency conditions.

But if you plug in the definitions into the Sub-Debt, why not plug them into the solvency condition in the notes? Why ignore the words "accordingly" and the connections to the definitional wording? These are all unanswered points on my learned friend's case.

The next point is the two solvency conditions. In relation to the solvency condition in the notes my learned friend said the end result is to ensure as much subordination as it could.

With respect, that is not right. He only gets to that conclusion because he wrongly reads debts as meaning all debts and not just being debts owed to senior creditors, because he ignores the words "as they fall due". And if my learned friend is right that the Sub-Notes can be read in this way and that the correct exercise is to compare and contrast solvency conditions, then the same approach could be applied to the Sub-Debt. If you read clause 5(2) in isolation from subordination

to the senior liabilities it requires you to pay all your liabilities. You could read it in the same way as the cash flow solvency conditions of the notes, because any excluded liabilities with a solvency condition would not have fallen due. And there's nothing that might constitute Sub-Notes and excluded liabilities in the Sub-Debt.

Third point. My learned friend said it doesn't matter that there are two different solvency tests. The cash flow solvency test is referable to all debts, both senior and non-senior liabilities, and a balance sheet test which is referable to senior liabilities.

With respect, that would create very odd results. We agree with my Lord, Lord Justice Lewison, that there are two limbs to the test. As we explained yesterday, when you look for the debts as they fall due, it does not include the junior debts. I would disagree with my learned friend Mr Beltrami that a cash flow test and a balance sheet test would ordinarily take as a relevant point a distinction re identity of the creditor in question, as the Supreme Court confirmed in Eurosail the description is one of futurity concerning the debts in question. In other words, will it fall due in the reasonably near future?

The fourth point is the parenthesis point. The

words in parenthesis in the solvency definition relate to both. My learned friend said it would be strange that it qualifies both, but open to your Lordships as a matter of construction. That is page 81, 16 to 17.

We say that is far more likely and gives effect to the definitional wording and treats the solvency condition as being a consequence of it, and it is also consistent with debts as they fall due.

The fifth point is, my learned friend referred to a rogue junior instrument which he said is not the answer to the meaning of condition 3 because it's hypothetical only.

Three sub-points, if I may. One, we remind you of what Mr Justice David Richards said about excluded liabilities in Waterfall 1. They are a category of potential liabilities and they are still relevant to the construction exercise.

Two, the important point to the reasonable reader would be that the note could rank above more junior creditors -- I am sure that point is not lost on your Lordships -- which meant that they could not at the same time be rock-bottom.

And as I submitted to you yesterday, junior debt could not be a debt that's fallen due. If there was junior debt it would not have fallen due and the notes

would rank before it.

It follows from that, contrary to my learned friend's submission, that the solvency condition is not an expression of juniority. And I want to make three points and then a final comment on the construction.

One, in the absence of an expression of juniority it means that outside a winding up the notes and the debt rank pari passu.

Two, despite my learned friend's submission that you can have contrary and conflicting regimes in one subordination provision, a unified approach to construction points to the same relative ranking, both inside and outside a winding up, you can have such an approach.

Accordingly, to the extent that there is any ambiguity in relation to the new regime inside a winding up, it should be resolved in favour of a pari passu construction so that the two regimes are consistent.

Then my final comment. My Lords, all of these instruments were part of the Lehmans regulatory capital structure. Your Lordships have heard my learned friend Mr Beltrami alight on the reference to debts in the solvency condition in the Sub-Note and say to your Lordships, very eloquently: well, there it is, the

expression of juniority. That is an expression that the notes say we rank junior to the debt.

On a more detailed analysis you discover that actually it isn't, and my learned friend actually on a detailed analysis is wrong, because a junior debt will not fall due before a senior debt and, of course, nor will a pari passu debt.

But that's an example of my learned friend's taking differences in the language used across these clauses and seeking to place on them a weight they do not bear.

And your Lordships will shortly hear my learned friend Ms Hilliard doing something similar with the pari passu wording in the PLC debt structure.

But what your Lordships have not heard is a single reason why any of the Lehmans companies would have made any of the lower tier 2 debt senior or junior to any other lower tier 2 debt. And no reason has been given, because there is none.

The plain and obvious answer is that these tranches of subordinated debt ranked pari passu as between themselves. It is the only answer that makes any sense. And absent any clear expressions of juniority, that is what the Sub-Debt did.

My Lords, may I spend a very short time on rectification. Just a couple of points to close with on

rectification, including an answer to your Lordship's question on clause 12. I will follow my learned friend's structure again, first dealing with the lack of evidence of intention from decision-makers.

My learned friend said the evidence was sparse, at page 102, and that cases like FSHC show you that rectification needs to be thrashed out in the witness box. That was at 106.

Just a couple of points. As we explained to the judge at trial, and as my learned friend accepts, oral evidence is not a prerequisite for a rectification case. And your Lordships have seen Oscatello v Murray, which my learned friends referred to your Lordships. That was a rectification case which succeeded and there was no oral evidence. And for your Lordship's --

LORD JUSTICE LEWISON: I remember doing a case in front of Mr Justice Lawrence Collins which turned on the agreement between two dead people, so there was no oral evidence. It had to be pieced out from the documents.

MR PHILIPPS: My Lord, that is precisely the point, my Lord. I am not over-emphasising it but that's the point.

LORD JUSTICE LEWISON: It's a question of evidence.

MR PHILIPPS: Exactly. There was a comprehensive disclosure of communications with the Lehman Group during the period of the amendment. Thousands of documents. There

was not a single document which show any discussion of a relative ranking, let alone a change in relative ranking. My learned friend showed you pages 100 to 101 which showed, he said, other members of the Lehman Group, in his words, quoting, "actively considering what the ranking position was pursuant to the amendments".

He was looking at SB2, 41 at 520. This was obviously a discussion about retaining LT2 status and remaining as debt, not equity. In other words, a regulatory issue, not the relative ranking of the instruments.

The ranking point wasn't raised because Mr Grant didn't think there was an issue and so he didn't tell Ms Dolby, and she said she didn't raise it with those other people because the issue wasn't raised with her. And the inference from the lack of discussions on this topic, in our submission, which is confirmed by Ms Dolby, was that there was no intention to alter ranking.

My Lord, Lord Justice Lewison, asked about the evidential basis surrounding Ms Dolby's statements that she shared her intention with Mr Rush and Mr Triolo. Your Lordships, that is page 116, 117.

Can I just make a couple of points for clarification. Mr Rush was the head of tax. He was

Ms Dolby's boss and shared an office next to her. They discussed the amendments and the purpose of the transaction in the run-up to sign-off. And for your Lordships' note again it is supplemental bundle 2570, internal page 129.

LADY JUSTICE ASPLIN: Sorry, that was -- supplemental bundle.

MR PHILIPPS: Number 2, tab 570, internal page --

LORD JUSTICE LEWISON: Tab 570.

LADY JUSTICE ASPLIN: That is why I was confused.

MR PHILIPPS: Page 570, I do apologise. I actually have a false reference. I apologise. I didn't notice.

LADY JUSTICE ASPLIN: Fine. Sorry, I put you off your stroke.

MR PHILIPPS: No, not at all, my Lady.

LORD JUSTICE LEWISON: That page shows discussions between Ms Dolby and --

MR PHILLIPS: Tab 54, my Lady. Yes, they discussed the amendments and the purposes of the transaction in the run-up to sign-off. That is what it goes to, my Lord.

Mr Triolo was vice president in the tax department. He was sent the electronic consent by Ms Dolby on 28 August. A gentleman named Mr Guth(?) based in the US asked for the electronic consent to be sent to Mr Triolo, adding "just email the resolution to the

directors and they will approve". And that, for your Lordship's reference, is SB1, tab 1, 312, which is in the rectification chronology.

Those materials formed the background to the questions which I put to Ms Dolby about her sharing her intentions with Mr Rush and Mr Triolo. And I am sure, my Lords, you will recollect that she did describe how she shared those intentions with them.

For your Lordships' reference, that is at page 571 of supplemental bundle 2, tab 54. It was internal pages 135 line 19 to 137 line 4. And the point that I was putting to her was that there was no evidence that anyone considered relative ranking of the debt and the notes at the time of the amendments because no one in the Lehman Group thought that they created a ranking issue. But that was shared between her and the individuals who signed the various resolutions.

Can I just say something about Mr Grant's intention, and then that will be it, apart from answering your Lordships' questions. My learned friend referred to the intention of Mr Grant. He did that at page 127. Can I be clear: it has never been part of our case that he was a decision-maker. He was just the draftsman. But his evidence is useful in terms of firstly what he was instructed to do and secondly the background to the

drafting process itself, and specifically my learned friend said that when Mr Grant said he did not intend to change ranking he said that was not so much the legal effect of the document. But the best expression of what Mr Grant was doing is in supplemental bundle 2 at tab 52, 552, internal pages 137 to 138.

If your Lordships feel that I have time I could show you now. If your Lordships would prefer to look at it later then --

LORD JUSTICE LEWISON: We will look at it in our own time.

MR PHILIPPS: Thank you, my Lord.

What Mr Grant says is that his intention was to make it clear that it in the winding up the securities continued to rank -- above upper tier 2 security was continuing to rank below the senior creditors. That is what one gets from it.

I think yesterday I did take your Lordships back to paragraph 52 and pointed out that my learned friend in fact hadn't read, when Mr Grant was referring to the ceiling, Mr Grant at the beginning of the paragraph had referred to the definition of senior creditors.

My Lords, that leaves me with one point to deal with, which is your Lordship's question in relation to whether the ranking alteration was within the scope of the power under clause 12. And I think I should just

open up bundle 3, tab 41 at page 728, which is clause 12(a).

If I can make the point before taking you to the language. This provides that any amendments to the notes can be made by extraordinary resolution, and it reserves certain matters which can only be amended by extraordinary resolution. It's the first two lines, the procedures memorandum:

"Provisions for convening meetings with noteholders to consider matters in relation to the notes ..."

And it's these words:

"... including the modification by extraordinary resolution of any provision of these conditions."

It then talks about the forum.

LORD JUSTICE LEWISON: Do we need to know anything about the procedures memorandum?

MR PHILIPPS: No, my Lord. That's just the procedures for passing an extraordinary resolution. The point your Lordship asked me was, does the --

LORD JUSTICE LEWISON: Yes. And you say any conditions would include relative ranking.

MR PHILIPPS: Absolutely. And my Lords, what you see is that the providing "however", up to a reserved matter identifies certain matters that can only be amended by extraordinary resolution.

I am not saying to your Lordships that the ranking is a reserved matter. But it does fall within any matter.

LORD JUSTICE LEWISON: Yes. Then you go on presumably to say a resolution in writing signed by all noteholders takes effect as if it were --

MR PHILIPPS: As if it was. Precisely, my Lord. It is a mechanism. It did apply. It could have applied. So the answer to your Lordship's question, done properly, is yes.

My Lords, unless I can assist your Lordships further those are our reply submissions.

LORD JUSTICE LEWISON: Thank you very much.

Submissions by MS HILLIARD

MS HILLIARD: My Lady, my Lords, the priority dispute here is between the PLC Sub-Debts and the PLC Sub-Notes.

The PLC Sub-Debts were three simple facility agreements, with PLC as borrower and LB Holdings as lender, to which LBHI now has title by way of assignment.

The investment structure that underpinned the issue of the PLC Sub-Notes is more complicated, and for that reason it's deserving of some brief attention in order to understand the provenance of the Sub-Notes.

First, GP1, the appellant. GP1 is the general

partner of five limited partnerships, although we're only concerned here with limited partnerships 1 to 3. The Limited Partnership Agreements for each of the limited partnerships are at bundle 4. 53 is for the first limited partnership. 4/54, with a supplemental agreement at 4.55, and that's in relation to the LP2. And the third Limited Partnership Agreement is at 5/56.

LORD JUSTICE LEWISON: I confess I haven't opened any of them.

MS HILLIARD: I mean, move me on if you want to --

LORD JUSTICE LEWISON: If I need to look at them of course I will, but I'm just telling you I haven't.

MS HILLIARD: I think it probably is worth looking at them, not in a huge amount of detail, but I think it does help to put in context the particular construction issue which we're involved with.

So the Limited Partnership Agreements, and they are dated 22 March 2005.

LORD JUSTICE LEWISON: So you want bundle 4.

MS HILLIARD: Yes, bundle 4 at tab 53, for LP1. You only really need to have a look at one Limited Partnership Agreement because they're all in materially the same terms.

So you have the general partner, LP Number 1 Limited; Chase Nominees Limited, who we will see is the

Initial Limited Partner; LB Investment Holdings Limited, a preferential limited partner. And then Lehman Brothers Holding Plc is guarantor, and Lehman Brothers Holdings, you will see, is joined for the purposes of giving an undertaking. We'll look at that in more detail as we go along. And the LP1 agreement is at tab 53.

The recitals provide:

"Whereas the general partners agree to become the general partners, preferential limited partners agree to become a limited partner."

And:

"The Initial Limited Partner being a nominee for the ...(Reading to the words)... depository of European ...(Reading to the words)... agreed acting principal, become a limited partner in a limited partnership to be formed under the Limited Partnerships Act in accordance with the terms and conditions set out in this agreement."

Then you will see that the guarantor and LBHI are not to become partners. Then you have the definitions and in particular you have schedule 2. If one goes to schedule 2 at page 1162, you have the definition of Initial Limited Partner, which is Chase Nominees Limited. You have definition of holder immediately

above, which provides that in respect of each preferred security each person registered on a register as the limited partner holding such preferred security. And then over the page at 1164 you have the preferred capital contribution, and that means:

"In relation to the preferred securities, the aggregate contributions to the assets of the Issuer being a whole multiple of €1,000 paid in cash by the holders."

Then you have the preferred securities:

"The outstanding fixed rate to CMS linked guarantee non-voting, non-cumulative ...(Reading to the words)... securities of the Issuer originally issued on the closing date in the principal amount of €200 million, each such security representing the interest of the holder."

So that is the ECAPS that stand behind the limited partnership. Then over the page you have the definition of subordinated guarantee, which means:

"Subordinated guarantee in respect of the preferred securities executed by the guarantor."

And that was the guarantee that was the subject of a consent order whereby those with the benefit of the guarantee agree that they were subordinated --

LORD JUSTICE LEWISON: This is what the judge called

Claim E.

MS HILLIARD: Yes, exactly.

And then subordinated notes means:

"Fixed rate ...(Reading to the words)... subordinated notes originally issued on the closing date in the principal amount of €200 million by UK Holding [that is PLC] and held by the Issuer [that is GP1] as initial partnership assets or any eligible investments which are held by the Issuer as partnership assets thereafter."

So if one goes back to page 1128 you have the commitment, which is defined as:

"Any amount of capital contributed to the Issuer and any amount of capital agreed to be contributed by any partner to the assets of the Issuer pursuant to clause 4."

Then 1129. Partner means:

"General partner, the Initial Limited Partner [so Chase Nominees who are going to be holding ECAPS] the preferential limited partner or any other general partner of the Issuer."

And partnership assets means:

"The assets of the Issuer from time to time and includes but is not limited to the name of the Issuer, capital contribution, commitments, the subordinated

notes or any of the ...(Reading to the words)... investments."

And then over the page at clause 2 you have the formation of the Issuer. And clause 2.4, 1131:

"The business of the Issuer should be to raise and provide finance and financial support to the guarantor and PLC and its group. In carrying on such business the Issuer shall ...(Reading to the words)... acquire the following ...(Reading to the words)... Subordinated notes."

Then over the page you have the identification of the partners, who include the initial limited partner. And then we can move on to clause 4.

LORD JUSTICE LEWISON: Just in a couple of sentences, what are we getting out of this?

MS HILLIARD: My Lord, I think what you are getting is at least the design of the investment structure which supported the issue of the notes. Unlike the facility agreement between the LBHI2 Sub-Debt, here we have the Sub-Notes that were purposely acquired by a limited partnership. And at the time -- there was never ever any intention that the Sub-Notes would be acquired by any other party at the time other than GP1 as the general partner of these different partnerships.

And at the same time there was a prospectus

advertising the issue of ECAPS and effectively inviting third party investors to invest in those ECAPS.

So it wasn't entirely discrete to the Lehman Group. There were outside investors that invested the ECAPS knowing that the proceeds of the ECAPS would be used to purchase the subordinated notes.

If one goes to clause 6 we can see the description of the preferred -- actually if one goes to page 114, one sees --

LORD JUSTICE LEWISON: 114 something.

MS HILLIARD: 1140. One sees the reference to capital contributions. Clause 5.1(b):

"The preferred capital contribution to satisfy the commitment in respect of the preferred securities referred to in 4(2) shall be €200 million, such sum to be paid by JP Morgan Chase Bank as common depository for Euro ...(Reading to the words)... Clearstream."

It is anticipated under the limited partnership that 200 million, which has been raised by issuing ECAPS to the market, will be paid into this limited partnership, which in turn will loan or give those monies to PLC in return for the notes.

We say that ultimately that may not make a difference because we say that what do you is you simply construe the two separate instruments.

LORD JUSTICE LEWISON: That's what I would have thought, which is why I'm a little bit puzzled about what this is all about.

MS HILLIARD: Well, I could have just ignored the structure, the investment structure, but in view of what my Lady said at the beginning of the appeal that made it clear that you hadn't even had an opportunity to look at the document, I thought it wasn't, you know, uninteresting or irrelevant that you saw them, so that you could at least see these instruments in their economic context.

If we can just now briefly look at the terms of the ECAPS. They're found in core bundle 3 and they are again in materially similar terms. So if we could look at the prospectus issued by LP1, which is at core bundle 350.

Here, we have 225 million fixed rate CMS-linked guaranteed non-voting non-cumulative perpetual preferred securities. It refers to the subordinated guarantee and the fact application has been made to link preferred securities on the Luxembourg Stock Exchange.

If one looks at the summary of preferred securities and subordinated guarantee and in particular page 894, there is provision for the ranking of preferred securities. And rights upon liquidation. And then on page 895, eligible investments:

"The proceeds raised by the Issuer [ie LP1] of the preferred securities will be used by the Issuer to purchase the subordinated notes."

LORD JUSTICE LEWISON: Sorry, where are you? Page 895?

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: Yes.

MS HILLIARD: And subordinated notes will be issued by UK Holding PLC and will have a maturity of 30 days.

And subordinated notes are defined at page 900 in the same way. This is found in the Limited Partnership Agreement, explaining that they are fixed rate CMS-linked subordinated notes ...

LORD JUSTICE LEWISON: Yes.

MS HILLIARD: We can now look at the terms of the Sub-Notes issued by PLC. They're found also in volume 3, tabs 46 to 47. They're all materially the same so we can have a look at tab 46, which is the issue to LP1. So then we have 225 million of fixed rate CMS-linked subordinated notes due 2035.

LORD JUSTICE LEWISON: This is what the judge called Claim D, is that right?

MS HILLIARD: Yes. And you can see halfway down the page that application has been made to list the notes on the Channel Islands Stock Exchange. And then if one moves forward you can see the definitions, terms and

conditions of the note. And there you have excluded liabilities, page 759, which are expressed to be:

"... and in the opinion of the insolvency office of the Issuer ...(Reading to the words)... junior to the subordinate liabilities in any insolvency of the Issuer."

Liabilities means all present and future sums, liabilities and obligations payable or owing by the Issuer.

And senior liabilities:

"All liabilities ...(Reading to the words)... the subordinated liabilities and excluded liabilities."

And subordinated liabilities means:

"All liabilities to the noteholders in respect of the notes and all other liabilities of the Issuer which rank or express to rank pari passu with the notes."

The definition of liabilities, excluded liabilities and senior liabilities is the same as in the Sub-Debt, which we'll come on to look at. The difference -- and we say, as you will have seen from our skeleton, the material difference is the definition of subordinated liabilities.

Then we have the status and subordination clause at clause 3, that's page 797, which provides:

"The notes constitute direct unsecured ...(Reading

to the words)... obligations to the Issuer and claims of the noteholder against the Issuer rank pari passu without any preference among themselves."

So that's the noteholders relating to this issue of notes.

"The rights of the noteholders in respect of the notes are subordinated to the senior liabilities and accordingly payment of any amount, whether principal, interest or otherwise, in respect of the notes is conditional upon ... "

And then we have a provision which is really materially the same as in relation to PLC under the LBHI2 level. So "accordingly" appears three times. And because we're in an insolvency process:

"Payment of any amount in respect of the notes is conditional upon the Issuer being solvent at the time of and immediately after such payment. And accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that the Issuer could make such payment and still be solvent."

Then (c):

"For the purposes of condition 3B above, prior to insolvency of the Issuer ...(Reading to the words)... to the insolvency of the Issuer by the auditors and on or after insolvency of the Issuer a report ...(Reading to

the words)... any relevant time as to the insolvency of the Issuer by an insolvency officer in each case in a form and substance acceptable to the FSA."

And that shall be:

"... in the ...(Reading to the words)... and treated and accepted by the FSA, the Issuer and the noteholders as correct and sufficient evidence of the Issuer's solvency or insolvency."

As I say, those notes were listed on the Channel Islands Stock Exchange. And at page 813 you can see that at the time of this circular LP1 had already agreed to purchase the notes. Page 806 refers to the fact that the notes will be issued initially in global form. And 807 describes how the proceeds of the notes are to be used, which is to strengthen the regulatory capital base of the group, to pay off existing loan and for general corporate purposes.

And as we have seen, these notes were purchased by LP1 with the proceeds of the issue of the ECAPS, the prospectus that we just looked at.

The PLC Sub-Debts are found at volume 3, tabs 423 to 425. We only need to look in detail at the first one. Interestingly they're for the same amounts as in relation to the LBHI2 Sub-Debts: 4.5 billion, 3 billion, and then 8 billion. I don't know why that was,

particularly, those figures.

The first Sub-Debt Agreement, as I say, is at tab 44. I don't think we need to look at it in any real detail because it's in exactly the same terms materially as -- there are slight differences but I think for our purposes they're in the same terms as in relation to the LBHI2 Sub-Debts.

LORD JUSTICE LEWISON: You want the one at tab 44. We started off at 43 but --

MS HILLIARD: 43.

LORD JUSTICE LEWISON: Right. These are all Claim C.

MS HILLIARD: These are all Claim C. And at page 755 you have the definition of excluded liabilities, which as I say is the same as Claim A, and also we see exactly the same definition in Claim D. The same definition of liabilities in Claim D, the same definition of senior liabilities in claim D, but the definition of subordinated liabilities is different.

And here the definition of subordinated liabilities means all liabilities to the lender in respect of each advance made under this agreement.

So whereas Claim D -- and we will come on to this in a bit more detail in a minute, but whereas Claim D admits of the possibility of liabilities ranking with it on a pari passu basis, Claim C says nothing about that.

Subordinated liabilities, when one's dealing with Claim C, is solely those liabilities in relation to that instrument.

My Lady, my Lords, Mr Beltrami made a number of introductory points about the subordination analysis that the court is required to undertake. We echo most of those points at our appeal and in particular what we say is, first, that the task is one of contractual interpretation and contractual application. Second, that the instruments all have to be interpreted according to their words.

Factual matrix is largely irrelevant, firstly because, as I think my Lord, Lord Justice Lewison, observed, these were negotiable instruments where the scope of the factual matrix is attenuated in any event. And further, the fact that the instruments under consideration were created to raise funds to provide regulatory capital, that in our submission takes the task of interpretation nowhere in circumstances where it's common ground that no one within the Lehman organisation ever gave any consideration to where these instruments ranked between themselves.

The judge at first instance found at paragraph 161 that Mr Miller's evidence was not legally relevant for the purpose of construing the LBHI2 Sub-Notes.

Likewise, we say Mr Miller's evidence is not legally relevant for the purposes of construing the PLC Sub-Debts and the PLC Sub-Notes.

LORD JUSTICE LEWISON: Is there perhaps a tension between your point that the factual matrix is largely irrelevant on the one hand and your reference to the fact that no one within Lehmans gave any thought to relative ranking?

MS HILLIARD: Well, it means that there were, if you like, no extraneous facts that one could take into account for the purposes of construing the particular instruments, because if no one gave any thought to it we are left with the language.

LORD JUSTICE LEWISON: I see. A sort of negative point.

MS HILLIARD: Yes.

And third, we echo Mr Beltrami's submission that Rule 14.12 of the Insolvency Rules is not, as I think LBHI would like to persuade you, is not some sort of principle of construction. We say that the rule only applies where construction runs out. There may be at the end of the day a very thin veneer or layer between when you can construe the parties to have agreed a pari passu ranking and when the construction doesn't take you any further, because there is just a complete circularity, a continuous loop.

But our submission is that you have to carry through the construction exercise first, and don't -- which I think my learned friend Mr Phillips would invite you to do -- don't immediately go to a pari passu conclusion, applying Rule 14.12. You may reach a pari passu conclusion, and we say that's possible, but we say you could do it with construction. You don't have to just leap for Rule 14.12 as providing the answer.

My Lady, my Lords, GP1's grounds for appeal are in volume 1, tab 12. They are very short. It's readily apparent from those grounds that our appeal is essentially that the judge erred in not giving full consideration to the words of the instruments being construed, and specifically the Sub-Notes.

Put shortly, the Sub-Debts do not, in terms, expressly provide for any other debt ranking at a pari passu level with them. The Sub-Notes do, in terms, expressly provide for debts ranking at the same level as them. And the oddity of the judge's conclusion, and that's at paragraph 356, his conclusion was that that definitional difference between the two instruments made no difference to the outcome, the outcome being that of a pari passu ranking. And he reached that conclusion even though neither instrument C

nor instrument D expresses itself, in terms, to rank pari passu with the other, and the possibility of a pari passu ranking is only acknowledged by the terms of one instrument, Claim D, the PLC Sub-Notes, and not the Sub-Debts.

Further, although the judge expressly found in paragraph 356 of his judgment that Claim C is subordinated debt and is not expressed to rank pari passu with the notes, he overlooked that Claim D admitted the possibility of another claim ranking pari passu without there being any expression of such a ranking being a competing instrument.

Then somewhat extraordinarily, having found that Claim C is subordinated debt and is not expressed to rank pari passu with the notes, he then went on to find that Claim C did indeed rank pari passu with the notes.

So in short, what we say is that a key part of the judge's reasoning as to why the instruments do rank pari passu is that they do not rank and are not expressed to rank pari passu.

We say this is a very strange result derived, we say, from the cursory attention that the learned judge gave to the question that he posed at paragraph 356, which is: is Claim C a liability of the Issuer ranking or expressed to rank pari passu with the notes? And he

answered that question in only two lines in paragraph 356. He said:

"Given that Claim C is subordinated debt and is not expressed to rank pari passu with the PLC Sub-Notes, this definitional difference makes no difference to the outcome."

LORD JUSTICE LEWISON: There's a bit of "now you see it, now you don't", though, isn't there? Because let us suppose that, leaving aside the terms of the instruments, two claims do rank pari passu. The definition of subordinated liabilities in the notes says, well, if they do rate pari passu they don't, because we are subordinated to them.

So it's a very odd concept, isn't it? On the one hand they are and they do rank pari passu, and on the other hand they don't.

MS HILLIARD: Well, we say that Claim C doesn't rank pari passu. That's the whole point.

LORD JUSTICE LEWISON: Well, yes, but suppose that there was a claim which did rank pari passu with the notes. According to the literal interpretation of the definition of subordinated liabilities, it wouldn't. But it does.

MS HILLIARD: Well, no, because the definition of subordinated liabilities is both expressed to rank

pari passu and does rank pari passu, so --

LORD JUSTICE LEWISON: But that's the point. If it does rank pari passu, how can it be subordinated? How can notes be subordinated to it if it does in fact rank pari passu.

MS HILLIARD: Well, they wouldn't in those circumstances. The notes wouldn't be subordinated --

LORD JUSTICE LEWISON: But that's not what the definition says.

MS HILLIARD: -- but it's necessary to also look at the other instrument. So I mean, if for example, in this case, D admits of a possibility of a pari passu ranking but actually when you construe C that doesn't admit of a pari passu ranking because the only subordinated liabilities under Sub-Debt C are those under that particular advance, and the only time that the pari passu ranking comes in is when you have to consider the Sub-Debts, the individual Sub-Debts, together.

And what breaks the circularity -- and we accept that. What breaks the circularity in that event is the statutory rule of pari passu.

But as we'll come on to explain, we say that the pari passu statutory rule doesn't actually have to be invoked in construing the debts in the notes in this case.

LORD JUSTICE LEWISON: I understand that. If the instruments themselves show a relative ranking. Then you don't get to Rule 14.12. I understand that.

MS HILLIARD: Yes.

LORD JUSTICE HENDERSON: Equally, Rule 14.12 is part of the whole background to the whole question of construction.

MS HILLIARD: Yes.

LORD JUSTICE HENDERSON: I'm slightly puzzled. I know it's not the principle of construction but surely on any view it's a highly relevant part of the background against which all these instruments are created?

MS HILLIARD: It's relevant when you get to the point where you can't construe the instruments any longer and you run out of rope, as it were.

LORD JUSTICE HENDERSON: Well, why is it only relevant at that point? I quite see it provides a tie-breaker when you get stuck. But I mean, it just -- you are placing a lot of stress -- and I quite understand why -- between the difference of the two definitions of subordinated debt.

MS HILLIARD: Yes.

LORD JUSTICE HENDERSON: But if it's really just pointing to something which is a commonplace, namely that the default rule anyway is pari passu ranking, does it really bear all that weight?

MS HILLIARD: If you let me develop my argument.
LORD JUSTICE HENDERSON: Of course.
MS HILLIARD: In relation to the pari passu wording of D, and where we come out to as to where C sits, there is perhaps a very, very thin, you know, paper thin difference between electing for the Rule 14.12 and construing it in a way in which we say it can be construed. But we still say that that's relevant. One has to have a consistency. And when you come on to see, there is no consistency, with the result, we say, that D ranks above.
LORD JUSTICE HENDERSON: Thank you.
MS HILLIARD: What we say, as I say, is that the judge really didn't grapple with or explore the fact that the two instruments are different. He just said it makes no difference. And what we say is that if he had the grappled with the language he would have concluded that Claim D must rank above Claim C. But before we get on to the language of Claim C and Claim D it's necessary to remind ourselves that in construing subordination agreements such as these a borrower's agreement with its creditors can only identify where the creditor is to be placed in the waterfall, the creditor can't relegate another creditor lower in the waterfall if the latter creditor has not agreed that outcome with the borrower.

So where a borrower agrees with two different lenders, where in the waterfall they rank, there are three possible outcomes as between those lenders. And we set that out at paragraph 33 of our skeleton.

First, claim X may provide that it ranks somewhere below claim Y in the waterfall. Claim Y in turn may provide that it ranks somewhere above claim X. And in those circumstances there will be a consistent statement of ranking across the two instruments and there's no difficulty. So in that instance Y will rank above claim X because they both independently agreed with the borrower where they should rank.

The second example is that claim X may provide that is ranks somewhere below claim Y but claim Y doesn't say that it's to be subordinated to claim X. And this was the judge's principal 2 that he identified at paragraph 198 of his judgment where he concluded that Claim A ranked below unamended Claim B.

In that case there's still no inconsistency, X treats Y as senior, Y doesn't treat X as senior both, and those statements can be true if X ranks behind Y. There's no need to break any circularity or resolve any inconsistency in that case because the terms of the instrument dictate the outcome.

Then the third possibility is that claim X may

provide that it ranks behind claim Y and claim Y says the same thing about X. And that's the position that we have seen in relation to claims A (i) to (iii). There's a straight inconsistency, the propositions can't both be true, and that's where you have to bring in a way to break the circularity and Rule 14.12 does it.

My Lord, Lord Justice Lewison, was asking on Monday about what tool is available in the law's armoury to deal with that inconsistency or circularity which is caused in the third example. There are three candidates and we say that the first two don't work and the third is to be preferred.

The first option is the default Rule under 14.12.

LORD JUSTICE LEWISON: The first one is default rule?

MS HILLIARD: Yes -- well, the problem with that solution is that it begs the question, the two instruments are only subordinated to the same senior creditors once it's been decided that the other instrument is not to be treated as a senior creditor for its purposes. And in this context I should address a comment by my Lord, Lord Justice Henderson, who cautioned against referring to the default rule because the rule reflects the starting point rather than the end point. And my Lord is of course correct, but it must be recalled that it's common ground in this case that there has been some degree of

subordination in all these instruments. The pari passu default rule that otherwise applies in an insolvency has therefore been displaced to some extent and certainly between these instruments and the general body of unsubordinated creditors.

The question is therefore at what point does the contract run out so that one has to revert to that default rule.

The second option is to treat the subordination provisions as ineffective between the two instruments when they present inconsistent results. But as my Lord, Lord Justice Lewison, put it on Monday, the problem is that they are not ineffective, they are too effective; it's the effectiveness that leads to the impasse problem. If they were not effective they would not be a problem and treating them as simply ineffective therefore again seems to begs the question of why they are ineffective.

So the third option that we would commend is a policy one. It was a point that we ran below in the context of a slightly different debate which arose following the circulation of the draft judgment. The concern there was that the solvency conditions, if they were to be given a separate life, might prevent payment of any dividends under the instruments even when they

were otherwise due. And our policy argument is this: in a winding up process it's necessary for the company's assets to be distributed so its affairs can be wound up and the company eventually dissolved. And as a matter of policy the parties can't by contract evade the operation of the Bankruptcy Laws. I mean, that is Lord Justice James in ex parte MacKay. It wasn't in the bundle, my Lord, but it is now in the bundle of authorities at tab 85 but I think probably it's generally accepted that that's the principle.

Lord Cross in the majority of the House of Lords, and we may want to turn that up, that's at bundle authorities 5, tab 87, Lord Cross in the House of Lords in British Eagle. At page 779E Lord Cross said:

"British Eagle then points out that even though there may be nothing in the Companies Act which deals expressly with a case of this sort the Court can always refuse to give effect to provisions in contracts which achieve a distribution of the insolvent's property which runs counter to the principles of our insolvency legislation."

And he cites ex parte Mackay. So he records with apparent approval the submissions that the court can refuse to give effect to provisions in contracts which achieve a distribution which runs counter to the

principles of insolvency legislation.

Of course those principles include the distribution of a company's assets pari passu upon a winding up. At 780F Lord Cross rejected the submission that such a power is limited to cases where the parties' dominant intention was to evade the statutory scheme and therefore disregarded the contractual mechanism for the clearing house arrangements then in issue because they had to yield to the general liquidation. That's at 780H to 781E.

While subordination provisions per se are not now considered necessarily to fall foul of those principles, there is no suggestion that those principles do not continue to be good law. So if the effect of the parties' contractual bargain is that neither can submit a proof in the insolvency until the other one has, and that any more junior creditors can't be paid either, that would be an agreement, in our submission, that even inadvertently prevents the proper operation of Insolvency Rules and should not be enforced to that extent.

In that event the rules of pari passu distribution will be applied to prevent a situation arising whereby the affairs of the company can't be finally wound up because of an impasse and the company can't be dissolved

because of an impasse created by the contracts made by different parties with the same insolvent debted company.

So the application of the pari passu rule in that instance is not applied because the pari passu rule automatically applies in that instance but it applies because without applying that rule the company's affairs can't be finally wound up. So it's a policy-driven solution.

LORD JUSTICE LEWISON: I mean, it's not entirely easy to understand the juridical basis for this. Let us suppose that a loan is made on the terms of one of the Sub-Debt Agreements. At its inception there is nothing wrong with that, nothing at all. Perfectly legitimate method of subordinating the debt to other liabilities. And were the borrower to enter insolvency the court would give effect to that clause. The problem only arises because another one comes along with exactly the same subordination provision.

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: So it's not a case, the sort of British Eagle case of an agreement trying to circumvent the insolvency regime, because neither of them do, I mean, it's the interaction between them that causes the problem.

MS HILLIARD: That's why we says it's inadvertent. There's no deliberation about it. As things have panned out because there's two agreements that create this circularity, if the companies' affairs are going to be finally wound up there has to be a solution found. And the solution is --

LORD JUSTICE LEWISON: Disapply.

MS HILLIARD: Yes.

LADY JUSTICE ASPLIN: So it's inevitably an extension of British Eagle.

MS HILLIARD: Yes, although British Eagle is wide enough to encompass the submission that we are making. The two agreements won't be void but they're just unenforceable to that extent. They are not void, they obviously have effect but they can't be enforced because -- well, they can't be enforced so that a payment is made because of the circularity.

That's why we say the policy solution is the right one because --

LORD JUSTICE LEWISON: So effectively I think that means the judge was right but missed one step in the analysis.

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: Because once you've disapplied the subordination provisions then Rule 14.12 must take over.

MS HILLIARD: Yes. Yes.

LORD JUSTICE LEWISON: Yes.
MS HILLIARD: But once you've recognised that they are unenforceable between themselves.
LORD JUSTICE LEWISON: Yes.
MS HILLIARD: My Lady, my Lords, with that framework in mind, I'm going to now turn to the instruments in this case. And before looking at the instruments individually I want to address you on a point that was made by both Mr Phillips and Mr Beltrami about simple contractual subordination versus contingent debt subordination. This was addressed by us as ground 2 of our grounds of appeal where what we said is that the judge erred in concluding that the subordination clause contained both a simple contractual subordination provision and a contingent debt subordination provision. I think we all agree that something went wrong there. But we submit that on a proper construction of the subordination terms in both instruments they comprised a single contractual subordination term and that the word "accordingly" means no more than consequently or, how I read it, "it follows", it's describing the consequences of the subordination provision at the beginning of the clause.

So as with the case of Claim A, what is either side of the word "accordingly" is the same. Once you've

identified who the senior creditors are, one knows who one needs to take into account for the purposes of meeting the solvency condition.

Moving on from that point, the first question is where does Claim C, we were looking at Claim C in tab 43 of volume 3 page 756, where does Claim C rank itself? So we've looked at the definition of liabilities, subordinated liabilities, senior liabilities and excluded liabilities. So clause 5(1) contains the subordination provision. And clause 5(1) provides that C's claim is subordinated to senior liabilities. C's claim is the subordinated liability, which I've already addressed you on, it's defined as all liabilities in respect of each advance made under this agreement.

So under the terms of C's agreement with PLC a debt under some other instrument can't be a subordinated liability because the only liabilities comprised in the definition of subordinated liabilities in C's claim are those liabilities created by C. More specifically, Claim D is not a subordinated liability because it is not a liability in respect of the advance made under Claim C's agreement with PLC.

So if Claim D is not a subordinated liability as a matter of construction, Claim D is either a senior liability or an excluded liability as defined in C's

agreement with PLC.

Senior liabilities in Claim C are all liabilities except subordinated liabilities and excluded liabilities, and excluded liabilities in Claim C are relevantly defined as liabilities which are expressed to rank junior to subordinated liabilities.

Pausing there, my learned friend Mr Phillips on Monday proceeded on the basis that an instrument can only express itself to be junior to another if it refers to it in terms. We do not accept that premise. For example, an instrument which contained an absolutely unequivocal statement of subordination to all other debt would be expressed to be junior to all that other debt, even without referring in terms to any particular other instrument. Similarly we would say that a debt which is expressed itself to be subordinated to everything but a preferential share is expressing itself to be subordinated to other debts which do not so peg themselves to the bottom of that level of the waterfall, even if the debt that subordinates itself to everything, the preferential share, doesn't refer to loans/other debts.

Although for the sake of argument and to make it simple it is convenient first to consider the analysis as if that premise were right, that you have to refer to

the other debt; in other words, we're going to proceed for now on the basis that an instrument can only express itself to rank junior to another if it refers to the other instrument.

LORD JUSTICE LEWISON: What do you mean by refers to? You mean by identifying the parties or by identifying the category or --

MS HILLIARD: No, the category. We mean expression in terms. So on that basis and still from the perspective of Claim C, the liabilities of Claim D are not expressed to rank junior to the subordinated liabilities. Because first of all Claim D doesn't refer to Claim C at all, which was your point, my Lord, thus Claim D is, pursuant to the terms of Claim C, not an excluded liability and it doesn't express itself to rank junior to the subordinated liabilities.

So according to the terms of C, D is not an excluded liability. So C, according to its own terms is subordinated to D.

It's now necessary to look at the terms of Claim D to see where D ranks itself. That provision we already looked at is at clause 3 and relevantly, at page 797, if you want to look at it, and relevantly clause 3(a) provides the notes, ie the notes which are the subject-matter of that note issued constitute direct

unsecured and subordinated obligations of PLC and the rights of the noteholder against PLC rank pari passu among themselves.

So those were the notes involved in that issue.

Then it goes on to say that the rights of the noteholders are subordinated to senior liabilities and payment of any amount is conditional upon PLC being able to pay its liabilities in full other than the subordinated liabilities excluding obligations which are not payable or capable of being established or determined in the administration and excluded liabilities.

I said before the definitions of senior liabilities excluded liabilities in Claim D are the same as for Claim C.

Claim C does not express itself to rank junior to D. So we know from D's perspective Claim C is therefore not an excluded liability.

However, the definition of subordinated liabilities in Claim D is different from Claim C, and we've seen the definition, it's all other liabilities of the Issuer which rank or are expressed to rank pari passu with the notes.

So within that definition of subordinated liabilities are: one, those claims which rank pari passu

with Claim D; or two, those claims which are expressed to rank pari passu with Claim D.

Claim C does not in express terms express itself to rank pari passu with Claim D. However, even though Claim C is silent on the point, Claim D does provide for the possibility that an instrument could rank pari passu in fact with Claim D. So Claim D doesn't exclude the possibility of Claim C ranking pari passu with Claim D, although C has not expressly provided for that outcome.

So at this point, from the perspective of Claim D, we've whittled the position of Claim C down to two possibilities: either Claim C is a senior liability, or it ranks pari passu with Claim D. But the outcome of treating C as a senior liability is, we say, not one that is sensibly or really available. The claim as a matter of construction -- because for Claim D to treat Claim C as a senior liability would result in both Claim D and Claim C being senior liabilities to each other, creating the endless loop that we saw with claims A(ii) and A(iii).

So sensibly and reasonably one wouldn't wish to construe Claim D as having that effect unless there was no other alternative conclusion. But there is an alternative conclusion. It's not the only option available from claims D's perspective, but it's the

sensible option, because Claim D can accommodate Claim C on a pari passu basis at the subordinated level, a pari passu ranking which is expressly provide for in D's definition of subordinated liabilities.

LORD JUSTICE LEWISON: You have to read the definition though as referring to a claim which but for this definite would rank pari passu, don't you?

MS HILLIARD: No, because what you are looking at is you are trying to rank other subordinated debt according to where D sees them in the waterfall. As I explained, there are two options. Once one has got rid of C not being an excluded liability, there are two options: it would be a senior liability or it would be a subordinated liability. And logically and reasonably why would D -- why would anybody as a matter of construction say, well, C must be a senior liability if it produces the endless loop that is created in relation to A (i) to (iii)? Why would one opt for an endless loop if one could produce the same outcome on the terms of D's agreement with the borrow? And that we can, because D's agreement with the borrower admits of the possibility of a pari passu ranking at D's level.

That, we say, is a more sensible outcome because it avoids the endless loop. C has already ranked D as a senior creditor, so you don't have to worry about C.

What we're talking about is where D would rank C and it doesn't make logical sense as a matter of construction for D to rank C or for the court to rank C at the level of a senior creditor which creates the very endless loop which is so deeply unattractive. We only are driven to an endless loop when there is no other solution and on this occasion there is another solution: D expressly provides for the possibility of an alternative debt ranking at a pari passu level with it.

LORD JUSTICE LEWISON: Then you get into the now you see it, now you don't, because having recognised that possibility D now takes priority over something which would otherwise have ranked pari passu with D. That's why I suggested to you that you might have to read the definitions as if it said: which but for this definition would otherwise rank pari passu.

MS HILLIARD: Well, it's not a now you see it, now you don't situation, because we've already established that C on its own terms has made D a senior liability. So we're only talking about where D is considering it should rank C.

D, by allowing C to rank pari passu, is not subordinating itself to C. The result of that construction is that Claim D is a senior liability according to the terms of Claim C's agreement with PLC.

LORD JUSTICE LEWISON: Yes.

MS HILLIARD: But Claim C is a subordinated liability according to the terms of Claim D's agreement with PLC. As I say, why should as a matter of construction the court conclude that Claim C is a senior liability according to the terms of Claim D's agreement with PLC, when that will create an endless loop when there is an alternative solution, which is Claim C being a subordinated liability pari passu with Claim D? And because Claim C has already elected to treat Claim D as a senior liability Claim D therefore ranks for payment before Claim C.

What we say is this conclusion is consistent with the judge's second principle articulated at paragraph 198 and which I addressed you on when I set out three possible outcomes. The first outcome being it's made absolutely clear, X makes absolutely clear that it ranks somewhere below Y, Y makes absolutely clear that it ranks somewhere above claim X. There's a consistent stage of ranking, no problem. The second example is where claim X provides that it ranks somewhere below claim Y, but claim Y doesn't say that it is to be subordinated to claim X. And that is the second principle that the judge identified at 198 and that the principle that we say applies in this case.

Here, instrument C subordinates itself to a senior debt, D. But the second instrument D does not subordinate itself to C because it does not treat C as a senior liability. The consequence is that C ranks behind D.

In short, Claim C's terms contain an unequivocal expression of subordination, C's terms do not say anything about being subordinated to a level which is pari passu with another instrument. But the same is not true of Claim D. And as a consequence we say that Claim C sees Claim D as a senior liability but Claim D doesn't see Claim C as a senior liability.

LBHI's complaint at paragraph 5 of its skeleton is that because we argue that the pari passu wording in the PLC Sub-Notes means that Claim C and Claim D may result in a pari passu ranking, Claim C cannot rank junior to Claim D. But this is to ignore the fact that when we acknowledge that the wording of the PLC Sub-Notes, that's D, admits of the possibility that Claim C may rank pari passu with Claim D, that is looking at the position from D's perspective. The relevant conclusion and the only relevant conclusion is that D doesn't treat C as a senior liability because to do so would be to create a circularity and, as I say, why would you opt, why would you deliberately create a circularity when you

don't have to when there is another provision in the instrument which avoids that result?

So D doesn't treat C as senior, because C may rank pari passu. But D can't dictate where C ranks by reference to it. Only that C does not rank ahead of it. And in order to find out where Claim D ranks from C's perspective it's necessary to look at the wording of Claim C and Claim C unequivocally subordinates itself to senior liabilities but not to liabilities which are expressed to be junior to the subordinated liabilities.

LORD JUSTICE LEWISON: I understand that, it's though you say whatever may or may not be clear about Claim D, it doesn't express itself to be junior to Claim C or anything in the category of claim C.

MS HILLIARD: Yes, and therefore as regards Claim C, D must rank senior.

LORD JUSTICE LEWISON: Yes. If you express yourself to rank pari passu with something else, you are not ranking yourself junior.

MS HILLIARD: No, exactly. And that's not the same when you are looking at it from D's perspective because D admits of the possibility of a pari passu ranking. So we say that paragraph 29 of LBHI's skeleton is wrong. Paragraph 29 submits that the judge's analysis of the PLC priority dispute was correct because it was

rooted in the fundamental similarity between Claim C and Claim D. I hope I've demonstrated to my Lady and my Lords that the similarity was not fundamental, the key provisions were different and unless you just -- you know, unless we just throw up our hands and just ignore the fact that the provisions were different in this case, then it's necessary to look at them and to try and give meaning to them. But the judge did not try to see where the differences led him as a matter of the construction of the language. On the contrary, extraordinarily, we would say, having concluded that Claim C was not expressed to rank pari passu with Claim D, the judge concluded that Claim C and Claim D did rank pari passu. That's what's so strange. I mean, if Claim D didn't express itself to rank -- how do you get to a pari passu ranking?

Secondly, LBHI submitted that the judge's analysis was correct because, they say, the interaction between the subordination provisions resulted in a meaningless outcome. But, as we've explained, the interaction between Claim C and Claim D doesn't result in a meaningless outcome. If you apply our analysis and our construction, Claim D ranks ahead.

LBHI's also wrong at paragraph 37 of its skeleton argument when it describes GP1's argument that Claim C

is a subordinated liability from Claim D's perspective, because it does in fact rank pari passu with Claim D. That's not GP1's argument. GP1's argument is simply that from Claim D's perspective it will not -- doesn't have to treat Claim C as a senior liability. And that's because it can accommodate it on a pari passu basis. So therefore it doesn't subordinate itself to it. Whether or not Claim C in fact ranks pari passu is not an outcome which is in D's gift. Where Claim C ends up ranking requires a consideration of Claim C's terms and then a comparison of the results.

LBHI is also wrong in its submission at paragraph 39 of its skeleton that it's not open to GP1 to hedge its bets by reference to a tentative pari passu ranking without committing itself either way. Again, and I'm sorry if I'm repeating myself in different ways, but again LBHI misunderstands the purpose of this iterative exercise. Claim D doesn't have to commit itself to ranking pari passu with the Sub-Debts. However, the fact that Claim D on its own terms can tolerate a pari passu ranking with the Sub-Debts has the consequence that Claim D, unlike Claim C, doesn't treat Claim C as a senior liability. And that's what we are saying at paragraph 21.2(3) and (4) of our skeleton. And LBHI's skeleton is no answer to it.

LORD JUSTICE HENDERSON: Can I come back to a point I was putting to you rather prematurely about half an hour ago, which is I'm a little troubled by the weight which this possibility of a pari passu ranking is being asked to bear bearing in mind that that's anyway the default position and of course one can always envisage another instrument which just expresses itself to rank pari passu with something else, that is really just a statement of the obvious, so just admitting that as a possibility, how can that really be sufficient, as it were, to make all the difference?

MS HILLIARD: Well, it doesn't make all the difference but we are left with Claim D with two options: a senior liability or a pari passu ranking with D as a subordinated debt. And all we're saying is that as a matter of construction why would D opt for C to be a senior liability which would create this endless loop?

LORD JUSTICE HENDERSON: In fact that bring one back to pari passu again, doesn't it?

MS HILLIARD: Well, it doesn't have to opt for being a senior liability because on its own terms D has, if you like, a get-out. D allows for the possibility that Claim C can rank itself as a pari passu liability with Claim D. And Claim C doesn't have that effect.

LADY JUSTICE ASPLIN: You are just saying that there is

potential for it.

MS HILLIARD: Yes.

LADY JUSTICE ASPLIN: And it's the more business efficacious construction. That's what you are saying.

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: I'll just try to put it in simple language so even I can understand it. You have an instrument under which somebody lends some money to the borrower and the lender says: well, I will subordinate myself to everything except that which ranks pari passu to me. And then another lender comes along and says: well, I'll subordinate myself to everything. And that's really where you get to.

MS HILLIARD: That's where you get to, yes. And that's not so extraordinary. That's just a function of the terminology. C was happy to go to the bottom of the pile but D admitted of the possibility that it didn't go to the bottom of the pile.

LORD JUSTICE LEWISON: Yes. You can pay your butcher's bill before you pay me because otherwise I will take the divvy to all your creditors. And then your dressmaker says: well, I'll come last.

MS HILLIARD: It's taking me a bit out of my time. But one of the possibilities that we posit in our skeleton is a claim F. Claim F, it's a bit as you describe,

my Lord, claim F comes along, and claim F expresses a flaw to the degree of the subordination, namely that it doesn't want to be subordinated to the same degree as Claim C. Such a term would not offend the principles of insolvency law as claim F would not be seeking to achieve a better outcome in an insolvency than it would have achieved but for the existence of subordination provisions. Prima facie Claim C is already more junior to claim F as Claim C is expressed to be junior to everything. And it wouldn't contradict the terms of Claim C because Claim C on its terms always falls to the bottom of the pile save in respect of debts which are expressed to be more junior still, which claim F is expressly not.

Now, on the other hand, at the same time as claim F is saying: I don't want to be subordinated to the same degree as Claim C, claim F could express itself to be subordinated to all unsubordinated creditors of PLC but to rank pari passu with Claim D. That again wouldn't offend the principles of insolvency law as they relate to subordination because claim F would simply be relegating itself down the order of priority it would have enjoyed but for such a term, and claim F wouldn't be impermissibly to promote itself, nor would it cause any problems with the terms of Claim D because the PLC

Sub-Notes expressly accommodate other debts expressed to rank pari passu at that level. So you could have claim F that says: I want to rank pari passu with Claim D, but I don't want to fall to the level of Claim C. Claim C has already said: I want to be subordinated to everything except that which is excluded.

LADY JUSTICE ASPLIN: So F is not pushing C down.

MS HILLIARD: No.

LADY JUSTICE ASPLIN: C has already taken its position at the bottom of the pile.

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: Right, I think we have that point.

MS HILLIARD: So we say that because claim F can express itself, without contradicting either Claim C or D or the insolvency principles, as ranking ahead of C, but alongside D, that means that D must rank ahead of C, using that sort of hypothetical example.

Now, LBHI seek to answer this hypothetical debt point at paragraphs 49 to 50 of their skeleton. They posit a Claim G, which expressly ranks itself junior to Claim C and senior to Claim D. Our submission is that Claim G doesn't provide any answer to the example that we give --

LORD JUSTICE LEWISON: I'm sorry, which paragraph --

MS HILLIARD: This is paragraphs 49 to 50 of LBHI's skeleton at volume 1, tab 19, page 303.

LORD JUSTICE LEWISON: Yes, I see.

MS HILLIARD: LBHI seek to answer this hypothetical debt point, they posit Claim G, which expressly ranks itself junior to Claim C and senior to Claim D. But Claim G, in our submission, doesn't provide an answer to the example that we give of claim F. If Claim D is senior to Claim C and Claim C is junior to Claim D, Claim G's terms have clearly resulted in a meaningless expression of subordination and it would be a matter for the court to determine whether G should be ranked junior to C or above Claim D in that instance.

However, the fact that Claim G, the terms of Claim G creates difficulties in ranking G in that instance does not result in our hypothetical at claim F not serving as an analytical tool to test the ranking of Claim C and Claim D as between themselves. And that's all it is, that's is all Claim F is. We are using it as analytical tool to test the ranking. We say that it's actually an inappropriate analytical tool because it demonstrates that C does rank below D.

This is a convenient point to relax the expression in terms approach and to rerun the analysis by looking to see whether C or D do express themselves to be more

junior to the other despite not referring to each other in terms. This is a much shorter exercise because of the analysis that we have already done. The conclusion that we draw is that C still ranks below D. We start again with Claim C, it's subordinated to Claim D unless Claim D expresses itself to be more junior still. To consider whether Claim D expresses itself to be more junior still one needs to consider the terms of Claim D and that's not reading the instruments conjunctively but looking at the terms of D when C requires one to. The problem is that when asking what Claim D expresses about its ranking, it's obviously necessary to refer back to Claim C because Claim D asks amongst other things whether Claim C expresses itself to rank junior.

Now, absent some logical tool to cut through the exercise, there is a never-ending jumping back and forth between the terms of the two instruments. But there is a logical tool to cut through the exercise which effectively imposes an answer we came to on the express in terms approach, that is to recognise that when one asks whether from D's perspective C is expressed to rank junior, there can only be two answers: yes or no. If the answer is yes then C is not a senior liability from D's perspective, and D is not subordinated to C.

If the answer is no, then from D's perspective that

might be because C is pari passu or senior but, as we've seen already, it would be absurd to posit the senior outcome as that leads to circularity which would revert to pari passu. From D's perspective, the worst case outcome is that C ranks pari passu, it expressly permits that outcome. So why as a matter of construction would one not be drawn to that outcome?

So when C asks whether D expresses itself to be junior to C, the answer is no. D views C as at worst equal to it. It does not accommodate an outcome where C is senior. And it doesn't depend on where you start. Start from D. D asks whether C expresses itself to be junior or not. Again via the same process D concludes that C either expresses itself to be junior or pari passu but it will therefore either be an excluded liability or a subordinated liability, never senior. Again, to construe Claim D in a way that treats Claim C as senior is to impose a circularity in the outcome which Claim D does not require there to be.

Short but sweet. Perfectly formed I would say. The main thing to bear in mind, my Lady and my Lords, is that there is an inconsistency, but C ranks D above it.

LORD JUSTICE LEWISON: Yes. Your main complaint about the judge is he didn't dive into the definition.

MS HILLIARD: No.

LORD JUSTICE LEWISON: He just ignored it.
MS HILLIARD: Yes, and the definition must mean something.
LORD JUSTICE LEWISON: Yes, all right. Thank you, Ms Hilliard. Who is next? Ms Tolaney.

Submissions by MS TOLANEY

My Lord, Deutsche Bank's case is that in a proper interpretation of the two sets of subordination provisions, like my learned friend Ms Hilliard, the PLC Sub-Notes have priority. That case arises only if your Lordship does not accept Ms Hilliard's textual analysis and argument. So the premise of my case, which I think is the same premise that Mr Phillips has, and indeed was the basis on which the judge approached it, is that the two sets are circular, the two sets of provisions are circular, and on their face the circularity needs to be resolved.

LORD JUSTICE LEWISON: We are to assume that they each rank each other senior.
MS TOLANEY: That's right. Read literally. So, my Lord, the structure of my submissions is that I'm going to start with a brief overview of my case and then I'm in your Lordships' hands, I can either address the issue of permission, because Mr Phillips takes a point that I don't have permission to advance this argument, or I can deal with the question of permission after

I've developed the argument, I'm entirely in your Lordship's hands.

LORD JUSTICE LEWISON: I think we had better see how the argument goes. Because I think you are trying to rely on it simply as an aid to construction of the instruments.

MS TOLANEY: I am, that's right.

LORD JUSTICE LEWISON: Whether that is permissible because it's particular background material which wouldn't necessarily have been known to the reasonable reader is a different question, but I understand that that is the way you want to deploy it.

MS TOLANEY: Indeed, my Lord. The short point is that the way the judge approach this argument at first instance was to address the question of the parties' subjective intentions, based on the evidence he heard. That was not a case that the bank ever advanced. It was evidence given by a witness, I accept that, but it wasn't advanced by us in opening or indeed in closing. Our case was and remains that objectively on terms of the debt structure one can see in this circumstance an intention which aids construction and it's an objective intention, it's nothing to do with that the parties agreed.

LORD JUSTICE LEWISON: I understand that but this is prayed

in aid of the priority of Claim D.

MS TOLANEY: It is.

LORD JUSTICE LEWISON: Which is the notes tradeable.

MS TOLANEY: It is.

LORD JUSTICE LEWISON: So you have to get your particular dividend stopper agreement into the --

MS TOLANEY: Tradeable notes. I understand that. I understand and I will address that. It's a difficulty, I accept. But it's one that I think on the facts of this case may be that exceptional case where you can do that, even though the instrument is a tradeable note.

LORD JUSTICE LEWISON: Right.

MS TOLANEY: My Lord, the starting point is that the judge did not in fact ever engage with this argument. And that was surprising because he actually said no authority was cited to him, and in fact the same line of authorities that we have cited in our skeleton on this appeal was cited both in opening and in closing to him.

In essence what we are saying is that there is a clear and objective indication as to what the parties would have intended had they turned their minds to the point. And that's apparent from the contractual debt structure. I will come on to develop that but can I make four points in brief summary by way of

an overview and then I will develop it.

The first point is that the PLC Sub-Debt was an intra-group liability that was settled by way of book entry. In contrast, the PLC Sub-Notes were part of a back-to-back funding structure involving securities which you've been shown briefly, the ECAPS, and the ECAPS, just so your Lordships knows, is an acronym for enhanced capital advantage preferred securities.

LORD JUSTICE LEWISON: Say that again.

MS TOLANEY: Enhanced capital advantage preferred securities. That's what the ECAPS stands for.

The crucial point is that these were issued to external investors, including Deutsche Bank, by partnerships controlled by LBHI.

My Lord, I'm raising my voice to outdo the scaffolding. If it gets too loud please tell me.

LORD JUSTICE LEWISON: Sorry about that.

MS TOLANEY: The short point is that the payments due under the ECAPS could not be paid unless PLC made the regular payments due under the PLC notes. I will show you that, but that was the funding structure.

So effectively PLC's payments under the Sub-Notes funded the distributions under the ECAPS.

The second of my four points is that under the terms of the ECAPS LBHI undertook not to pay any dividends or

repurchase any stock if any of the regular payments were not made under the ECAPS. That's the dividend stopper.

For your Lordships' note, that is addressed in our skeleton at paragraphs 42 to 45 and I will come back to it.

The judge described the dividend stopper in an unchallenged finding at paragraph 366(6) of his judgment, which I will show you in a moment. What he said was that it was a commercial incentive on LBHI to ensure that PLC could pay all sums payable under the Sub-Notes. He recognised at subparagraph (5) of the same paragraph of his judgment that there was a strong commercial incentive because triggering the dividend stopper would have been extremely damaging to the Lehmans Group.

The third point is that under the express terms of the PLC Sub-Debt, this is the point you've been addressed on this morning, all other subordinated debt had to be either senior or junior. As Ms Hilliard has been explaining. What we say is that having agreed by the express terms against the background of Rule 14.2 that provision, the only possible conclusion is the parties intended to change the outcome that would have applied under Rule 14.2. So the debt was either junior or senior, it was not to be pari passu. And that much

one can see from the parties' intentions.

The fourth point, and this is one point where Mr Phillips and I agree, the subordination provisions in the Sub-Debt and the Sub-Notes were intended to and did operate in a solvent situation. And that was at the time of every payment under each instrument.

So the for PLC to make regular interest payments under the Sub-Note to fund the payments due under the ECAPS PLC had to be able to satisfy the solvency condition to that payment. So when interpreting these instruments the court should have in mind the possible commercial consequences of any possible interpretation in a solvent situation not just an insolvent, because that, we submit, would give a real clue to what the parties would have intended had they addressed their mind to the point.

What we draw from those four points, which I'll develop, is that first of all each of those points would have been known to the parties to the PLC Sub-Notes, that's PLC as the issuer and the LBHI-controlled partnerships as the subscribing noteholders. That may be relevant to the fact that this is being implied into notes as to whom the noteholders were and what the purpose of the structure was, which I'll come on to.

The second point one can take from it is that

1 therefore, from the perspective of the reasonable
2 objective person in their position, what they would have
3 intended had they thought about the relative priority of
4 the Sub-Notes and Sub-Debt, was first of all, as I've
5 said, the intention appears to be that the Sub-Debt
6 would rank either senior or junior, those being the only
7 options on the terms of it, and we say they would
8 plainly have intended the Sub-Notes to rank senior,
9 knowing that they funded external liabilities, the
10 failure to meet those liabilities triggering
11 a disastrous scenario with the Lehman Group, and in
12 particular had they been ranked pari passu PLC's ability
13 to pay the Sub-Notes even outside insolvency would have
14 been competing with its very substantial intra-group
15 liabilities to LB Holdings under the debt.
16 Just to put that in context, the total amount that
17 could be drawn under the debt facilities was 3 billion
18 and 12.5 billion with a floating interest rate that
19 could vary significantly. So why put at risk the
20 triggering of the dividend stopper by putting them into
21 competition with that sort of internal Sub-Debt?
22 So that's the case in a nutshell and obviously I'll
23 have to develop that and make that good.
24 Just standing back and looking at what the judge
25 did, the judge, rather than seeking to resolve the

conflict in circularity by seeking to determine as a matter of contractual interpretation which of the two sets of provisions prevailed, effectively, we submit with respect, just abandoned any process of construction. He almost accepts that in his judgment. He says no authority was cited to him and he accepts it's a fairly novel approach. We submit that the one thing the judge should not have done was that. Even if he'd reached a different outcome he had to go through a process of contractual interpretation. And the reason he appears to have done what he did was a misunderstanding that the pari passu rule was some form of default. But that's just not right.

As you've heard from both, I think, Mr Beltrami and Ms Hilliard, the pari passu rule is simply a rule of distribution, it provides for the claims of creditors with the same right to payment be treated equally but it doesn't determine whether the two creditors have the same right to payment in the first place. So it's only a default in the sense that it operates unless there's a contractual agreement and I think Mr Phillips accepted that, it's not a default, it's not a tiebreaker, the contract trumps, so you have to say there's no contract before you get to that position, and you have to interpret the contract before you can get to that

position.

What we say is that the judge properly interpreting the contract, whether or not he followed the approach that we are advocating, the one thing which he did which was, we say, unacceptable was to ignore the express terms. That's because we say that he arrived at the one conclusion that's precluded by the parties' agreement, namely that the Sub-Debt couldn't rank pari passu with any other debt issued by PLC. I think Ms Hilliard was developing that point.

So we say if you take that as the starting point on the express terms, his result, or at least the way he went about it, was wrong, and we submit that that's a clear indicator, and then the question is junior or senior, and we say that can be discerned not on the words but looking at what the parties would have intended. The line of authorities we rely upon is the Bromarin line, and, my Lord, I'm going to take the court to my Lord, Lord Justice Lewison's book which sets out all the relevant extracts and one case, and essentially, as the court will know, this is where the parties on their face haven't actually provided for the scenario, the court then, I think, as it's put in one of the cases, doesn't just throw up its hands, it looks to find what the parties would have intended as best it can.

That's not to say the court has to rewrite the contract, it's not to say that the parties' irrelevant subjective intentions can come into play, and it's not to say that the court can always do it. But at least it's a process one should try to engage with, and that is what we are suggesting to the court.

We are saying that the judge's approach should actually just be set aside because he didn't engage with this process and actually he appears to have analysed this argument on entirely the wrong basis.

So can I show your Lordships quickly the authorities and then I will come back after lunch to develop my --

LORD JUSTICE LEWISON: Just a thought goes through my mind, bearing in mind that Mr Beltrami yesterday was describing the details, as it were, as mechanism, I mean there are cases which say that where a party's machinery fails a court can step in. That's not quite the same principle as working out what the parties would have decided if they'd thought about it, but it's maybe a related principle, a sort of Sudbrook v Eggleton-type case.

MS TOLANEY: I can see that, my Lord.

LORD JUSTICE LEWISON: Sorry, it may be another red herring, just as bad as Kemp v Neptune Concrete. But it's a thought. Anyway, where are we going?

MS TOLANEY: Can I refer first to my skeleton.

Paragraphs 28 to 32 is where the principles are set out. For your Lordship's note, I don't think we should turn it up, this was all set out at first instance and one can see that in the first volume of the supplementary bundle tab 11 at paragraph 166 onwards. So it was all there at first instance.

LORD JUSTICE LEWISON: Sorry, I was looking at wrong skeleton. Which paragraphs?

MS TOLANEY: 28 to 32 of the appeal skeleton. That's in the core bundle at tab 18. The key propositions are as follows. First, where there is an event or circumstance that is not contemplated in the parties' contractual agreement judging from the language of the contract, if it is clear what the parties would have intended, the court will give effect to that intention. That's the citation from Lord Neuberger's judgment in Arnold v Britton, which follows on from the Bromarin line, and obviously we emphasise the words "would have" because obviously the premise of this is that the parties did not.

The second point which follows on is the question of whether or not the event or circumstance was contemplated is to be judged from the language of the contract. So it's not concerned with whether the

parties subjectively failed to contemplate the relevant circumstance. What matters is that the court is faced with a situation for which objectively the contract fails to provide and that is why the court is engaging in this exercise.

I will just pick up that point because my learned friend Mr Phillips mounts an attack on the application of the Bromarin principle on the facts of this case. For your Lordships' note, in his skeleton argument, which is at tab 19 at paragraphs 68, he says you have to look at whether the particular event was unforeseen at the relevant time, namely when the contract was made, which we agree with provided that is an objective exercise, not a subjective, and if you look at paragraph 69 of his skeleton the test changes to whether the event was unforeseeable, which we say is not the right test.

So the fact that he predicates his submission on saying, well, obviously the parties must have foreseen or it was foreseeable that the FSA Standard Form point he make and that this scenario could have happened, that's not the right test. On the face of it the test is: did the parties cater for the situation? And if the words don't appear to suggest they did, that's when you look at what they would have done. So that's why we say

the principle applies here.

LORD JUSTICE LEWISON: What strikes me as odd, it's just my own reflection, is that the FSA didn't see this problem when they were promulgating their standard form.

MS TOLANEY: I think that's because it doesn't matter to the FSA how subordinated debt ranks amongst itself. That's I think why. I think as long as it's within the tiers, they accept and they don't mind what happens in the ranking at the bottom. That's the understanding.

The third point, my Lord, is if the principle is engaged then as an objective exercise the court's task, as this court well knows, is to identify from the terms of the contract and the admissible factual matrix what the parties would have intended. And obviously the judge made various comments about what the admissible factual matrix was. Now, I am not trying to pray in aid facts and matters known from discussions that were had or that type of factual matrix, I am actually looking at part of the back-to-back funding structure, so the ECAPS was a back-to-back structure with the notes, and that's the matrix I'm looking at.

Can I just ask your Lordships to look at authorities bundle 4, tab 73, which is an extract from my Lord, Lord Justice Lewison's book, it may be unnecessary for my Lord, Lord Justice Lewison, to look at it, but this

sets out the extracts from the various cases on the point and it may be helpful if after lunch I can just show you the Munich case, which is the last case cited. It may be that you would prefer just to cast your eye over these two pages.

LORD JUSTICE LEWISON: Yes, you needn't read it aloud. (Pause). How much do you want us to read?

MS TOLANEY: If you could cast your eye other the Bromarin principle and then over the page, 2.119, the Nagel case, which I think my Lord, Lord Justice Henderson, is familiar with, and then finally the Munich case.

LORD JUSTICE HENDERSON: I was at one stage, yes, thank you. (Pause).

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: I was going to show you either now or after lunch, I'm in your Lordship's hands, the Munich Capital case. It should have been added to your Lordships' bundles at tab 85.

LORD JUSTICE LEWISON: Shall we do this after lunch. I imagine it's going to take more than a couple of minutes.

MS TOLANEY: I think it will.

LORD JUSTICE LEWISON: 2.00.

(The short adjournment)

(2.00 pm)

MS TOLANEY: My Lords, I was going to take you to the Munich case, which is at bundle 5 of the authorities, tab 88.

My Lords, the case concerned the interpretation of a reinsurance policy and the issue was the correlation, if you like, between the terms of the insurance policy and the reinsurance policy. And essentially you can see from paragraph 1 of the judgment that it was Ascot reinsuring Munich Re in respect of Munich's liability under the underlying insurance policy.

And the underlying insurance policy provided cover for a project period and then for a lower level of cover for a maintenance period, and the project period was to run for a fixed period of time; the maintenance period was then to run for a 12-month period after the expiry of the project period. And you can see that from paragraph 15.

LORD JUSTICE LEWISON: Sorry, which paragraph?

MS TOLANEY: Paragraph 15. You see here the "project period" and the "maintenance period", and it's the wording of the maintenance period that is particularly crucial.

The reinsurance policy, which is governed by English law, incorporated all the terms of the underlying policy, and if you look at paragraph 2, the last sentence, you can see that it was common ground that it

was intended to be back-to-back with the insurance policy. But when the project overran, Munich Re agreed to extend the project period under the underlying insurance policy but, in error, failed to correspondingly extend the terms of the reinsurance policy. You can see that from paragraph 3.

The competing arguments are essentially that Munich Re said that even though it had failed to extend the project period under the reinsurance policy which had expired, it benefited from the maintenance period, reading the clause literally. And Ascot argued that despite the literal interpretation the maintenance period had not begun upon the expiry of the project period as it said, because it had been intended by the parties that it would only cover the maintenance after the end of the construction period. Which had happened.

And the relevant clause you can see set out at paragraph 30. And over the page, maintenance period. The question was, when did the maintenance period begin, given the literal wording but given the background to the contract?

And at paragraph 50, the judge held, understandably, that the maintenance period, read literally, supported Munich's argument but that she was not persuaded nevertheless that the construction was right.

And the judge, if one goes back to paragraph 43, under the heading "The law", reached her conclusion based upon the case law that she set out, Arnold v Britton and Chartbrook.

Obviously at paragraph 18 she puts the well-known proposition that the worse the drafting the more ready the court can be properly to depart from the natural meaning. And at 19 she refers to -- 19 of the citation, this is.

LORD JUSTICE LEWISON: 19 is in the quotation from --

MS TOLANEY: It appears to be in the quotation from Arnold v Britton.

LORD JUSTICE LEWISON: Arnold v Britton, is it?

MS TOLANEY: It is. At 19 she makes the point that commercial common sense is not to be invoked retrospectively.

LORD JUSTICE LEWISON: I think that is Lord Neuberger's point.

MS TOLANEY: That's right. I beg your pardon. Lord Neuberger makes the point; the judge relies on it.

I just highlight that because that's not what I'm doing. If one drops down, commercial common sense is only relevant to the extent of how matters would or could have been perceived by the parties, or reasonable position in the parties' place as at the date of

the contract.

Now, that's the territory I say I am in. And I will show you why.

Mrs Justice Carr, as she then was, cites at 45 her conclusion from what the court is to identify, and says:

"Meaning has to be assessed in light of the natural and ordinary meaning of the clause, any other relevant provision of the contract, the overall purpose of the clause and the contract, the facts and circumstances known or assumed by the parties at the time the document was executed, and commercial common sense."

Then at paragraph 48 onwards, she says:

"Given the issues arising on the facts of this case, it's helpful to refer to two further authorities specifically dealing with the exercise of contractual interpretation in changed factual circumstances, against the background of Arnold v Britton."

And here she cites the Bromarin case, and also the Nagel case.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: That leads her to the conclusion that the literal reading, despite it being clear on its face, isn't right, because, as she says at paragraph 51:

"Clause 21 falls to be construed in circumstances not objectively envisaged at the time that the parties

entered into the reinsurance policy."

And she relies on what was objectively contemplated. Then if one also looks at paragraph 53 to 55. (Pause).

The judge went then on in paragraph 56 to look at the commercial context, which she regarded as important. And if I could just refer your Lordships to paragraphs 57 and 66. (Pause).

LORD JUSTICE LEWISON: So just to see what she's actually doing. So we have project period. That's in paragraph 15, I think, is it?

MS TOLANEY: That's right.

LORD JUSTICE LEWISON: The relevant definition.

MS TOLANEY: That's right.

LORD JUSTICE LEWISON: It attaches on 1 March 2011. Cover until 30 March 2014 but not beyond 30 September 2014. And she said at 67 it did not expire on 30 September 2014.

MS TOLANEY: That's right, because an extension was given under the insurance policy, which was then not mirrored in the reinsurance policy. So the point was that under the insurance policy the project period carried on, but under the reinsurance policy it had expired, and therefore the maintenance period kicked in under the reinsurance policy even though that didn't mirror what was happening under the insurance policy.

LORD JUSTICE LEWISON: So in practical terms she has excised the words "not beyond 30 September".

MS TOLANEY: That's right. And she did that, one can see, based on, for example, paragraph 51, on the objective understanding that the insurance policy was mirroring the reinsurance policy and essentially that they were part of a wider contractual structure, rather than literally construing the words in the reinsurance policy.

LORD JUSTICE LEWISON: Does that go a bit further than the previous cases? Lord Justice Sedley, in the bit quoted in the book, says you have to be creative with the words.

MS TOLANEY: That's right.

LORD JUSTICE LEWISON: That's not being creative with the words, that is striking out the words.

MS TOLANEY: But I think in a sense that is what she's envisaging, because the premise is that the words don't say what the court is going to do. And that's where we get into the theoretical objective intention, because you are ascribing an intention the parties never really had.

But the reason this case is significant is not just because it goes beyond. It shows in a back-to-back commercial contractual situation, where you can glean

an understanding from contract A about what was supposed to happen with contract B, you should look at it as part of a picture, having in mind the commercial consequences. And here the commercial consequences were that it would be nonsensical to have the period kicking in of the maintenance when the project was still on foot.

Now, in our situation we know that's nonsensical to have a never-ending loop, and there is a back-to-back contract that one should have a look at to see which out of the two was envisaged to be senior.

LORD JUSTICE LEWISON: Whose intention are we looking at --

MS TOLANEY: In the --

LORD JUSTICE LEWISON: -- for the purpose of this argument?

MS TOLANEY: The parties to the Sub-Notes. And I'll come on to show you that the parties to the Sub-Notes were well aware of the dividend stopper and the terms of the limited Partnership Agreements, and that's why you can ascribe intention to them. And I will also come on to why in fact their notes isn't relevant in this case.

So shall I move on, then, to show you the facts I rely on. The starting point is the ECAPS. The ECAPS are the holders of the Sub-Notes of which GP1 is the general partner. The background to this, my Lord, is that PLC, part of the Lehman structure, wanted to

raise money from external investors for tax and regulatory reasons, to reduce the internal debt. And there were different benefits under the US and UK regimes. I think that's common ground.

LBHI set up the three partnerships with GP1 as the general partner, as Ms Hilliard has explained. The partnerships then issued the ECAPS to the external investors, and the partnerships then used the money raised to buy the Sub-Notes from PLC. So there's a back-to-back structure, the purpose of which is to get some external funding in and hold the monies in a way that gives tax benefits.

The Sub-Notes were only ever intended to be issued by PLC to the Partnerships, so they're all Lehman entities. So although these are notes listed on the Channel Islands Stock Exchange, they were listed for tax purposes, and for all real purposes they are an internal structure used to fund tradeable securities, being the ECAPS. So the PLC notes are an internal, essentially, Lehmans construct.

LORD JUSTICE LEWISON: You say they were listed for tax purposes. Is there evidence or a finding to support that?

MS TOLANEY: Well, I will show you the terms of it, because what you can see from the terms of the notes is that

they had to be tradeable but then if they were traded they were immediately replaced on the same terms. That, we deduce, is for tax reasons.

So the idea was to provide a funding mechanism. And because they were only ever intended to be held within the Lehman group, we say for these purposes your Lordship can not regard them as third party negotiable instruments for the purposes of looking at construction. That's why we say that you can construe it in this way and imply a term, whereas I understand that usually in tradeable notes one would be quite reluctant to do that. That is the point of distinction.

LORD JUSTICE HENDERSON: The terms contemplated that they might be sold to third parties, albeit that they were going to have to be replaced with something similar.

MS TOLANEY: Exactly.

LORD JUSTICE HENDERSON: Isn't this rather against you, because that does contemplate them going outside the Lehman Group?

MS TOLANEY: I would say that, but I would also say that was a construct as much in itself because they had to be contemplated to be tradeable to get the tax benefits, is my submission. There is no evidence they were traded, and if they are traded they would then immediately have to be replaced on the same terms.

LORD JUSTICE HENDERSON: But doesn't the point that the notes would then -- in that situation they would go outside the Lehman Group and that therefore must, one might think, inform the approach to the construction?

MS TOLANEY: I fully accept --

LORD JUSTICE HENDERSON: You are not suggesting this is a sham or anything like that?

MS TOLANEY: I'm not suggesting it is a sham, but I'm suggesting that because of the reasoning behind setting them up, and when looking at the terms being something that one can't construe easily, one can see that first of all they weren't in fact ever traded out of the group. The purpose of them was not for them to be traded out of the group. I absolutely accept that the terms suggest it was possible for them to do so. But the fact that they then had to be replaced on immediate terms, identical terms, supports my case that this was a structure put in place for tax regulatory reasons. And therefore the relevant knowledge and/or intentions, as my Lord Lord Justice Lewison said, is of the holders to the notes. And the prospect of bringing in third parties' knowledge, we submit, is actually less relevant on the facts of this case.

If you are against me on that --

LORD JUSTICE LEWISON: I should say, I share my Lord's

scepticism, first of all because as he rightly says they were tradeable notes, and secondly because the intention of the Lehman entities not to trade them outside group sounds suspiciously like subjective intention. So ...

MS TOLANEY: I wasn't taking it as subjective, I was taking it as objective, because the structure of this construct was only to fund the ECAPS. So there would have been no purpose in trading them out of the group. So I'm not relying on a subjective intention, I'm relying on the objective structure looked at as a whole.

And in any case, even if you were looking at it from the perspective of them being traded out, it wouldn't make any sense, in the interests of noteholders who might acquire the notes, to construe the Sub-Notes as junior. So even if you did take into account the intentions of a possible third party, looking at this structure with the dividend stopper, we would submit, which would be relevant to anybody buying the Sub-Notes, they would assume, we would suggest, that they wouldn't be inferior to internal Lehman debt.

LORD JUSTICE LEWISON: So what, the dividend stopper agreement or the agreement which contains the dividend stopper can pass to a third party via the notes, are you saying?

MS TOLANEY: I think they could have been aware of it

because the third party would see it in the ECAPS offering circular. Can I show you the documents?

LORD JUSTICE LEWISON: Well, maybe I haven't understood the structure, but the notes are separate from the ECAPS.

MS TOLANEY: They are, but they are part of the back-to-back structure.

LORD JUSTICE LEWISON: Yes, we are thinking about what happens if the notes are traded. The ECAPS could stay where they are.

MS TOLANEY: That's right, but the holders of the Sub-Notes, the Sub-Notes being used to fund the ECAPS would probably be aware, we could suggest, because of the back-to-back structure, a bit like the reinsurance policy and insurance policy.

LORD JUSTICE LEWISON: Anyway, you wanted to show us something.

MS TOLANEY: Yes. Core bundle 3 at tab 50. I think Ms Hilliard showed you this this morning.

LORD JUSTICE LEWISON: Tab 50.

MS TOLANEY: Tab 50. This is the ECAPS offering circular. If one starts with the investment considerations, and over the page you see the reference to distribution and capital --

LORD JUSTICE LEWISON: Where are we?

MS TOLANEY: I was just showing you the heading "Investment

considerations" at 889. Then over the page within that section is "Distribution and capital stopper".

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: And that's at page 890. If you then go over the page to 891 you see the Issuer is LB UK Capital Funding LP. And you see at the bottom of the bullet points that the Issuer's principal assets will be the subordinated notes, the PLC notes.

And at the bottom of that page you see the use of the proceeds. You can see the structure of this, being the funding for the Sub-Notes.

On page 892 you see the distribution rate definition. And if you could read the first two paragraphs, please. (Pause).

Then drop down to the paragraph that starts:

"The holders will be entitled to receive distributions only if the Issuer ..."

If your Lordships could read to over the next page. (Pause).

So from this you can see that distributions were payable annually but only if the Issuer has received sufficient funds under the PLC Sub-Notes and as long as GP1 has not published a no payment notice.

Then if you go to bundle 4 at tab 53. Keep open bundle 3, please, if can you. This is one of the

partnership agreements. And if you go to 1168 of the bundle the terms are all here. 2.3, for example. You also see in this agreement at page --

LORD JUSTICE LEWISON: What are we actually looking at here?

MS TOLANEY: I was looking --

LORD JUSTICE LEWISON: This is a schedule which does what?

MS TOLANEY: -- at page 1168. And this will show you the underlying terms in the Partnership Agreement that I have shown you in the offering circular, the terms of the preferred securities.

LORD JUSTICE LEWISON: Sorry, I'm not quite there. 1162 --

MS TOLANEY: 1168.

LORD JUSTICE LEWISON: 1162 starts with a schedule to terms of preferred securities. That is the part of the document we are looking at.

MS TOLANEY: That's right, and that is the attachment to the Limited Partnership Agreement.

LORD JUSTICE LEWISON: And the preferred securities are the ECAPS.

MS TOLANEY: Yes. So this is just showing you the underlying terms annexed to the Partnership Agreement, which also contains at 1155 the dividend stopper by way of an undertaking of LBHI.

Going back to the offering circular, which was in bundle 3, that we were just looking at, you also see

that advertised, that distribution and capital stopper, at page 893.

Then I should show you at 895 the eligible investments point, which, as I have accepted, shows that these could be traded but has the clause that they will be substituted on identical terms.

And the limited partnership agreement containing the dividend stopper was available for inspection to anybody buying the Sub-Notes.

LADY JUSTICE ASPLIN: Sorry, could you say that again?

MS TOLANEY: The limited partnership agreement was available for inspection to anybody buying the Sub-Notes.

LADY JUSTICE ASPLIN: Thank you.

MS TOLANEY: So that is how they would have known about the dividend stopper.

The upshot of this structure was that LBHI had to ensure that regular payments were made under the ECAPS or else it would be forced to suspend its whole dividend and stock repurchase programme for a full year until after the regular distributions resumed.

If one looks at the judgment at paragraph 366, the judge recorded a number of these points in findings that are unchallenged by both sides.

LORD JUSTICE LEWISON: Just a moment. (Pause).

MS TOLANEY: Page 462 of the bundle.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: And he records that distributions will be made only if the Issuer has received sufficient funds under the PLC Sub-Notes. He records the no payment notice. And he records that it was that discretionary nature of the obligation to pay distributions which enabled the tax benefits.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: He then records the Partnerships constituted by Limited Partnership Agreements to which LBHI was a party. And he records in subparagraph (5) the damaging consequences if the dividend stopper had been triggered.

Then over the page his finding that one can imagine the lengths that LBHI would go to to avoid triggering the dividend stopper and that this would act as a kind of commercial assurance to the ECAPS holders that the distributions would in fact be made.

Pausing there, the distributions come from the Sub-Notes.

And if you drop down to the end of subparagraph (6):

"The whole point of the dividend stopper, as I see it, was to create a commercial incentive on LBHI to ensure that PLC could pay."

Now, just while I'm in the judgment, the judge then

drops down at 368 -- and I'm going to come back to the judge's approach, but obviously he criticises the arguments on the basis they bear no reference to the terms of the instruments themselves, and he says he will consider them. In fact, he doesn't then go on to consider the bank's argument but rather considers the impact of the evidence he heard, which is a different argument and I'll show you that in a moment.

LORD JUSTICE LEWISON: There are two ways you might put this argument. One is to use it in support of Ms Hilliard's construction. But at the beginning of this section of your submissions you asked us to assume that she was wrong about that and that there was a circularity between claims C and D.

So are you disavowing reliance on the dividend stopper argument as an additional prop for Ms Hilliard's argument or not?

MS TOLANEY: Ms Hilliard's argument relies just purely on the terms themselves not having a circularity.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: To the extent she needs a commercial reason for her construction, then obviously the dividend stopper would assist. But the way she has argued it is that she doesn't.

LORD JUSTICE LEWISON: No, I understand that.

MS TOLANEY: So the answer is that the argument in its primary form arises if there's a circularity and one needs to look at what the parties would have intended. I think your Lordship's point is that the parties' actual intention could also be relied on as informing the construction.

LORD JUSTICE LEWISON: Yes. Does it enable us to -- or does it help us to choose between the rival interpretations or does it come into play after we have considered interpretation and come to the conclusion that there is a circularity? That's really my question. Or is it both?

MS TOLANEY: I think it could be both, my Lord. And perhaps whichever one would win.

LORD JUSTICE LEWISON: That is, if I may say so, a typical advocate's response.

MS TOLANEY: I think the answer, my Lord, is that, strictly speaking, if your Lordship can see a commercial intention that informs the actual words used and you accept Ms Hilliard's construction with a different definitions, then yes, of course this would inform that argument.

It also, however, informs a separate argument, which is if you consider that the words used simply don't give the solution and you have to look for something else.

And what we say is -- and this isn't just a commercial argument; this is what the parties must have intended because it is commercially sensible -- it is more than that, because it is in a back-to-back structure, which I am not sure the judge gave any credence to, but once you understand that the only way the PLC notes could pay the ECAPS dividends and the non-payment of the ECAPS distributions, so called, would be catastrophic, you would understand why you would prioritise the payment of the notes over what was about 25 billion of internal debt. If it came to it. Because why would you keep it competing?

And that may give a clue to why the wording is what it is. So you are right, that could give the actual intention. Or if the wording is nonsensical, that would be the sensible choice to make, as indeed Mrs Justice Carr in the case I showed you did, because it doesn't make sense. First of all, we know it can't be pari passu, is the truth, looking at the wording and the very fact there is a contractual agreement.

The only way the judge got to pari passu -- and I will show you this -- is through two mechanisms:

He got to it, one, because he approached it from entirely the wrong perspective. And I will show you. He looked at the tranches of the Sub-Debt and then

applied the same reasoning. And the two don't go across. And I will show you that.

But secondly, and more colloquially, he got to it by just saying the contract is hopeless.

And your Lordship may conclude the contract is hopeless, but it would have to have been having gone through the exercise of saying the contract is hopeless and we can't ascertain from the words and/or the objective circumstances what the parties would have intended, so we essentially abandon the contract.

And that's what the judge didn't do. He treated it as if it was another option when it really wasn't another option. It was: the contract doesn't work.

So my Lord, can I just show you what the judge actually did --

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: -- and why he got to his conclusion and why it's wrong. The relevant section of the judgment is paragraphs 151 to 154. What the judge is dealing with here are the sub-tranches of the same debt.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: So it's Claim A(i), (ii), (iii), all of which were in materially the same terms. And what the judge did was to essentially say at paragraph 152 that it was all circular because they're all in the same terms and

1 therefore he couldn't break the circle.
2 And what he then does in paragraph 155 onwards is
3 essentially conclude -- and the conclusion is at
4 paragraph 250, page 421 -- that it's all meaningless.
5 LORD JUSTICE LEWISON: Yes.
6 MS TOLANEY: And he says it's because, in 249, you can't
7 work through an interpretative approach.
8 Now, in relation to the tranches of the Sub-Debt,
9 the three tranches, there was no need to go down that
10 route, because if you go back to the definition of
11 subordinated liabilities -- this is in the LBHI2
12 agreement, and it's at bundle 3, tab 38, page 676. So
13 you have here the individual tranches of the same
14 Sub-Debt, the LBHI2 debt. And what you see in this
15 clause is the words "all liabilities to the lender in
16 respect of the loan" et cetera.
17 Now, the word "lender" causes no difficulty when you
18 read it across the three tranches of the same debt,
19 because it's the same lender. And it would be true of
20 any future lender because it includes any permitted
21 lender. The word "agreement" is not separately defined.
22 But looking at the ordinary meaning of the words you
23 could happily construe "agreement" as including the same
24 three tranches under the same debt.
25 It's not a stretch to say that each tranche of one

debt is covered by this agreement. There is a contractual interpretation, because you wouldn't be construing the word "agreement" when you are looking at three tranches of the same debt in a vacuum. You know the other two tranches exist, or could exist.

LORD JUSTICE LEWISON: Well, you do now, but you construe it at the date of the agreement.

MS TOLANEY: But you know it could exist if they were going to -- they could have had future tranches.

LORD JUSTICE LEWISON: Future tranches. Would they not be different debts?

MS TOLANEY: They would be different debts but under the same agreement between the same parties, essentially. And that's the crucial point. If the judge had looked at: it was a permissible construction as a matter of commercial common sense to say for the purposes of this it's not circular because this agreement can be read wider to encompass the other tranches of the same Sub-Debt between the same parties on materially identical terms issued for the same purpose, and therefore it was possible to reach a conclusion that they ranked pari passu, other than simply saying, "None of it works; I'm going to set it all aside".

He could have at least engaged in that process. He didn't. What he did was simply say: because they're all

the same and it's the same tranches, it doesn't work; therefore it's pari passu. And he then moved over, for the same reasoning, it doesn't work, to claims C and D.

And what we say is that that was wrong because there was a commercial construction, whether it's Bromarin or actual words, that could have made that work in a sensible way.

The same isn't true -- just to take the point out the play -- isn't true as between the Sub-Debt and the Sub-Notes, because obviously you have different parties. And so the same analysis doesn't work in relation to C and D.

So we suggest that first of all the judge just didn't engage in even the process. Your Lordship may not agree that that's the right answer, but it was obviously commercially sensible that you looked at the three different tranches of the same debt and saw whether the agreement, properly read, could be construed to mean all of them.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: And he didn't do that. He just simply in a sense put up his hands and said, "It doesn't work; it's meaningless, and because this is meaningless everything else is meaningless, so it's all pari passu".

And Ms Hilliard has already addressed you on why we

say that reaching pari passu as between the notes and the debts in D is wrong because actually the express terms, if they do anything, indicate that pari passu wasn't what the parties intended. And at least the judge should have engaged with that.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: My Lord, coming back, then, to the dividend stopper. Your Lordships have heard my argument as to why we say it's relevant and how it comes into play. I fully accept that one might say, well, I understand the dividend stopper, I understand all the commercial consequences, but why does it affect the ranking in the Sub-Notes/Sub-Debt? That's the question.

And the answer to that, on my case, is that first of all it's not two unconnected contracts. They are a back-to-back structure. So it's obvious that you would look at it all in the round together.

Once you approach it -- and everybody would have known about that. I have shown you the documentation. That is how it was put together.

Once you approach it from the perspective of the back-to-back structure, having regard to that really quite strikingly unusual commercial incentive and the structure of it being to ensure that the notes would be paying through to the ECAPS, you do understand that, if

nothing else, the parties wanted to make sure that the notes paid the ECAPS. That must be right.

That leaves you then with the third step, which is that if you have a situation, which I suggest we do, where the notes and the debt have to be either junior or senior, pursuant to the parties' express agreement so far as it goes, then it's obvious that had the parties addressed their minds to it, and given that commercial undertaking in place, they would have wanted to ensure that the notes took priority over debt -- they are both subordinated; no one is shying away from that -- but the notes would take priority over the debt because any other conclusion would be irrational. And one has to look at it when they were solvent.

LORD JUSTICE LEWISON: But if the borrower was solvent, why would it matter?

MS TOLANEY: Because the dividend stopper was so crucial that -- let's say for any reason payment couldn't be made under the notes and debt. They wouldn't have wanted to trigger having to pay the debt at the same time as the notes, on a cash flow basis or any other basis.

LORD JUSTICE LEWISON: One would have thought that if they couldn't pay the distributions they were insolvent.

MS TOLANEY: It's not just the -- the solvency test requires

them to pay everything. So they could have had -- and I'm coming on to this; this meets my learned friend's point over the timing. They needed to be able to pay everything. So they could have been solvent on a cash flow basis but not on the solvency test basis, which was what the trigger was here.

LORD JUSTICE LEWISON: Oh, the cash flow or balance sheet point, yes.

MS TOLANEY: Exactly. So that's why we say that when you look at that it isn't Deutsche Bank simply saying, "Here's a commercial reason, therefore you must construe". There is actually an absolute link in the structure, and it was put together on that basis.

And nobody is saying that the parties discussed this or formed this view and that's what the terms say. What's being said here is that the parties -- this is on the premise that the parties didn't discuss it, but you can draw their intention from the back-to-back contract.

And I would say, my Lords, putting aside the question over 'does it help Ms Hilliard's argument?', in this scenario you have the judge's approach, Mr Phillips' approach and my approach, all of which require you in a sense to try to impose a solution.

I'm going to come on to Mr Phillips' approach, because he's saying that his approach is either

a purposive construction or an implied term for pari passu.

The judge is saying there's no contract.

So all three approaches recognise that there's a problem that has to be resolved. And Deutsche Bank's approach is the only one that says, well, here's the contractual structure, and you can see how it was set up, and there's a good commercial reason why, if you had to pick between the Sub-Notes and the Sub-Debt, the notes would rank senior.

And that was actually In LBHI's own interests, as the judge recognised.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: My Lord, can I then address the criticisms of my arguments made by Mr Phillips. They are at paragraph 61 of his skeleton argument in tab 19 of core bundle 1.

LADY JUSTICE ASPLIN: Sorry, could you repeat that?

MS TOLANEY: Paragraph 61. It's at page 308.

LADY JUSTICE ASPLIN: Thank you.

MS TOLANEY: I have been told by my junior that I said 25 billion for the Sub-Debt. In fact my maths is wrong and it's around 15 billion.

So at paragraph 61(i) to (ii), my learned friend suggests that the bank is wrong because the judge

accepted LBHI's case, denying that the commercial incentive identified by the judge required any particular priority.

We submit, irrespective of the fact that we criticise the judge's judgment anyway, we don't think you reach that conclusion. And what he said, as Mr Phillips sets out in paragraph 2 of his skeleton at 61(ii):

"The judge concluded that the overriding purpose of the subordinated debt structure was to provide regulatory capital."

That's in his judgment at paragraph 15. He concluded that the structure of the ECAPS, including the dividend stopper, was driven by tax efficiency. That is at 373, subparagraph 2 of his judgment.

But what we say is that that only explains why there was a dividend stopper in the first place. It doesn't say anything about the commercial incentives created by the dividend stopper.

And one of the reasons that your Lordships need to treat the judge's judgment on the conclusions he draws about the dividend stopper with some caution is this -- and it's probably a good time to show you.

I showed you how he accepted the bank's case as to the dividend stopper and how it came about and its

purpose. What then happened was, he deals with, in section 3(6)(9) of his judgment -- that's at page 464 -- he deals with the evidence.

I'm not suggesting that your Lordship has to read the whole of this, but if one just goes through the pages to 467.

LORD JUSTICE LEWISON: He didn't think much of Mr Katz.

MS TOLANEY: He really didn't. His evidence was very roundly rejected. I don't shy away from that.

What you can see in paragraph 2 of 373 is that what the judge didn't believe was the suggestion Mr Katz made in his oral evidence for the first time that there had been an actual discussion about the ranking. And you can see that in subparagraphs (2) and (3) and (4) as well. He insisted that there had been discussions.

What I can show you, but I won't turn it up unless your Lordship wishes to see it, is that in the written opening submissions of the bank and the written closing submissions of the bank the case that was put by the bank is the one I'm putting to your Lordship. It's an objective exercise, on the basis that there had been no agreement as to it.

But the judge didn't deal with that case, and it was very clearly set out in the closing that it was not a case supporting the suggestion of actual intention.

But what the judge deals with in his judgment is the actual intention in the case. And you see that in the conclusion paragraph at 376 that that the dividend stopper argument fails on its facts. And he says that the evidence would go to contradicting or varying the meaning.

And it's not actually clear what clear meaning the judge attached to it. But then he says:

"Factual matrix needs to be treated with some caution."

That was his general comment. And then thirdly he talks about material relating to the drafting history documents.

So what he's dealing with in here is a case that there was an actual discussion, even though it wasn't recorded in the documentary evidence. And he rejects that case. He doesn't deal with the case that I'm putting to you, that this is an exercise of --

LORD JUSTICE LEWISON: You are saying it doesn't matter what Mr Katz says; just look at the document.

MS TOLANEY: And we said so in our closing submissions. The reason why this is relevant is that my learned friend tried to suggest that the judge made certain findings about the nature of the dividend stopper. But the paragraph he was citing as relying on was 373(2). And

in this paragraph what the judge is doing is explaining why he disbelieved Mr Katz's evidence. He's not making a finding that the dividend stopper had no consequences beyond tax consequences. And indeed we've seen that he in fact makes the opposite finding.

Going back to paragraph 63 of my learned friend's skeleton -- I don't know if your Lordship still has that open. That is in bundle 1 at tab 19.

LORD JUSTICE LEWISON: 63, yes.

MS TOLANEY: His next criticism is that the bank relies on a false factual premise that the incentive on LBHI requires Claim C to be payable in priority to D. And he makes two points:

At paragraph 64 he says it's wrong that the notes and the debt were -- we're wrong that we say they were competing, because payments were due on different dates. This is the point I just alluded to.

That point's wrong, because it misunderstands how the solvency condition operates in the PLC Sub-Notes. And your Lordship will remember, we looked at this. It is clause 3A of the Sub-Notes, and it requires -- the solvency test looks at the ability to pay liabilities in full. It's not a cash flow test.

So the issue isn't that there's insufficient cash to make one competing or two competing payments at any one

time. The issue is, at a time when a payment under the notes would otherwise fall due, PLC is contractually precluded from making that payment unless it can satisfy the contractual solvency test. And that looks at total assets and liabilities.

So the actual management of payments is irrelevant. The judge held it was irrelevant at trial and that's why that's not a good point.

The second point that's made is at paragraph 65, that there'd be no competition if the PLC Sub-Debt were a subordinated liability under the Sub-Notes, because they would be excluded by the insolvency test.

And there are two answers to that. The first is that even if it was possible the Claims C to B are subordinated liabilities under the notes, notwithstanding the apparent circularity of the terms, the same isn't true the other way round. That is Ms Hilliard's point. There's a difference in the definition.

And the second point is that the function of the solvency test in these instruments, as I've said, is that no sums are payable unless and until the test is satisfied. And so if the notes and the debts are subordinated liabilities and rank pari passu, then PLC is contractually obliged to make payments under each

instrument without taking into account its ability to pay under the other.

If, on the other hand, the Sub-Notes are a senior liability under the Sub-Debt, then in a liquidity constrained scenario nothing would be payable under the Sub-Debt unless and until there were sufficient assets to pay the Sub-Notes. And that's why there's a competition point.

Then finally, at 71 Mr Phillips suggests there is a linguistic inconsistency. I think that is true of all of us. We are all saying that the express terms require some help.

Can I come on, then, to the problems with Mr Phillips' case, by contrast to what he says are the problems with mine. We can see his case at paragraph 81 in e same document.

What is being said by LBHI is that you can construe the agreements commercially or purposively in order to find that it operates on a pari passu basis. And alternatively, that there's an implied term, although it's not very clear what the implied term would be. And the key difference, we would say, is that we can't discern a purposive construction within the arguments that are put forward.

The reasons that are given are twofold. First of

all it's said at paragraph 80 that the subordination categories in the PLC Sub-Debt and Sub-Note are entirely symmetrical.

Now, that's not right, because we have seen that the definitions are in fact different, and there is no engagement with that. But in any case it is uncertain why the similarity of the definitions would give a pari passu ranking, because as far as we can see they're operating to make each other senior or junior. And on this hypothesis all the provisions do is create a circularity. And it's not therefore clear why that would lead to pari passu by way of a purposive construction.

The second reason, which I think is the main reason prayed in aid, is that the regulatory regime and statutory default favours a pari passu ranking. This is set out at paragraph 82, subparagraph (4) in particular, at page 315.

Now, the judge concluded that the regulatory regime was indifferent to the relative ranking of PLC subordinated debt, because it didn't matter from a regulatory perspective. The only thing that mattered was that all subordinated debt ranked lower than unsubordinated creditors in order to count as regulatory capital.

So it's not clear why the regulatory regime would provide a favouring of pari passu. As I said to your Lordship earlier, I think this morning, that may well be why the FSA standard form doesn't deal with it, because the FSA doesn't have a concern.

It would obviously be open to the parties to specify a pari passu ranking. But they didn't, we submit. And all the statutory regime provides for is that the two debts entitled to prove at the same time rank for distribution pari passu. But that begs the question as to what the parties agreed on subordination. So unless one disapplies the subordination provisions entirely, as the judge did, we don't get to pari passu. And therefore the suggestion that there is a purposive construction that leads you to pari passu, we submit, with respect, is wrong. Similarly(?), an implied term.

Then I think the finale arguments relied on by my learned friend are that it is commercially implausible to suggest that the FSA Standard Form did not permit pari passu ranking subordinated debt. That is at 81(3).

But the answer to that is, well, you have to look at the express terms of this contract, and if there are inferences or commercial reasons why pari passu may have been the right reason, then it's for my learned friend to argue that. But that's not what he's arguing, so far

as we can see, in these paragraphs.

He also relies on some sort of alleged general market expectation -- I think Mr Beltrami addressed this -- that all LT2 subordinated debt would rank pari passu. And Mr Beltrami has outlined why that's not sustainable. And it's not based on any finding made by the judge. We would refer the court to paragraph 161 of the judgment, which seems to be opposite to that.

So my Lords, that's why we say that if you look at the alternative argument you see that there isn't, we would respectfully submit, a purposive commercial construction or a basis for an implied term.

So what you are really left with is the conclusion, and it's a stark conclusion, that even though the contracts are operative and functioning as contracts, the Sub-Debts, the Sub-Notes, the mere fact that the court can't find a solution to the interaction means that the subordination provisions are effectively completely set aside or abandoned.

That's the judge's solution. The only alternative solutions are a textual construction, which means you never get into that, or looking along the Bromarin approach for what the parties would have intended in a scenario they obviously hadn't anticipated or foreseen in express terms clearly enough, and then finding the

solution through the contractual structure.

And the solution I am offering is one that is commercially grounded and falls from the terms that I've shown you.

I have one alternative case which I would just like to take very shortly, which is set out in writing at paragraphs 62 to 66 of my skeleton. And this is our ground 3(a). This case proceeds --

LORD JUSTICE LEWISON: Can I just ask you this: I know you are not involved in the rectification appeal --

MS TOLANEY: No.

LORD JUSTICE LEWISON: -- but the point has been made very forcefully by Mr Beltrami that the question is not what the parties would have agreed but what they did agree. And if you are in the 'what they would have agreed had they thought about it' territory you cannot rectify.

You are saying, well, if you know what they would have agreed had they thought about it, you don't need to rectify; you just apply the contract. Is there a tension between those two positions?

MS TOLANEY: I don't think so, because on rectification what is being said is that the parties actual intended something else and that the court can see from the relevant evidence that that's what was intended across the line and so on and so forth, and therefore the

contract can be rewritten to reflect what was the parties' actual intention.

And for the purposes of rectification, where you strike a line through what it said and put something different in, which is the case that is being advanced, that's the test. What I'm putting forward is different, which is that you have contractual provisions but it is not clear how they are intended to operate on their face. That either the court is then faced with simply striking them out and saying, "We're not going to give effect to this bargain because we don't know how to interpret it", or, which the court has done traditionally, to look at is there an objective inference of the parties' intentions as to what they would have intended in order to make this contract work.

LORD JUSTICE LEWISON: I just had this uncomfortable feeling that rectification is supposed to reach the parts that contracts can't reach.

LORD JUSTICE HENDERSON: Is the important difference in rectification cases the intention you are looking at is a subjective intention and has to be shared?

MS TOLANEY: Exactly.

LORD JUSTICE HENDERSON: That is the point -- a deal cleared up following endless disputes and disagreements about it on that topic, whereas on your argument it is objective

the whole way.

LORD JUSTICE LEWISON: That may be the answer.

MS TOLANEY: That's exactly right.

LORD JUSTICE HENDERSON: So it is only quite a narrow area of ground where one differs from the other, but it does differ in a critical enquiry as to what was actually subjectively in the minds of the protagonists, which is completely irrelevant to any question of contractual construction, including the Bromarin extension.

MS TOLANEY: Exactly. That's right.

There is also one other difference just on the facts of it, which is that Mr Phillips is seeking to change clear wording to mean something different, whereas I'm in a situation where, on a different point, everybody agrees on this hypothesis that one has to work out what it means.

LORD JUSTICE LEWISON: Anyway, ground 3(a).

MS TOLANEY: Ground 3(a). We covered this in writing, and this is a point that proceeds in the alternative on the assumption that contrary to our primary case the judge was right to hold that claims C and D, the notes in the debt, could prove in PLC's insolvency at the same time. So it proceeds on that hypothesis.

And where we disagree on that hypothesis with the judge is that it doesn't follow, even if they can prove

at the same time, that they would be able to be paid out in the same time.

And why that is is that there is a separate question of whether the contractual conditions to payment of each debt have been satisfied at the second stage of the analysis, which requires a solvency test to be applied.

So putting that a little bit more clearly, I think, than I have just done: the first stage of the analysis was to consider when in time the two debts could prove. And the judge said pari passu.

That's not the end of the question because the next stage then would be, and this is a conceptually different stage, whether the conditions to payments of each of the Sub-Debt or the Sub-Notes had been fulfilled. And then that requires looking at the solvency test within each instrument.

And if you look at that second stage in that way, Claim C would qualify as a subordinated liability under the notes because it ranks pari passu. But Claim D would not qualify as a subordinated liability, because of the different definition. And so the contingency under the PLC Sub-Debt would not be satisfied unless PLC could pay Claim D in full, which it can't, but the contingency in the note would be satisfied without taking into account Claim C. And so the upshot is that

Claim D would have to be valued at zero for the purposes of distribution.

I beg your pardon, Claim C would have to be, sorry, (inaudible) the debt.

My Lord, I think that only leaves me, on the first of my two arguments, with any residual point on permission. And the short point is that, as I have shown you, the judge dealt with a completely different argument.

LORD JUSTICE LEWISON: We had better have a look and see what the judge said.

MS TOLANEY: I have shown you that the argument that the judge addressed was an argument as to whether the parties actually agreed the ranking. And there is then a debate at a hearing. Can I just show you this. I am sorry to do this but the order itself, we would say, is very confused. So I have to go through the transcript, which isn't ideal.

The transcript is in supplemental bundle 2, tab 58. The relevant page of the bundle is 620. It starts at page 207 in the internal numbering.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: The debate had been over appealing in relation to the dividend stopper, but there was a mismatch because obviously the bank's argument was an objective

argument, and the judge found as to subjective. And the judge was saying to my learned junior Mr Fisher that the order would contain an effort at both the positive and negative side of things. Line 11.

LORD JUSTICE LEWISON: Page 207.

MS TOLANEY: That's right. Top right-hand corner. And he says:

"Whilst I do consider that it is for the Court of Appeal to decide what is a construction point and what isn't, it is for me to decide whether the dividend stopper, as I framed it in my judgment, goes forward. And I'm making clear it does not.

"Now, there may well be means by which the material which at the moment is addressed under the heading dividend stopper can be regarded as a construction argument. That is a matter for the Court of Appeal."

And then if one drops down on page 208 to line 4, he says:

"I have taken the view that most of what you call dividend stopper argument isn't construction, but if you want to say on appeal that it is, that is a matter which you can run as a matter of construction. And it is for the court to say what is and what is not within the Arnold v Britton test."

Then if one drops down to line 18:

"All I am saying is that the pure dividend stopper argument, as I characterise it in my judgment, is not by my permission going further."

Now, what I understand from that is that he's saying you can't appeal on my factual findings against Mr Katz. There was no actual agreement. And that's the argument he addressed in his judgment. And there's no attempt to run that or appeal against that, because it wasn't a case that the bank ever argued.

But he is saying that insofar as you are saying it's an Arnold v Britton objective construction point, then that is a matter that you can run as a matter of construction, and it's for the Court of Appeal.

So what we would suggest to your Lordship is that that's plainly what this argument is, and obviously it's been run and been --

LORD JUSTICE LEWISON: And the order says?

MS TOLANEY: The order says -- if I can show you. It is core bundle 2, tab 23, at page 483, and it's at paragraph 17.

He gives permission to appeal the declaration at paragraph 7, which is the finding on the seniority ranking. And then he says:

"It is as defined in paragraph 32(2) and further explained at 3(6)(vi), any contention that the court

erred in making the factual findings or rejecting the arguments made or recorded as having been made and described in the judgment."

So there is no attempt to appeal his factual findings or indeed the arguments made as recorded in his judgment. It's an entirely different argument he didn't deal with.

LORD JUSTICE HENDERSON: It does look like a fairly comprehensive wording to rule out anything to do with --

MS TOLANEY: I agree, and I was just about to say that the problem with this order is the word "including".

LORD JUSTICE HENDERSON: Yes.

MS TOLANEY: And the reference to 32(2). So it is a very confusing order. And it's why I have had to show you the transcript, because the judge did say, in terms, that a construction point was open to us. And also it's a rather rum order in circumstances where the judge didn't deal with the construction point that was argued.

So my Lords, I would submit that having looked at the transcript and the order, which is quite frankly quite confused, it's clear we do have permission and the reality is that it's really for your Lordship now to assess the merits of the argument as it stands as a matter of construction.

LORD JUSTICE HENDERSON: Wasn't the wording at paragraph 17

a matter for agreement between counsel? I mean, what did the judge -- he didn't draft the order himself, did he?

MS TOLANEY: I'm sorry, my Lord, I would have to take instructions. I wasn't involved in this. I can take instructions on it.

Right. It was settled by the judge.

MR PHILIPPS: There was a lot of back and forth. We didn't agreed and so the judge settled it.

I'm sorry, I didn't want to interrupt my learned friend.

MS TOLANEY: I'm grateful. So I'm afraid the order gives rise to a number of construction points itself.

LORD JUSTICE LEWISON: What he's refusing permission for is the argument as defined at paragraph 32(2) of the judgment and is further explained in 3(6)(6). As far as I can see, 3(6)(6) does not explain the argument. But 32(2) does. And if you go to 32(2)(a) he's quoting from -- I imagine it's position papers. This is all about -- the provision in paragraph 30 is all about commercial rationale for the ranking advocated by Deutsche Bank.

So it is being used there, it seems to me, as an aid to interpretation.

MS TOLANEY: It is.

LORD JUSTICE LEWISON: And the judge has refused you permission to run that argument, has he not? And I don't think you applied to this court against that refusal.

MS TOLANEY: My Lord, I understand we didn't. But the interpretation with the transcript that was given to this is that it was against the, as he put it, pure dividend stopper -- those are the words he used in the transcript -- which is what he explains in 365 to 377.

LORD JUSTICE LEWISON: I understand that. But appeals are appeals against orders.

MS TOLANEY: Well, my Lord, all I can do in that situation, having argued it and seen the problems, is ask for permission now, if there's any ambiguity.

LORD JUSTICE LEWISON: Right.

LORD JUSTICE HENDERSON: If there is a difference between what he said in argument and what he actually said in the order which he finally drew up himself, apparently, I suppose one ought to take the latter as his finally considered view on the matter.

MS TOLANEY: Well, my Lord, I understand that. I think there was some confusion about what the judge really intended. But as I say, the parties have both put out their submissions. We are in a position to argue it.

LORD JUSTICE LEWISON: We have heard your side of the

argument. Whether we hear Mr Phillips' side of it we will decide.

MS TOLANEY: Indeed. And if there is any ambiguity I would ask for permission now.

LADY JUSTICE ASPLIN: Ms Tolaney, you would also presumably rely -- although maybe I read it too quickly -- upon paragraph 32(2)(b) of the judgment, which says that because of the generality of the points I'm going to deal with it later at H, which takes you back to the different argument.

MS TOLANEY: It does. It's a different argument. And that's why I said, I think if you read everything together he's dealing with the argument he dealt with. But I fully accept on face of the order it appears to (inaudible).

My Lord, just one point, which is that, I think in answer to one of my Lord Lord Justice Henderson's questions, LBHI accept that the Sub-Notes were listed for tax purposes. And the reference to that is the reply position paper, paragraph 18.2, subparagraph 1. And the reference is core bundle 3, tab 37, page 635.

LORD JUSTICE LEWISON: Thank you.

MS TOLANEY: My Lord, I'm afraid I'm carrying on because it's now on a different topic, which is partial release.

LORD JUSTICE LEWISON: Yes. This is the ruling against

1 double proof point.
2 MS TOLANEY: Yes. My Lord, the issue for the court on this
3 topic is, what is the effect of LBHI releasing its claim
4 as guarantor in respect of the PLC Sub-Debt in PLC's
5 insolvency as part of a Settlement Agreement?
6 LORD JUSTICE LEWISON: It's common ground, is it, that
7 that's what the Settlement Agreement did? It is the
8 Clause 8.02 point, I think.
9 MS TOLANEY: That's right.
10 LORD JUSTICE LEWISON: Speaking personally, I find this very
11 hard to understand, but it looks pretty comprehensive.
12 MS TOLANEY: It is, and I can show you from my learned
13 friend's skeleton the facts which show it's
14 common ground.
15 LORD JUSTICE LEWISON: It seems to be agreed that in its
16 capacity as guarantor LBHI has given up its right to be
17 indemnified by the principal debtor.
18 MS TOLANEY: That is right. This is therefore quite a short
19 point, because the point is simply: what is the effect
20 of the release on a ruling in insolvency?
21 LORD JUSTICE LEWISON: That is not a feature, as far as
22 I can see, of any of the cases to which we have
23 been referred.
24 MS TOLANEY: That's right.
25 LORD JUSTICE LEWISON: It's not a feature of the Australian

or the New Zealand cases. So we don't need to choose between them, do we?

MS TOLANEY: No.

LORD JUSTICE LEWISON: All we have to decide is, does it make a difference that the surety no longer has a right to be indemnified by the principal debtor?

MS TOLANEY: Exactly. And it's common ground that in an insolvency where a surety has guaranteed payment of a debt, the creditor can prove for the full debt, even if the surety has made part-payment of the debt, and the surety can't prove. That is also common ground, and it's common ground that that is a special rule in insolvency.

And the rationale, as I will come on to show your Lordship, is to prevent competing claims in insolvency for the same debt.

And the creditor is treated as senior to the surety and therefore has the right to prove for the full debt and will account to the surety in the event of a full recovery in that scenario.

But as your Lordship has just said, this case is a novel scenario not considered by authority, because you have the release, so there is no longer the competing surety claim within the insolvency.

And the question is, then, what happens to the

special rule? And we say that given that there is no competing claim, and that's the rationale for the rule, the special rule doesn't apply and the creditors' proof should only be admitted for the amount that takes into account his own debt, so less what he's already been paid, because any other result would unjustly enrich the creditor and subvert the pari passu rule because the creditor would be receiving, at the expense of the general body of unsecured creditors,
an excessive distribution.

And we say that's the only result that makes sense.

Now, we also say, to the extent your Lordships are interested, accepting that it's not definitive, that outside an insolvency that would be the case, that the claim against the --

LORD JUSTICE LEWISON: That's LS Fashions.

MS TOLANEY: Exactly. So we say that's the position. There's an argument about that. But actually on my case I don't even need to succeed on that, because if I persuade your Lordship that the special rule has no application --

LORD JUSTICE LEWISON: I think you do, don't you? You have to say that that's the position outside insolvency, because if you can't say that's the position outside insolvency then none of the creditors' debt has been

repaid, so it's all outstanding, so he ought to be able to prove for all of it.

MS TOLANEY: My Lord, it could say that. But what I was going to say was that in a sense you have the special rule, presumably because it isn't --

LORD JUSTICE LEWISON: But your point is, the special rule doesn't apply where the surety has given up his right to indemnity --

MS TOLANEY: What I'm saying is exactly that. And in an insolvency situation you have to have the special rule.

LORD JUSTICE LEWISON: Suppose that the surety -- suppose there's a debt of £1 million. And a surety pays half a million. And let's suppose that outside of insolvency that does not discharge the creditor's debt, and let us suppose that the surety has given up his right to indemnity. The creditor surely in those circumstances, because his debt has not been repaid, could prove for £1 million. And if a dividend of, say, 60p in the pound were declared, he would pocket £600,000 out of the insolvent estate, add it to the half million he has received, total 1.1 million.

MS TOLANEY: And get a windfall at the expense of the estate and the other creditors.

So that's why we say that there are two stages to

the analysis. I'm happy with taking both together or -- actually I say I could win on just the first stage, which is that because it is an insolvency situation you also have to have in mind the effect on other creditors if you allow a proof for too much.

And that's why the special insolvency rule shouldn't apply here. But in any case, I say that that reflects what would happen outside the insolvency position. And I would therefore give the court some comfort that it was the right answer for that reason.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: Now, my Lord, at the risk of saying something negative about the judge again, the judge just didn't deal with this point. The relevant part of his judgment is at paragraph 288 to 303.

But what's just a bit startling about this is that the key point is, as your Lordship has identified, what's the effect of the release?

The judge never even engages with the question of the release, despite it being in a full written closing note and pointed out when the judgment came in draft.

So Lord Justice Newey gave permission, and this court is essentially hearing the argument afresh.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: I think your Lordship can see that the release

just isn't addressed.

So my Lord, turning then to the case that arises. The facts, as your Lordship has identified, are common ground. They are set out, if your Lordship needs to see them, at paragraph 88 of my learned friend's skeleton. So you can be confident of the commonality of that.

And what's clear, therefore, is that the guarantor's claim for an indemnity, having made a part-payment, has been released. And LBHI, who was the guarantor, its claim is as the assignee of the original holder. So it's only claiming as the principal debtor.

LORD JUSTICE LEWISON: Yes, wearing a different hat.

MS TOLANEY: My Lord, the special rule applicable in the usual scenario is set out in our skeleton argument at paragraphs 81 and 82.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: The rationale is explained in some of the text. If I could show you, by way of example, authorities bundle tab 71.

LADY JUSTICE ASPLIN: Sorry, which authorities bundle is that?

MS TOLANEY: Bundle 4, sorry, at tab 71. I'm looking at the second page within the tab, which is 2363.

LORD JUSTICE LEWISON: Yes. This is Andrews and Millett, is it?

MS TOLANEY: It is. And what you can see if you read the first paragraph --

LORD JUSTICE LEWISON: 9001.

MS TOLANEY: No, it's 13.002, sorry. It's the second page, page 2363.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: What you will see is:

"The essence of this rule is that the insolvent estate should not be compelled to entertain more than one proof in respect of the same debt, for to do so would unfairly distort the pari passu principle of distribution in an insolvency."

Then if your Lordship goes down to the paragraph under the heading "Re Kaupthing Singer", the third down, in the middle of that paragraph you can see a sentence:

"PD has the primary obligation to see [et cetera]. But if PD is insolvent, S may not enforce that right in competition with C."

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: And then if one goes over to 2369 of the bundle, and it's 13.007, this is just showing you the part payment point. And it's the same point, if one looks about seven lines down, about receiving a dividend in competition.

If I could just emphasise four points. The first

point is that it's an approach that's adopted as a special rule in insolvency proceedings.

Second, the rationale given is important. It's because the surety has undertaken to be responsible for the full sum guaranteed that the surety is prevented from proving in competition and claiming its right in indemnity. And so this rule reflects the subordinate status of the surety.

The third point is that the idea is also to prevent there being two proofs for the same debt. The competition point.

And the fourth point is that the estate bears liability for the full amount due and therefore the creditor proves the full amount. But we would suggest that that's predicated on there still being a competing right. It's just that it's not being manifested in a separate proof.

LORD JUSTICE LEWISON: Just say that last point again.

MS TOLANEY: The fact that the creditor can prove for the full amount, we say, is because there is the premise that the surety has a right to be indemnified.

LORD JUSTICE LEWISON: I see.

MS TOLANEY: So that's why the estate still owes the money. And the assumption would be that the creditor will account if it recovered the full amount, because that

claim is there. And this rule is about not allowing a competitive or double proof.

LADY JUSTICE ASPLIN: And not requiring the estate to enter into an enquiry about these matters.

MS TOLANEY: Exactly.

You then come on to what's the impact of the release. And here the creditor has benefited from a payment by the surety. The estate is not liable to make any indemnity payment to the surety, so there's no prospect of competition between the surety and the creditor.

LADY JUSTICE ASPLIN: I'm sorry, I'm going to have to ask you to say that last part again. The creditor benefits from the payment from the surety. And then you went on: "The estate is not liable ..."

MS TOLANEY: To make an indemnity payment to the surety.

Then thirdly, because of that, there is no prospect of competition between the surety and the creditor. And therefore there is no risk of a double proof. So the rule against double proof is irrelevant.

We say, therefore, if there's no competition, no risk of a double proof, that only leaves the creditor's proof and the question of the amount of that proof.

LORD JUSTICE HENDERSON: The rule against double proof is a judge-made law, but it's not something set out in

1 the rules.
2 MS TOLANEY: That's right.
3 LORD JUSTICE LEWISON: The rules of judge-made law that
4 Lord Neuberger refers to in Waterfall 1.
5 MS TOLANEY: That's right.
6 LORD JUSTICE LEWISON: Which he says is capable
7 of development.
8 MS TOLANEY: Yes.
9 And here, what we would say is that there's
10 an obvious policy reason that underpins the special
11 rule. But where there is no surety there's no good
12 reason to allow the creditor to claim for more than the
13 creditor is in fact owed, when there is no surety.
14 And in answer to my Lord Lord Justice Lewison's
15 point, there may be an extra point in an insolvency
16 which goes beyond the position outside, which is that
17 otherwise the estate and the other creditors in
18 an insolvency will be prejudiced by a creditor who has
19 already had recovery gaining more than he should do.
20 And we say that would actually be contrary to the
21 pari passu principle of fair distribution.
22 Can I deal with two points that LBHI make. First of
23 all it's suggested that the rule in Re Sass, which
24 I will show you, continues to apply notwithstanding the
25 release, and that the bank's approach is contrary to

that decision.

And the short answer to that is that Re Sass doesn't deal with the scenario in which there's a release of the surety's indemnity claim. So we don't accept that it's contrary to that decision. There's a sentence in it we don't agree with, and I'll show it to you. But that sentence is then developed afterwards.

LORD JUSTICE LEWISON: That is your overarching point, really, that none of the cases that considered this question has ever considered the case where the surety has released the right to indemnity.

MS TOLANEY: That's right.

LORD JUSTICE HENDERSON: If one looks at the underlying rationale, you say there is only one sensible answer, which is, the only way you can avoid the risk of effectively the creditors as a whole getting too much, is by limiting -- sorry, the original creditor's recovery to what is left after the part-payment.

MS TOLANEY: Exactly. That is why I said it's a short point.

LORD JUSTICE LEWISON: I think we have that point.

Can I ask another question. Andrews and Millett suggest at 13.008 that if you make a part-payment under a negotiable instrument, the rule against double proof doesn't apply. Everybody seems to have taken the view

that these notes are a negotiable instrument. Does that exception apply? Or is that irrelevant?

MS TOLANEY: My Lord, I think that's irrelevant.

LORD JUSTICE LEWISON: Irrelevant.

MS TOLANEY: For the purposes of this. It would be a nice answer if it was.

My Lord, I will show you, shall I, Re Sass, even though it doesn't deal with it, unless --

LORD JUSTICE LEWISON: By all means.

MS TOLANEY: It's in volume 1 of the authorities, and it's in tab 1 of the bundle.

The facts are clear from the headnote, which is that an all money guarantee was given to a bank for sums that became due or owing from the customer, up to a limit of £300. The customer became bankrupt. The bank received £300 under the guarantee and sought to prove for the full amount without giving credit. And the trustee challenged it. And the court held the bank could prove the full guaranteed sum.

The big issue in the case was whether this was a guarantee for the whole amount but up to a limit or should be construed as a guarantee only for £300, which would have made a difference.

So that was the actual issue in the case. If one looks at the judgment of Mr Justice Vaughan Williams at

page 11 of the bundle, the sentence we disagree with, which I am going to come on to develop, is the second sentence, I think, the common law right of the bank. But that's not material to his decision on this case.

LORD JUSTICE LEWISON: Where did he get that from? He doesn't cite any authority for it.

MS TOLANEY: He doesn't.

LORD JUSTICE LEWISON: I have looked at the authorities that were cited to him and none of them seem to support that proposition.

MS TOLANEY: That's right. And we say actually the cases that I will show you show it's not right. But that's the sentence we don't agree with.

But then if one carries on reading through the judgment, it's the third sentence that's actually key:

"When the bankruptcy supervenes the rights of the principal creditor ..."

And your Lordship will see that the judgment in fact deals mainly with the question of this construction of the guarantee in this case, and he reaches the conclusion, opposite the second hole punch on the page:

"It is true that his liability was to be limited."

But he construes it as a guarantee nevertheless for the whole amount, and then he reaches his conclusion about the bargain at the end.

LORD JUSTICE LEWISON: I'm a little bit puzzled by the statement, "if the surety is surety for part of the debt, then the principal creditor can only prove for the remainder", compared with his previous statement that at common law the creditor can sue for the whole debt, never mind what he's been paid. I don't quite see at the moment how these two statements fit together.

MS TOLANEY: That's right, what his rationale -- your Lordship's sees the inconsistency. But for present purposes there's nothing in that case that is contrary to the bank's position other than the outside insolvency point.

LORD JUSTICE LEWISON: Right.

MS TOLANEY: So insofar as that's a point taken by LBHI that's the answer.

The second point taken by LBHI is that allowing the creditor to prove only for the sum that he's now owed, if I could put it that way, leads to the unjust enrichment of the insolvent estate and the general body of creditors because the estate essentially gets a windfall because it doesn't have to pay off the surety. That seems to be his point.

And what my learned friend says at I think paragraph 105(2) of his skeleton, that gives a windfall.

LORD JUSTICE LEWISON: Sorry, I'm in wrong volume.

MS TOLANEY: It's volume 1, tab 19, my Lord.
LORD JUSTICE LEWISON: Paragraph 102?
MS TOLANEY: It's paragraph 105, subparagraph (2). He says it would be a windfall. But then if one then goes back to 87(4) at page 317, what you can see is this continues, I'm looking at Re Sass, but you see on the fourth line:

"If LBHI cannot prove it as surety at all, and cannot prove as creditor for the full amount that would result in unjust enrichment."

But obviously LBHI cannot prove as surety because it's released its right to do so. So if the premise is suggesting that LBHI can't prove, then it ignores the release and if the release has given a benefit to the estate presumably it's been done for reasons that are known to LBHI but it shouldn't be allowed to permit the principal creditor to recover excessively at the expense of other general body of creditors.

My Lord, I think that then deals with the position as a matter of the insolvency context. I'm not sure there are any more ways I can put the same point.

That takes me on to then the position outside an insolvency.

And as I said, I recognise the point's not determinative but we say it is actually consistent with

the analysis. We have addressed this point at paragraphs 72 to 80 of our skeleton argument in bundle 1, tab 18. If I could just start with MS Fashions v BCCI, which is in authorities bundle 1 at tab 16, a very familiar decision. The decision is obviously focused on the question of set-off. But the facts are relevance and there's a general statement of principle on which we rely. If I could show you the general statements of principle first and then I can show you the rest of the case. My Lord, if you go to page 448 at letter D, you see:

"If there is a set-off between Mr Amir and Mr Ahmed [who were directors who had given guarantees] that must automatically reduce or extinguish the indebtedness to BCCI, the companies."

Then if you drop down:

"It operates to reduce or extinguish the liability of the guarantor and necessarily therefore operates as in effect a payment to him to be set against the liability of the principal debtor. A creditor cannot sue the principal debtor for the amount of the debt which the creditor has already received from a guarantor."

So it's that general statement is the principle.

LORD JUSTICE HENDERSON: I am bound to say the natural --

I suspect the off-the-cuff reaction of most lawyers to that would be to say, "Well, of course that's right."

MS TOLANEY: Exactly.

LORD JUSTICE HENDERSON: And it's only when you look at Re Sass that you think, well, actually, is there a different rule after all?

MS TOLANEY: Exactly. And I think the points that are taken by my learned friends are -- they suggest that the payment from the directors was being analysed as a principal debtor payment. And that's not right, they were principal debtors and guarantors and you can see that. The relevance of the principal debtor status was that the court held there was no need for a demand before claiming. So that was the relevance of it. And one can see that if you start with the judgment of Lord Justice Dillon at page 291 of the bundle. You can see the broad proposition stated at 444 at the top, which sets out what the issue is.

Then at 447G to H you can see that the court considers, at the bottom, that the effect of him having liability also as a principal debtor was to dispense with any need for a demand.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: The other point made by my learned friend is that the case is somehow limited because it's dealing

with set-off. We would suggest that the passage that I've shown your Lordship at page 448D to E is not so limited, it's a statement of principle, and as my Lord Lord Justice Henderson said seems a fairly obvious one. So we don't see a reason for suggesting that that principle is limited to set-off, and nor is it limited to a case where there's a charge, which is another point I think that was taken.

We then come on to the authority at tab 19 --

LORD JUSTICE LEWISON: Can I just make a couple of points about MS Fashions. You will obviously know that the case came before Lord Justice Hoffmann at first instance. If you look at page 427 of the report you will see that Ulster Bank v Lambe was cited to him.

MS TOLANEY: That's right.

LORD JUSTICE LEWISON: Which is why the case was being referred to. If you go on to 432, letter B, you see that Mr Justice Millett refused relief but the Court of Appeal allowed the appeal. And if you look the report of that appeal Lord Justice Scott says exactly the same thing about the effect of payment by a guarantor. I think he used the word "clearly".

Then if you look at the declaration that Lord Justice Hoffmann made at 439 -- the order itself is not set out in the report but he says he's going to

declare the indebtedness of each of the companies -- that is companies to BCCI -- has been extinguished or reduced by the amount standing to the creditor, the directors, and that declaration is upheld by this court. So that is the ratio of the decision.

MS TOLANEY: Exactly, my Lord. You are absolutely right to point that out and it's clear that it's not limited to set-off.

My Lord, if we then go to the authority at tab 90.

LORD JUSTICE LEWISON: This is Milverton.

MS TOLANEY: Milverton. The case involved a lease under which there were six people liable to pay the rent, by reason of being the tenants, former tenants or guarantors of the tenants or former tenants. And a claim was made against the original tenant for the amount of rent. And it was disputed on the basis that some of the guarantors had made part-payments to which no credit was given and the landlord said that no payment by a guarantor could extinguish the liability of the tenant to pay rent, and that these payments had been made in return for a lease under the guarantees. This case involved an argument in particular that payments have been made in return for a release under the guarantee. I should just say as a point of distinction there's no suggestion in this case that the indemnity

was in any way by virtue of the part-payments released.

The first paragraph of the report, the decision of Lord Justice Glidewell, identifies the issue of principle. And it's framed as being as to the impact of receiving payment from a guarantor in return for release of the obligations as a guarantor. That's why I said there is a point of distinction here, because that's not the position here.

One then goes to page 5, and halfway down the page Lord Justice Glidewell identifies the first question considered by the judge:

"Does payments by a surety of an instalment of a lessee's rent discharge the lessee's obligation not to pay the same rent?"

And the question is posed by reference to the surety making payment, and the passage quoted from Woodfall(?) is to the same effect.

And Lord Justice Glidewell says over the page on page 6 that he doesn't think the authorities cited in Woodfall(?) support the proposition.

If your Lordship could read from halfway down, "I agree with the judge's conclusion on this issue ..." to the end of the paragraph.

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: So the court is saying that the payment by

a surety does operate to pay the rent for the relevant period. And this is approached on the basis that the payment is made as a surety. You see that from the reference to "lessee" and "assignee" and "a surety". I make that point because Mr Phillips suggests that this case should be read as if it's six principal debtors. And that's not right, as you can see from the passage.

And if one drops to the second hole punch you can see the explanation as to why, and the point that it would be so unjust that equity would prevent it, in the middle of that paragraph, starting "The sureties have each made a payment ..."

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: On page 9 you then have the decision of Lord Justice Hoffmann, as he was then, agreeing, and the key passage is at page 9, the red-lined passage, where it was argued that the payments were made in consideration for being released and not in satisfaction of a guarantor's obligations.

If your Lordship would just read from "for the purpose of deciding ...", which is in the middle of the highlighted passage. (Pause).

LORD JUSTICE LEWISON: Yes.

MS TOLANEY: We say that that makes it plain that the payment wasn't to be treated solely as in return for the

release but was referable to the guarantee, and in this case anyway there's no release of the guarantee.

LORD JUSTICE LEWISON: Neither Andrews and Millett nor Savoy(?) much like that decision.

MS TOLANEY: No.

LORD JUSTICE LEWISON: Chitty, on the other hand, seems to think it's right.

MS TOLANEY: That's right. There's a lot of academic disagreement on this and in particular the policy considerations. But we suggest it's obvious that if you have the money you shouldn't be able to get it twice. And the special rule on insolvency is about competitive proofs, not about allowing double-recovery.

LORD JUSTICE HENDERSON: Even in insolvency it does produce a rather clumsy outcome, doesn't it? If you have to pay the full amount even though you have already had received credit for half of it you end up with the rather complex and unsatisfactory solution of the surplus being held on trust for the surety.

MS TOLANEY: That's right.

LORD JUSTICE HENDERSON: That can give rise to all sorts of problems of enforcement and ignorance of rights and goodness knows what. It seems to make far more sense to say, you can just reduce the debt pro tanto rather than have all this superstructure and opportunity for things

to go wrong.

MS TOLANEY: That's absolutely right. And even more so here, where you have had the surety make a deal, why should the court then try to in a sense go behind it to give the surety more?

LORD JUSTICE HENDERSON: Yes, it's an a fortiori case.

MS TOLANEY: It is.

My Lord, the only other case I was going to show you, but I don't know whether having seen those you wish to see it is the Octaviar case, which is in bundle 2 at tab 34, an Australian decision. And the relevance of that case really was to say that Ulster Bank v Lambe was wrong and that it shouldn't be followed, and really to deal with some of the criticisms made in Goode and text about favouring the position in Re Sass. I can show your Lordship that decision, obviously it's not a decision of this court but it's informative.

LORD JUSTICE LEWISON: It's up to you, Ms Tolaney, but if as at the moment I think MS Fashions ratio is that the liability to the creditor is partially discharged, and if I'm right to say that that is the ratio, then it binds us so it doesn't really matter what the Australians think.

MS TOLANEY: I will leave it there but with liberty to respond on this case --

LORD JUSTICE LEWISON: I mean, this is Murdo J, is it?
MS TOLANEY: It is.
LORD JUSTICE LEWISON: Well, he considers Mr Justice Fisher and Mr Justice Tattall(?) and all that --
MS TOLANEY: He does. And he thinks clearly that it operates in the way that MS Fashions suggests and that the prevent authority doesn't assist.
LORD JUSTICE LEWISON: Speaking for myself, I have read it.
MS TOLANEY: I don't think, my Lord, I have then anything to add. We have one further alternative point which is I think in answer to Mr Phillips, which Mr Fisher is going to deal. But unless I can assist you further.
LORD JUSTICE LEWISON: Right.

Submissions by MR FISHER

MR FISHER: My Lords, my Lady, it's a very brief point, just to add to those made by Ms Tolaney. We made it in our skeleton at paragraphs 98 to 101, which is at tab 18 of the first bundle, page 285.
LORD JUSTICE LEWISON: Relevance of clause 7(f).
MR FISHER: That's correct, my Lord. My Lord it's the sum, albeit perhaps not too much relevance. We rely on it to make this point, which is one of the arguments made by my learned friend is to say well, as Ms Tolaney pointed out, any other result is unfair to them as the creditor. And we say it works the other way round. We say unless

we are correct the unfairness is suffered by the estate because it's a subversion of the pari passu principle.

But the one additional point we just wanted to draw to your attention was the way in which the documents had anticipated this scenario would actually work. And that's where clause 7(f) comes in. If I could just ask you to take that up. It's in core bundle 3, tab 43, page 759.

These are the standard terms and conditions which form part of all of the subject. One can see at page 759, 7(f), there was an undertaking from the lender that they would:

"... not take or enforce any security, guarantee or indemnity from any person for all or ...(Reading to the words)... subordinated liabilities, and the lender shall, upon obtaining or enforcing any security, guarantee or indemnity, notwithstanding this undertaking, hold the same and any proceeds on trust for the borrower."

Which is PLC.

Now, as far as we are aware, that didn't happen, and there has been no suggestion that any monies were retained on trust for PLC. And this issue proceeded before the judge in accordance with the agreed facts effectively shown by Ms Tolaney. But the point we make

is very brief and it's based on the economic effect which would have occurred had clause 7(f) been complied with, because in that scenario, my Lords, my Lady, the monies received would have been held on trust, PLC, and PLC would have been entitled to them in the case of insolvency.

And so although they wouldn't have been applied in satisfaction of the guaranteed liability there would have been no set-off and effectively the economic result would have been the same as we are now advocating, because the monies would have had to go to PLC in full, because they were held on trust, and although the creditor would have therefore retained a claim for the full amount you would have had to hand over the monies which had been held on trust and the net effect would have been, as we now advocate, that they would have been limited to economically a claim for effectively the difference between full guarantee to sum and the amounts which had been made by the guarantor.

Now we say that's just a further point to note, and in support of the arguments made by Ms Tolaney that there is in fact no windfall to the estate in the scenario which we are positing, and the way in which the rule should operate is exactly as we have said, which avoids unjust enrichment of the creditor at the expense

of the body of the creditors.

Now an objection is taken to us relying on clause 7(f) by Mr Phillips. We did raise it in our position paper, it wasn't argued at trial and before the judge. All I'm relying on it for is to make this observation, in terms of economic effect: if one looks at the terms of document quite clear what should have happened, and there is a parity of outcome between what the document anticipated and the result for which we are arguing as a consequence for partial(?) (inaudible).

My Lords, my Lady, that is the simple point we have on clause 7.

LORD JUSTICE LEWISON: Right.

You can you have five minutes now if you want, Mr Phillips, or if you like we can start afresh tomorrow.

MR PHILIPPS: My Lords, I am feeling like the twelfth man for sure in this case. It seems to be my place to finish the day and start the next day.

LORD JUSTICE LEWISON: "The night watcher" I think they are called now.

MR PHILIPPS: With my eyesight I'm not sure I can be called a watcher.

My Lords, may I just trouble you on one point --

LORD JUSTICE LEWISON: Yes, of course.

MR PHILIPPS: -- which will assist us hugely overnight, depending on the answer to this point, and that is the question of the dividend stopper. If, my Lords, you take the view that I do not need to address you on the dividend stopper that would save --

LORD JUSTICE LEWISON: I tell you what, we will go out, see where we are --

MR PHILIPPS: I'm sorry.

LORD JUSTICE LEWISON: It doesn't matter. Don't go away. We will come back and tell you within the next five to ten minutes.

MR PHILIPPS: I am so sorry, my learned junior has just made a point that when you look at 32(2), where at 32(2)(b) where the learned judge says, "Because of the generality of the point", and he goes on to deal with schedule A, the generality of the point was that it was common to LBHI2 and PLC. That's what that meant in that paragraph of the judgment. I'm sorry about that.

LORD JUSTICE LEWISON: Don't worry. We will go out and we will be back in five or ten minutes.

MR PHILIPPS: Thank you very much.

(4.10 pm)

(A short break)

(4.12 pm)

LORD JUSTICE LEWISON: Well, we have some sympathy with

Ms Tolaney's position, looking at the transcript of the consequentials hearing. But we are all of a view the order is clear and the argument is not open to Deutsche Bank.

MR PHILIPPS: Thank you very much, my Lords. Your Lordships understand why I asked, and I'm very grateful.

LORD JUSTICE LEWISON: Of course. All right.

10.30 tomorrow.

(4.13 pm)

(The hearing adjourned until the following day at 10.30 am)