Thursday, 7 October 2021

(10.30 am)

Submissions in reply by MR PHILLIPS

LORD JUSTICE LEWISON: Yes, Mr Phillips.

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

LORD JUSTICE LEWISON: Could you just help me about this before we continue. Where are we now on the timetable?

MR PHILLIPS: My Lord, we have done very, very well. And the position at the moment is that I am now --

LORD JUSTICE LEWISON: You are on Day 5.

MR PHILLIPS: -- responding on what is the afternoon of Day 4.

LORD JUSTICE LEWISON: I see.

MR PHILLIPS: That was the afternoon of Day 4, my Lord.

Whether we manage to finish today, that is a possibility but --

LORD JUSTICE LEWISON: That's what I was wondering.

MR PHILLIPS: I understand, my Lord. Absolutely, it's a possibility. I think we are all alive to it. I have quite a lot of work to do in particular in relation to partial release. I want to help your Lordships on the law in relation to that. It's a very important area of the law.

But first I was going to start, if I may, with the construction question, and then I'll come to that.

LORD JUSTICE LEWISON: This is C versus D.

MR PHILLIPS: C versus D, my Lord, yes.

My Lords, my Lady, the judge held that the claims under the PLC Sub-Debt and the PLC Sub-Notes ranked pari passu. He reasoned that the subordination provisions in Claim C and Claim D were ineffective as between each other, such that the claims prove at the same time and rank pari passu pursuant to Rule 14.12 of the Insolvency Rules.

Our position is that the judge reached the correct conclusion in relation to the PLC priority dispute. In addition to the route the judge took, he could also have reached the same conclusion by reason of the case LBHI advanced at trial, which is in our respondents' notice. For your Lordships' note that is at C1, tab 15, page 198.

Both approaches are based on similar considerations. First, Claim C and Claim D are both dated subordinated instruments issued for regulatory capital purposes.

Second, each of them used definitional wording that was similar. That was no coincidence, because under IPRU(INV) the subordination provisions of Claim D were required to, and did, replicate as closely as possible the subordination provisions of Claim C, which, as your Lordships know, was drawn up on an FSA Standard Form.

Both instruments had a solvency condition in materially similar terms. The effect of these similarities on the learned judge's conclusion was that the subordination provisions were ineffective as between each other, leading to a pari passu outcome.

On our alternative case the similarities mean that the instruments ranked behind the same senior liabilities and ranked pari passu because of the operation of Rule 14.12. Either way, the outcome is pari passu ranking.

My Lords, I don't want to leap ahead but I will go over many of the other alternatives that we have discussed.

We say this is an entirely unsurprising result. There is no contractual language in either document which refers expressly to the other or seeks to engage with their relative subordination. Claim C and Claim D were both lower tier 2 or tier 3 capital and, as your Lordships know, no reason has ever been identified from either a regulatory or a commercial perspective for why Claim C and Claim D should rank anything other than pari passu.

Against this, the appellants contend that the judge should have found that Claim D is senior to Claim C.

GP1 advances an argument based solely on the

definitional wording that you find in claim D. It relies on what it calls a "subtle but key distinction" in the wording of the definition of subordinated liabilities in the PLC Sub-Notes. The definition extends to liabilities which rank pari passu with the Sub-Notes.

From that, they argue that the Sub-Debt ranks junior to the Sub-Notes because the Sub-Debt does not admit to the same possible pari passu ranking.

Our position is that this argument is absurd and obviously wrong.

Deutsche Bank. Deutsche Bank's ground 3A only arises on the assumption that your Lordships consider that the judge was right to slice up the single subordination provision and to apply the solvency conditionality inconsistently from the definitional wording.

I will come on to that. And of course, my Lords, in addition to the construction arguments Deutsche Bank have their additional argument on partial release, which, as I have indicated, we will address at the end of our submissions.

My Lords, we will avoid duplication and we will try to avoid duplicating submissions we have already made in the LBHI2 appeal. We will not spend time on the

following issues, and what I'd respectfully ask you to do is just to read those submissions across from the one to the other. So we won't go back over the statutory scheme, we won't go back over the subordination case law, and we won't go back over the solvency conditionality in these instruments, save to address Deutsche Bank's ground 3A.

Can I turn to the general framework. There are three points on the framework for approaching the ranking question between Claim C and D, and we would like to identify some common ground between us and GP1.

First, a couple of points on the pari passu principle. We are not seeking to elevate it impermissibly. The first point is that, as my Lord Lord Justice Henderson put it, Rule 14.12 is part of the whole background to the question of construction. It is not just relevant at the point at which one reaches a contractual impasse.

Secondly, it is a critical part of the statutory regime for distribution and proof in which these agreements' subordination provisions must be viewed. It is a starting point and an end point in the sense that it applies whenever two debts prove in an insolvency. And my Lord Lord Justice Henderson is right that in a sense it is unhelpful to think of it as merely

a default.

Second, the approach to subordination. The key point of contention on the PLC appeal, aside from Deutsche Bank's ground 3A, is not about subordination mechanics. Both we and GP1 see how subordination works in a similar way.

My learned friend said yesterday, and I'm quoting:

"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."

For your Lordships' note, that is page 52, line 24, to 53, line 5.

My learned friend Ms Hilliard agrees with us that the judge was wrong to distinguish between simple contractual and contingent debt subordination. And our only disagreement relates to how you interpret the definitional wording in Claim C and Claim D and how they rank relatively.

Third, we also agree that where there is circularity between two instruments, like C1, C2 and C3, pari passu is in principle the right outcome. And we will address this point further in a moment but that is obviously a major point of agreement between us.

May I turn to an outline of the priority dispute. We do not propose to take your Lordships through all of the instruments again, but it would be helpful, if I may, just to look briefly at the notes which, my Lords, you'll find in core bundle 3 at tab 46 at 792.

Just to remind your Lordships, there is more than one offering circular, but they all the same. Just to remind your Lordships, we're looking at the 225 million fixed rate subordinated note(s?) due in 2035. And if I could ask you just to look at the first paragraph -- I wanted to show you something about the regulate purpose first of all. First paragraph, three lines up from the bottom:

"Under the existing requirements of the FSA, the Issuer may not redeem or purchase any notes prior to their maturity date unless the FSA has given its prior consent."

Then next paragraph:

"The notes will be unsecured obligations of the Issuer, and such obligations will be subordinated to the senior liabilities."

Which refers forward.

Then if I could take you through to 795. It's a different set of definitions I just wanted to show your Lordships. The definition of financial resources

and the definition of financial rules.

The financial resources is the financial resources that apply to the Issuer as calculated under the financial rules.

And you can see financial rules further down when you get to IPRU(INV) 10 in the handbook.

And the financial resources requirement is the financial resources requirement that applies to the Issuer as calculated under those rules and are notifiable to the Issuer via its subsidiary regulated by the FSA from time to time.

So there is a requirement for a certain level of financial resources and it is in that context that subordinated debt is issued, and of course redeemed.

Can we go forward to 807. "Use of proceeds".

"The net proceeds of the issue of notes, expected to amount to ...(Reading to the words)... million are used to strengthen the regulatory capital base of the group."

That is all I wanted just to draw your Lordship's attention to in relation to that. Can I turn to the key definitions. If I start at 796. Your Lordships have seen the definition of liabilities, and your Lordships have seen that the definition of senior liabilities is materially the same as the definition under the Sub-Debt. In other words, it is all liabilities except

the subordinated liabilities and the excluded liabilities.

And then we have the definition of subordinated liabilities. "Subordinated liabilities":

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

Two points on the definition. First, this is the definition on which GP1's appeal in relation to the PLC priority dispute rests. It includes that pari passu wording that GP1 relies upon.

LORD JUSTICE LEWISON: Just to get the structure of this, if something falls within the definition of subordinated liabilities, then it is not a senior liability.

MR PHILIPPS: Correct. Absolutely correct, my Lord. That is why one looks at them -- I'll come back to what ranks pari passu and what express rank pari passu means. I just wanted to give your Lordships the structure.

But what this means, my Lord, is that the other instrument either expresses itself to rank pari passu, in other words you have an instrument that says, 'This instrument shall rank pari passu with these notes', or it ranks pari passu in fact because it proves at the same time.

If you get two debts that when you construe them

prove at the same time, they rank pari passu.

Then if I may go back to 795 for the excluded liabilities because, as your Lordship rightly points out, there are these two exclusions from senior liabilities. The second one is excluded liabilities. And excluded liabilities means:

"Liabilities that are expressed to be ..."

And in the opinion of the insolvency officer:

"... are expressed to be and do rank junior to the subordinated liabilities."

So again, you get an expression of juniority in those other notes, which say: I rank junior to these subordinated notes.

LORD JUSTICE LEWISON: You wouldn't expect that, though, would you? Because somebody putting up money wouldn't necessarily know who else has put up money. So you wouldn't, would you, expect an express reference to the notes in any other instrument? There will be a category --

MR PHILIPPS: Well, it may or may not say specifically these notes. But it may say: we rank junior to all subordinated notes issued by whatever.

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: I understand your Lordship's point. Of course it will depend on timing, as to whether or not a

particular set of Sub-Debt exists, and the junior debt is issued afterwards --

LORD JUSTICE LEWISON: That depends on whether the subsequent lender knew about the earlier --

MR PHILIPPS: Of course. Of course. It's a matter of construction, my Lord. But you need an expression of juniority.

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: And that's crucial. There must be an expression of juniority in the excluded liability.

LORD JUSTICE HENDERSON: Presumably, I mean, there's no magic in the words used for that purpose, as long as it's clear from the express wording in the instrument that there is the necessary juniority.

MR PHILIPPS: Yes. There's no magic language that you have to have --

LORD JUSTICE HENDERSON: Just -- slight ambiguity in what one means by an expressed statement of juniority. Does it have to say that, you know, in so many words? Or it is enough to say expressly or to use the express language which leads inevitably to that conclusion.

MR PHILIPPS: I think that's more difficult, but what you are looking for at the end of the day -- I hate using that phrase, but what you are looking for is language in the other instrument that expresses juniority. So there

has to be an expression of juniority. And whatever you are construing, you have to say, yes, that is an expression of juniority.

LADY JUSTICE ASPLIN: And there has to be that wording, but then I'm just looking at "and in the opinion of the insolvency officer" that they do rank junior.

So is that that the insolvency officer then becomes the arbiter of whether the words are sufficient for junior ranking? In other words he construes those words?

MR PHILIPPS: Yes, that's absolutely right, my Lady. And what the learned judge said in his judgment is that for these purposes the court's direction to the insolvency practitioner does that.

LORD JUSTICE LEWISON: Let me just see I have understood the argument against you. As I understand the argument against you, there are in effect three categories of debt. There are those which are senior debt, those which are pari passu debt and those which are junior debt. And the argument against you is that on this instrument the noteholders have agreed to subordinate themselves to the first two categories, that is to say both senior debt and pari passu debt. The only category which they have not agreed to subordinate themselves to is junior debt.

MR PHILIPPS: Yes, that's right. And the problem for my learned friend -- and we will come back to it -- is that in order to either express yourself or to rank pari passu, the other instrument has to do that. You can't -- I will come back to this, but the possibility that there might be other pari passu debt which will not rank senior isn't enough to say, well, you've subordinated yourself to two categories, ergo someone else who hasn't subordinated himself to pari passu debt ranking with him has to be junior to you. I will come back to that, but that's the problem.

In relation to this, I just remind your Lordships, while we are looking at excluded liabilities, of what Mr Justice David Richards said about the definition, this definition where he said:

"The obvious purpose of the exclusion of such liabilities is to cater for the situation in which the borrower issues further debts on terms that it is expressed to rank junior to the subordinated liabilities created by these subordinated liability agreements."

And he also referred to the possibility that the borrower might wish to issue such debt.

LORD JUSTICE LEWISON: This is Waterfall 1.

MR PHILIPPS: Yes, Waterfall 1. My Lord, for your Lordships' note it's at AB3, tab 51, 1493. But the

point the learned judge was making, and I just wanted to remind you of it, is that this indicates that there might be further debt introduced in due course.

May I then go to page 797, which is the status that was in paragraph 181, my Lady, the judgment where the judge dealt with it.

LADY JUSTICE ASPLIN: Thank you very much.

MR PHILIPPS: Paragraph 3, clause 3, is status and subordination. And again I will do this quickly because you've seen it.

You have numbered phrase 3:

"The rights of the noteholders in respect of the notes are subordinated to the senior liabilities."

And that is materially the same as paragraph 5.1 in the PLC Sub-Debt. Then you have the word "accordingly", which links phrase 3 to the conditionalities, which are then introduced. And we have discussed that "accordingly" in the sense of "therefore" or "so" or "as a result".

And then you have the conditions 3(a)1 and 3(a)2, but 3(a)2 and condition 3(b) replicate 5(1)(b) and 5(2) of the Sub-Debt. That is what I'm dealing with. These are the same. I will just make three points of condition 3:

One, the subordination provisions in the PLC

Sub-Debt and the PLC Sub-Notes are structured in materially the same way.

Two, the definitional wording in the Sub-Notes tracks that of the Sub-Debt very closely, save for the extended definition of subordinated liabilities, which, my Lords, we've just been looking at.

Applying my learned friend Mr Beltrami's test when he said that the critical issue for your Lordships is to look at the conditionalities. If you accept my learned friend Mr Beltrami's approach in relation to these two sets of interests, two sets of subordinated debt, there is no difference at all between the way the conditionalities in C and D are expressed.

No party argues that -- and this is important -- no party argues that the PLC Sub-Debt is expressed to rank pari passu with the PLC Sub-Notes. Claims C and D are entirely silent as to each other's existence, despite the fact that the notes were issued after some of the debt.

GP1's case depends on the pari passu wording in the Sub-Notes subordinating the Sub-Debt to the Sub-Notes. And before your Lordships consider whether the language in the Sub-Notes could subordinate the Sub-Debt, the critical question is whether the pari passu wording in the Sub-Notes, which is Claim D, has the effect of

causing the Sub-Notes, which is Claim D, to rank above the Sub-Debt.

And the answer is no.

Before I develop the analysis, can I just take your Lordships to four key findings in the judgment if I may. And to do that I just need to have up bundle 2 at tab 22, which is the judgment.

The first the four points I wanted to deal with was what the judge said about the regulatory purpose. The judge identified -- this is going to be paragraphs 15 and 18, which were on 343 and 344. I wasn't going to read them out. The judge identified the contractual purpose behind both the Sub-Debt and the Sub-Notes as being to provide regulatory capital to the Lehmans group.

So you have those references and you have seen the regulatory purpose because I just showed it to your Lordships from the face of the instruments themselves. And no one has identified why subordinating the debt to the notes was consistent with or advanced that sole purpose.

LORD JUSTICE LEWISON: Nor has anybody said it's inconsistent, have they?

MR PHILIPPS: The regulatory purpose was to make the subordinated debt subordinated to the

unsubordinated debt.

LORD JUSTICE LEWISON: I follow, but the judge found that the relative priorities as between subordinated debt was of no interest to the regulators.

MR PHILIPPS: That is actually incorrect. I'm about to show your Lordships.

LORD JUSTICE LEWISON: So that is a finding that you challenge, is it?

MR PHILIPPS: No, sorry, my Lord, what your Lordship just said is correct. I'm now going to show your Lordship how it worked in a regulatory framework. Sorry, I misspoke. Apologies.

The second key point out of the judgment was the requirement to replicate the standard forms. And the learned judge dealt with this in paragraph 68, which is at page 360 of the bundle.

The Sub-Notes were required to replicate the standard form used for the Sub-Debt as closely as possible under the regulatory framework. And my Lords and my Lady, if you look at 68 --

LORD JUSTICE LEWISON: Sorry.

MR PHILIPPS: 68. So sorry, my Lord, I do this far too often. What is said in 68 is:

"This is why the loans in the notes were considered more particularly ...(Reading to the words)... contain

subordination provisions. As Ms Hutcherson explained, the FSA originally used standard form agreements for regulatory capital. Thus, the LBHI2 Sub-Debt agreements were in standard form, and the PLC Sub-Notes, because they involve notes and were not in standard form, required the specific sanction of the FSA."

Now, that specific sanction your Lordships should see. If I could ask you to take up authorities bundle 5 at tab 82.

LORD JUSTICE HENDERSON: Sorry, that reference again, please. My fault.

MR PHILIPPS: Authorities bundle 5, tab 82.

LORD JUSTICE HENDERSON: Thank you.

MR PHILLIPS: I am going to take you to 2635. This is the IPRU rules.

LORD JUSTICE LEWISON: Say the page number again.

MR PHILLIPS: 2635. If your Lordships and your Ladyship have that page, and if you look at rule 10.63(2), which provides that a firm may include a subordinated note in its financial resources only. And that's a crucial word.

And (a):

"If it is drawn up in accordance with standard forms obtained from the FSA."

Then there are references to signatories, but that

doesn't matter. But then at (g):

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

So each change to the subordination provisions in the PLC Sub-Notes need to be reviewed and approved by the FSA.

LORD JUSTICE LEWISON: Would that apply to the Sub-Debt as well?

MR PHILIPPS: No, the Sub-Debt was on the standard form. If they had wanted to adopt an amended version of what is form 10.6, then yes, absolutely, they would have had to do that.

LORD JUSTICE LEWISON: There was a bit of flexibility for both, is that right?

MR PHILLIPS: You could apply to amend the standard forms. But I'm now going to show you how that operated, because your Lordships will see what it was the FSA was concerned about.

If I could go back to the judgment at paragraph 61(3)(b), which is on page 357. What the learned judge says is, which is right, he says:

"Secondly, and as further described below, the regulators unsurprisingly took a great deal of interest in the nature and terms of regulatory capital. In

particular, the regulators wanted to be assured that the debt agreed by these instruments was appropriately subordinated so it could properly act as regulatory capital. This level of interest was such that the terms of the subordination clauses in the instrument considered in this judgment were variously imposed by the FSA or else derived from wording that stemmed from the FSA or, at the very least, had an underlying regulatory function."

What I'm now going to show you is that PLC duly submitted a waiver application. So if I can take you to supplemental bundle 2 at tab 59. It starts at 623. This is the waiver application form. And at 628 in paragraph 18 of the form where it asks for an explanation as to why you are applying for a waiver, in the second paragraph:

"We are applying for a waiver in respect of rule 10.632(a) on the basis that the subordinated loan capital which Lehmans Brothers Holding Plc is seeking to raise is not provided in the form of a subordinated loan from a commercial bank but rather is raised by way of dated subordinated bonds vested in the Channel Islands Stock Exchange and consequently it would be inappropriate to use the pro forma documentation applicable only to loans."

Then if you look at the bottom of the page they enclose certain documentation. The first is the offering circular relating to the 225 million fixed rate subordinated loan notes, which is what we are looking at. And the fourth item is a copy of a letter from Allen & Overy confirming that the terms and conditions of the notes are materially identical to the FSA Standard Form. And that is Form 10.6. And that's the form of the Sub-Notes.

If I could take you to 635, showing your Lordships the attached letter from Allen & Overy.

LORD JUSTICE LEWISON: Say the tab number again.

MR PHILIPPS: Tab 60, page 635, my Lord. The first paragraph:

"We hereby confirm that, subject to set out below, the terms and conditions of the notes ...(Reading to the words)... 225 million fixed rate notes are materially identical to the corresponding standard terms in the FSA's authority Form 10.6."

Then:

"The terms and conditions differ materially from the corresponding provisions of the standard form in the following ways:"

And over the page your Lordships will see it deals with the definition of subordinated liabilities:

"Subordinated liabilities means all liabilities to the lender in respect of the loan or each advance made under this agreement and all interest payable thereon."

Which is the normal. Then:

"Subordinated liabilities means all liabilities to the noteholders ...(Reading to the words)... and all liabilities of the Issuer which rank or are expressed to rank pari passu with the notes."

So the subject-matter of the waiver is the language we are looking at. And then Allen & Overy explain to the FSA:

"We have used this definition, which better reflects borrowing in a bond, rather than a loan format. In particular, no reference is made to the concept of advances being made by us. Unlike a loan facility, there is no provision in the terms of the notes to draw down funds on an ongoing basis but rather a disbursement of funds in full as at the issue date of the notes, followed by a bullet redemption in full of the notes at maturity or such earlier date on which the notes are redeemed."

Your Lordships will have seen immediately that Allen & Overy did not say that by reason of that pari passu wording in the definition of subordinated liabilities the Sub-Note would not be as deeply

subordinated as the Sub-Debt on the standard form.

LORD JUSTICE LEWISON: Not be as deeply ...

MR PHILIPPS: As deeply subordinated as the Sub-Debt on the standard form, because the submission that's being made, the case that your Lordships are considering, is that the Sub-Debt on the standard form is more deeply subordinated because it does not admit of the possibility of pari passu ranking. Which is this.

And Allen & Overy -- the FSA and Allen & Overy can see the conversation. They did not say: this will not be as deeply subordinated as the Sub-Debt on your standard form.

LORD JUSTICE LEWISON: And this comes into the construction process as what?

MR PHILIPPS: My Lord, I'm going to show you in a moment, because there is then a published document. And this is, on any view, part of the factual matrix.

Our submission is, just to be absolutely clear, if the Sub-Notes were on terms that subordinated the standard form less deeply, in other words the notes were being made to rank above debts on the FSA Standard Form 10, Lehmans and Allen & Overy would have told the FSA, and the FSA would want to know.

And instead of that, Allen & Overy told the FSA that the terms were materially identical.

Now, as I've slightly trailed, the FSA gave a specific waiver direction in relation to the Sub-Notes. And the waiver direction was a publicly available document and would have been available to participants in the banking or financial services community and would, on the judge's finding, form part of the factual matrix.

If your Lordships weren't minded to take that as sufficient, that is our submission in any event.

LORD JUSTICE LEWISON: Yes. You were going to show us the public document.

MR PHILIPPS: Absolutely, my Lord, that is exactly what I'm going to do. In tab 61, which helpfully is over the page, this is the FSA letter to the regulatory officer at Lehmans. The FSA, a Mr Meadon(?) from the FSA, says:

"I am writing to inform you that your application for a waiver modification of the rules 10.63(2)(a) and 10.63(3) has been approved. Please find enclosed your direction."

And I'm going to show that to your Lordships:

"The direction is effective from 26 May and will be valid until 30 March unless revoked or any conditions in the waiver modification cease to be fulfilled.

"The direction will be published in full on the FSA's website. Please note that you are required

...(Reading to the words)... immediately if you become aware of any matter which could affect the continuing relevance or appropriateness of this waiver modification."

And then over the page on 639, this is the waiver direction which, as your Lordships and your Ladyship have just seen, is published on the FSA's website. It identifies the modifications. And you can see that it says 10.63(2)(a) is replaced with the following:

"If it is drawn up in accordance with the requirements set out at the end of this rule 10.63(2)."

So they set out the amendment. And the text set out in the schedule to this direction is inserted at the end of the rule.

And just turning over the page, "Conditions":

"This direction is conditional upon the firm obtaining a legal opinion from its external legal advisers that the requirements of 10.63(2) as modified by this direction are met."

And 2:

"The loan capital referred to ...(Reading to the words)... would meet the requirements of lower tier subordinated loan capital under IPRU."

So it was required to meet LT2 capital.

Then if I can take you over the page. This is the

text in the schedule that's referred to. And if I can show you, what it does is it refers to paragraph 4 of the direction and it says:

"The requirements referred to in (a) are as follows."

And it sets out what the requirements are:

"(a) The degree of subordination of the loan capital is no less than that provided by Form 10.6."

Your Lordships have seen that not only is that the subject matter of the waiver direction but of course Allen & Overy wrote a legal opinion confirming that. It is no less than that provided by Form 10.6. That is the form of the Sub-Debt. And this waiver direction required the Sub-Notes to provide a degree of subordination no less than that provided by the form of the Sub-Debt.

And my learned friend's submission, and it won't be lost on you, is that because of the amendment to that very definition this Sub-Note was senior to that Sub-Debt. So it did the precise opposite of what this required, according to my learned friend's submissions.

And then in (e):

"Taking into account both the provisions of the loan documents not in Form 10.6 and the provisions in Form 10.6 omitted from the loan documents, the loan

documents are, in substance if not in form, the same as 10.6 except as set out in the following table."

There is then a table. And what it's saying is that in substance it's the same as 10.6 other than or apart from, and the third one is:

"The definition of subordinated liabilities may be changed to reflect borrowing in a bond rather than a loan."

Now, my Lords, it won't be lost on you that the FSA, when considering a waiver to their standard form subordinated debt, says the degree of subordination is no less than that provided by their standard form.

LORD JUSTICE LEWISON: I am confused.

MR PHILIPPS: So sorry, my Lord.

LORD JUSTICE LEWISON: No, it's my fault. This is the waiver for the Sub-Note.

MR PHILIPPS: Correct.

LORD JUSTICE LEWISON: That is to say Claim D.

MR PHILIPPS: Yes, my Lord.

LORD JUSTICE LEWISON: Claim D must have a subordination of capital no less than Claim C.

MR PHILIPPS: Correct.

LORD JUSTICE LEWISON: If Claim D were to outrank Claim C, then it would not have achieved what this rule requires.

MR PHILIPPS: Precisely, my Lord.

LORD JUSTICE LEWISON: If, on the other hand, Claim C outranks Claim D, then this rule has been complied with.

MR PHILIPPS: That would not create the same problem. And if they ranked pari passu it certainly wouldn't create a problem.

LORD JUSTICE LEWISON: So the only thing that this prohibits -- and tell me if I've got this all the wrong way round -- is Claim D outranking Claim C.

MR PHILIPPS: Yes. And that's my learned friend's submission.

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: But there is another point. This is part of the factual matrix. What your Lordships see is that they use as their benchmark, when they are considering a variation from their standard terms, that the loan capital, the degree of subordination must be no less than their standard terms.

I don't want to put too much weight on that precise description, but what it indicates is that the FSA's view was that the loan capital on their standard terms had a degree of subordination. And that you would find across the loan capital on their standard terms. And in our submission it's another very strong indication that these subordinated instruments, which are either on FSA terms or amended FSA terms, subject to waivers, are all

intended to rank pari passu. And in our submission the waiver direction runs directly contrary to my learned friend's arguments on this appeal.

My learned friend's argument that the Sub-Notes were less subordinated or ranked senior to the Sub-Debt would not have been permissible pursuant to the waiver direction. If the language used in that definition made the Sub-Note senior to the Sub-Debt, the degree of subordination would not have been 'no less'. I don't want to labour the point too much, my Lord.

My Lords, your Lordships will have picked up that what this waiver direction approved was a modification to the subordinated liabilities definition to deal with the fact that these were notes and not debt. That was what that was about, and that was the reason why they did it.

So when we submit to your Lordships and your Ladyship, when we submit that my learned friend is wrong to attach so much weight to that amended wording, to that pari passu wording, your Lordships will have in mind that it could not, from a regulatory perspective, have the sort of weight they seek to attribute to it.

I'm going to come back to the way my learned friend developed the argument about "it's all common sense" and this, that and the other. But I'm sorry, it's all so

inconsistent with the waiver direction, which is published.

So it's very important for your Lordships to have in mind that this behalf A is on the FSA's website. So anybody looking at this sees that this is supposed to have a degree of subordination no less than provided for. So it's public.

My Lords, that was the FSA waiver process. May I then move on to the learned judge's conclusions on the priority dispute. For that we'll need bundle 2, tab 22.

Your Lordships and your Ladyship should be aware that the approach the learned judge took mirrored the approach he took in relation to Claim A(i), A(ii), A(iii), which of course was the question between three tranches of standard form Sub-Debt, save for immaterial differences.

So your Lordships know that we do say, and we say it across the piece, that the learned judge was wrong to treat the instruments as being comprised of both simple contractual and a form of contingent debt subordination. That is an approach that he did apply to the PLC Sub-Debt and Sub-Notes. And if I could just show you in paragraph 335 the learned judge says:

"For the reasons that I gave earlier in 172, I consider the subordination provisions ...(Reading to

the words)... cumulatively in the Sub-Debt Agreements ...(Reading to the words)... and contingent debt."

And at 344, perhaps, just for your note, he said the same in relation to Claim D.

Your Lordships will note, however, that the judge's contingent debt analysis did not affect his conclusions in the PLC priority dispute, because he ultimately disposed of that solely by reference to the definitional wording. And for your Lordships' reference that is at paragraph 364, where the judge cross-referred back to 253.

So he did determine this part of the debate by reference to the definitional wording. And he considered the definitional wording at paragraphs 331 to 335, which starts on 456.

Just taking your Lordships through this, at 341 he set out the relevant definitions, which we have looked at. At 342 the judge addressed what he termed the significant difference in the drafting of subordinated liabilities in Claim D. And you can see that in the second and third lines. And he said:

"The definition of subordinated liabilities under the Sub-Debt was not followed because the debt created in the case of the Sub-Notes does not arise out of an agreement but of individual and legally

distinct notes."

So the learned judge was right. He picks up the notes point, and he says that that fact required an adjustment to the definition of subordinated liabilities in the case of the Sub-Notes.

And the observation was consistent with the waiver application and waiver direction, which your Lordships have seen.

LORD JUSTICE LEWISON: Remind me -- correct me if I am wrong, but I don't think the waiver direction played any part in his reasoning on construction, did it?

MR PHILIPPS: No, it didn't, my Lord. I'm reminded we did make submissions in relation to it. But your Lordship is right.

Now, to say something helpful to the learned judge, it is unfair of my learned friend to say, as she did yesterday, that the learned judge erred in not giving consideration to the pari passu wording. That was yesterday in the transcript at page 39. He had considered very similar words to it in the LBHI2 Sub-Notes, because one has to remember that when one gets to the PLC part of the analysis he's already done the LBHI2.

And he did grapple with what the pari passu wording meant, and he did that in 166(2)(e)(i) on 394. He says:

"It draws a distinction between subordinated claims ranking relative claims ..."

LORD JUSTICE LEWISON: Where are you?

MR PHILIPPS: I'm sorry, my Lord, it's on page 394. I'm in paragraph 166(2)(e)(i) of the judgment. What he says is:

"The distinction is an illusive one. It appears to differentiate between the order of legal subordination described in (e)(ii) above and the ...(Reading to the words)... described in (e)(iv) above where the position can be changed by party consent. The problem is that this provision applies to subordinated creditors of the Issuer, which by definition could exclude those creditors relying solely on their priorities determined by the law, so it's very difficult to make anything of this provision."

But he did consider it. And it echos, really, something my learned friend Lord Justice Lewison raised yesterday -- did I say "my learned friend"? I'm so sorry. My Lord Lord Justice Lewison. I do apologise, my Lord.

LORD JUSTICE LEWISON: I take it as a compliment.

MR PHILIPPS: If an instrument does rank pari passu with another, how can it be subordinated? Which was a point my Lord made yesterday. And how at that point can

either debt be said to be subject to continuing subordination?

The pari passu wording is referring to something commonplace and, as my Lord Lord Justice Henderson said on Monday, it is the starting point and the end point. So for a claim to recognise a principle of equitable distribution and use it to justify seniority is very odd.

And the learned judge plainly adopted this approach when considering the pari passu wording in Claim D. And so it's slightly unfair to say that he didn't look at it at all.

Just for your Lordship's note, my learned friend Ms Hilliard's skeleton recognises as much in paragraph 26. That's just for your Lordships' reference.

Can I turn to C1, C2 and C3 -- no, apologies.

LORD JUSTICE LEWISON: Do we need to worry about that? I think everybody agrees they rank pari passu.

MR PHILIPPS: Yes, they do, and in fact I misread my own heading. What I should have said was, before turning to how the judge resolved the ranking issues C and D we should consider how he addressed the issue between A(i), A(ii) and A(iii), just so that your Lordships have it.

And it's paragraph 150 that is the key. What the

learned judge's reasoning was -- and I don't need to read it to your Lordships, but his reasoning was that it was the similarity in the subordination provisions that gives rise to the circuity(?).

I think your Lordships have the point, but it is central, and in our submission the observation applies equally to Claim C and Claim D, which are materially similar.

LORD JUSTICE LEWISON: It all turns on the word "materially" in a sense. A(i), A(ii) and A(iii) as I understand it are identical. C and D are not identical. You say they are materially similar. I think Ms Hilliard will say, yes, they are similar but they are different.

MR PHILIPPS: Well, what I would say in answer to that is, the only difference is that definition of subordination, and that does not impact on this part of the --

LORD JUSTICE HENDERSON: That's the point, isn't it? The argument is that that makes all the difference.

MR PHILIPPS: Well, of course it's the argument but, with respect, it's wrong.

LORD JUSTICE HENDERSON: That's what we have to decide.

MR PHILIPPS: I'm going to come on to that. But when I say "materially", that is what I mean.

Then in 151(1)(b) he held that they are not excluded liabilities for each other's purposes, which is plainly

right. And in other words, what the learned judge is finding is that there is no relevant expression of juniority in A(ii) and A(iii) which qualifies as excluded liabilities in A(i). And the paragraph, and you might want to make a note somewhere, is important because he cross-refers back to it when he deals with C and D.

And as your Lordships know, he found each was senior from the viewpoint of the other. And then in 152 he deals with the 'infinite race to the bottom' conclusion. Whether that's the way one wishes to describe it, you have each of them saying that the other is senior.

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: And he then engaged in a complicated cross-referential tabular exercise in the same way that he did in relation to A and B.

If I could go to page 421/250. What he says is, and I pick it up in the third line:

"If operating independently as I have described, two subordination causes serve to create an endless loop. When they interact ...(Reading to the words)... the obligations they seek to subordinate rank pari passu as between those obligations, that is simply because ...(Reading to the words)... to subordination does not work ...(Reading to the words)... and the default

ranking would pertain ...(Reading to the words)... subordination terms and is not displaced."

I just want to pause here if I may. The key point is that, save for Deutsche Bank -- and your Lordships are aware of this -- the key point is that, save for Deutsche Bank, all the parties to these appeals agree that in the event of circuity, if I can put it that way, or clash, between subordination provisions, you ultimately reach a pari passu answer.

And your Lordships and your Ladyship are well aware of that. And I could give you DP1's skeleton, 13 and 17, and PLC's skeleton, paragraph 16, where Mr Beltrami says that if the provisions were ineffective the contract would have run out.

LORD JUSTICE LEWISON: I may have misunderstood Deutsche Bank's position but I thought that the argument against pari passu was based on the dividend stopper.

MR PHILIPPS: It is, subject to the 3A, which I will come back to. I will come back to it.

The reason why I have gone to that is that your Lordships have heard a variety of solutions from the parties as to how one gets to the pari passu solution. And what we thought might be helpful is to just draw some of those together for your Lordships at this point in our submissions.

The first possibility is what I would describe as ineffectiveness, which is the learned judge's solution. In our submission this works if it does not require a freestanding contractual principle. And what we mean by that is that where it is unclear and equivocal whether A has waived its right to prove until after B, and vice versa, such that their subordination provisions cannot be enforced against one another, the rules are applied.

They can prove at the same time, and they will rank pari passu. And what one gets from that is, there is no effective alteration to the creditor's right or enforceable prohibition which can stop either creditor from proving.

How can A, for example, enjoin B from proving ahead of it if it's contract says that B is senior? And how could B enjoin A from proving if its contract says that A is senior? They can both prove at the same time and will rank pari passu.

So that's ineffectiveness, possibility 1.

The second is my learned friend Ms Hilliard's public policy argument. My learned friend appears to accept that, on analysis, it is very similar to the judge's solution.

What I mean by that is that as I understood my

learned friend during the exchanges with your Lordships she described it as a paper thin difference between the two. But what my learned friend did was she bolted on a further step, which was the rule of public policy in British Eagle.

Now, in our submission this further step is not necessary but it may be helpful additional background for your Lordships, in a sense being part of the statutory framework, because my Lord Lord Justice Lewison acknowledged the facts of British Eagle were different to this case, where the issue relates to the validity of a clearing house agreement. And it was the clearing house agreement that meant that it infringed the public policy behind the pari passu distribution.

You don't have that here. We just have a series of agreements, which all stand on their own.

And my Lady Lady Justice Asplin was right to observe that applying that principle to this case would require an extension of the principle. However, we do agree with the thesis that public policy should promote the smooth operation of an insolvency and that where the rules have been replaced by contract, which, to use my learned friend Mr Beltrami's words, have run out, the rules step in again as the solution.

Now, I hope this is helpful, but if you could take up supplemental bundle 1 at tab 8 at 227. This is an appendix that we produced to our submissions at trial.

And what we did in this appendix is we analysed the subordination authorities. So this is an analysis that we have done of those authorities. And if you are looking at those authorities you might find, in particular as my learned friend referred to ex parte Mackay and British Eagle -- you might find that of some assistance.

So that was the second potential answer. The third potential answer is a contractual answer to the problem of circuity. And that has been canvassed in various forms. Three have been suggested.

Number 1 is an implied term. Your Lordships have seen paragraph 5 of Golden Key. Lady Arden said that there can be an implication of such a term unless contract says otherwise.

And one way of serving the circuity issue is to imply a term permitting two instruments caught in an endless circle to prove at the same time as each other and share pari passu.

Second, an implied term was suggested to the judge at first instance but ultimately rejected by the judge

because he thought that it might cause market disruption.

And for your Lordship's notes you can see that reasoning at 154 and 155 of the judgment. Each of the parties, PLC, us, Deutsche Bank, proposed an implied term in some form to address the impasse. And you can see that in our respondents' notice, paragraph 81 and 84 of our skeleton, we suggested this as an alternative case to prevent the impasse occurring, the implication of terms in the Sub-Debt to break the circuity.

Another way that we put it in 81 and 84 was that you could adopt a purposive interpretation in this context. And just for your Lordships' notes, Antaios is in the bundle at AB1 at tab 12.

But either form of implied term would allow instruments caught in a circle to rank pari passu. And it is a consensual answer that goes beyond merely bolting on 14.12, the Rule.

Another -- this is the second potential contractual answer that has been floated with your Lordships.

LORD JUSTICE LEWISON: Sorry to stop you. You said the judge rejected the implied term at 154 and 155.

MR PHILIPPS: Yes, my Lord. Have I got that wrong?

LORD JUSTICE LEWISON: I'm not sure that he did in those paragraphs. He may have rejected them elsewhere. I was

just looking -- yes, you are quite right. He says -- in two and a half lines at the end of paragraph 54, is it?

MR PHILIPPS: Yes, it's very short, my Lord. I don't pretend that there was a formal detailed analysis.

It's one of the options. I'm sorry, it's not wonderfully helpful to have the parties saying it's one of the options that we floated, but I'm trying to draw it together for your Lordships so you can see the whole of what has been attempted.

Another contractual answer is a Bromarin approach. We pointed out certain difficulties with that approach in our skeleton in response to Deutsche Bank. And the reason for that is that our submission was that it could not be used to promote the notes over the debt.

But if one were to consider what the parties would objectively have intended as between the instruments in this case, we say it would be pari passu. And plainly it's not live, but not the dividend stopper. And my learned friend's objective commercial solution and the PLC Sub-Note seniority, well, we say that pari passu actually is clear answer if one were to say: if the parties had considered, what would they have agreed if they had realised that there was this potential circuity, the answer is pari passu.

So that was the second option.

Finally, the third option, but it's one we disagree with, was my learned friend's argument of reading the word "agreement" in the Sub-Debt as encompassing what my learned friend described as different tranches of debt. We say that because each one is a different debt and contains its own differences between the debts. So for example, C3 is dated 31 October. It came over a year after the other two. It's in euros not dollars. It had different interest rates and had different maturity dates. So with respect our submission is that that just doesn't work.

Going back to the judge's resolution, as regards the PLC priority dispute, the judge correctly concluded that Claims C and D ranked pari passu for distribution. He dealt with the interaction between the definitional wording at 349 and following, which is on page 459.

And what the judge did was he construed the provisions of Claim C and Claim D independently, and he came to the conclusion that, seen from each other's perspective, they were senior liabilities, leading them to be ineffective in that particular instance, with the effect that the pari passu principle applies.

So if I can just pick up some of the paragraphs. I don't want to go through this at length or for too long. At 352, where he says:

"The rights under Claim D cannot constitute subordinated liabilities as understood by Claim C. They do not arise under any of the agreements comprising Claim C. They cannot constitute ..."

And so on. So that was the first step. So Claim D are not subordinated liabilities. Unless Claim D were excluded liabilities, they have to be senior liabilities. Then at 353 he then deals with the definition of excluded liability:

"The parties were agreed ...(Reading to the words)... and the court would inform the opinion insolvency officer."

That was the point we made earlier.

He then gets to 355 and he says:

"Claim D has exactly same definition of senior liabilities as C. The only difference is in the definition of subordinated liabilities."

357, again by reference to his analysis of A(i), A(ii) and A(iii), he says, "Claim D is not an excluded liability." Then he concludes in 358 that, "Claim D is a senior liability from the perspective of Claim C." And with respect that was correct.

It was a slightly long winded way, perhaps, of going around saying it has to fall within one of the exclusions; and it doesn't.

Step 2, from the perspective of Claim D --

LORD JUSTICE LEWISON: Is he right, in 357, to say the question is the one considered in the context of A(i), A(ii) and A(iii)? A(i), A(ii) and A(iii) are identical, and here we have a difference in the wording. It's Ms Hilliard's complaint, in effect, that he never focused on that difference. It's a similar question but it's --

MR PHILLIPS: It's a similar question ... I mean the reason is, and I have shown you what he did say about the pari passu, he said they are not expressed pari passu and the ranked pari passu language doesn't make any difference. That's what he said. In my submission actually that's right. Whether one could have added some analysis I can't say any more than the judge has said in relation to that, but the answer is right and I will come on to my learned friend's argument shortly.

Then he looks at it from step 3's perspective, the analysis is repeated, and he gets to 357 where he says:

"The result is each viewed through the prism of the other subordination provision ranks as a senior liability. There's no expression of juniority in Claim C which might make it excluded."

Then he gets to his step 3 in 364, where he's saying that because of the similarity in the simple contractual

subordination provisions he gets to a meaningless outcome in the form of an endless loop and a further step was needed. And then he construes them separately, he says that each is pushed to the top of the other, and the result, as the judge found, was that they prove at the same time and rank pari passu.

So if I can just summarise the judge's conclusions and make it a bit cleaner.

The judge's reasoning to resolve the PLC priority dispute had three central components.

From the perspective of Claim C, that is step 1, Claim D is a senior liability because it is neither a subordinated liability nor an excluded liability.

From the perspective of Claim D, at step 2, Claim C is a senior liability, because it is neither a subordinated liability nor an excluded liability.

At step 3 those provisions are ineffective to subordinate one to the other or vice versa, the debts are entitled to prove at the same time and rank pari passu.

The answer is correct. Whether ineffectiveness is the correct route is where the alternatives fall to be considered.

And your Lordship should be aware as to the first element of the reasoning that is accepted by my learned

friend Ms Hilliard and appears to be accepted by Deutsche Bank. As to the second element, GP1's case is focused solely on that limb. And the third element is accepted in principle.

So the scope of GP1's argument is very narrow and it's quarrel is just with the judge's second step and his ultimate conclusion.

I now want to turn to GP1's appeal and I want to make a couple of introductory points in relation to GP1. They show that my learned friend's submissions that there is a difference between Claim D and Claim C is illusory. The first question is whether Claim D is a senior liability in Claim C. We agree with GP1 that Claim D is not a subordinated liability and Claim D is not an excluded liability, so the answer is it is a senior liability.

The second question is whether Claim C is a senior liability in Claim D. And the answer to that is yes, unless Claim C is expressed to or does rank junior or Claim C is expressed to rank or does rank pari passu.

Claim C does not express to rank junior and does not rank junior. And GP1 agree with us in relation to that.

Claim C is not expressed to rank pari passu. And we agree with GP1 about that.

Where we part company is on whether Claim C does

rank pari passu with Claim D. In our submission Claim C without more does not rank pari passu in Claim D and we say, as the learned judge did, that as a matter of independent construction it is senior. And it cannot rank pari passu because it ranks senior. You cannot say as my learned friend did, that the solution to the conflicting seniority construction is that you then rank them pari passu and once you do that it ranks pari passu therefore it's subordinated. You can't, with respect, do that.

In its skeleton --

LORD JUSTICE LEWISON: Just counterfactually, suppose that Claim C said this claim is to rank pari passu with the Sub-Notes.

MR PHILIPPS: If it was expressed.

LORD JUSTICE LEWISON: If it was expressed. Then according to the Sub-Notes they would be senior, wouldn't they, despite the fact they say we rank pari passu? Is that step right?

MR PHILIPPS: Yes, that's right. But the reason for that is that if Claim C chose to put that in its definitions, if it chose to say that, it knows what the definition of subordinated debt is in Claim D. So it knows that it is cutting itself out of the seniority.

LORD JUSTICE LEWISON: Yes, but I mean I think where you get

to is that giving the definition in Claim D effect does mean you have a 'now you see it, now you don't' sort of outcome, because although something might otherwise be ranked pari passu, Claim D says, well, despite that, we will postpone(?) ourselves to it.

MR PHILIPPS: Yes. It says precisely that if another claim expresses itself to rank pari passu --

LORD JUSTICE HENDERSON: Or is pari passu.

MR PHILLIPS: Or is pari passu. And of course -- well --

LORD JUSTICE LEWISON: That's the conundrum. If it is pari passu then it stops being pari passu because of the definition of --

MR PHILIPPS: With respect, my Lord, that is where it becomes complete nonsense.

LORD JUSTICE LEWISON: That is why I want to understand, how you say this definition works.

MR PHILIPPS: If it ranks pari passu it ranks pari passu.

LORD JUSTICE LEWISON: Then what do you do about subordinated liabilities, the definition of subordinated liabilities?

MR PHILIPPS: You are not getting to it ranking pari passu. Because if it ranks pari passu that's it. You can't then say -- and your Lordship is absolutely right, it's "now you see it, now you don't". You can't then say, aha, because you rank pari passu you rank senior. You

can't declare yourself to rank pari passu and as a consequence of that rank senior. You either rank pari passu or you don't. So when your Lordship says "now you see it, now you don't", you are absolutely right.

LORD JUSTICE LEWISON: So this part of the definition simply doesn't work?

MR PHILIPPS: It works for different things. But the important point is if it ranks pari passu it ranks pari passu. You can't conclude something ranks pari passu and as a consequence it ranks senior.

LADY JUSTICE ASPLIN: So basically you are saying you just don't come back to the definition?

MR PHILIPPS: You don't keep going backwards and backwards and bouncing to and fro --

LADY JUSTICE ASPLIN: That is what you are saying?

MR PHILIPPS: Yes. And what my learned friends' submission was -- there is not, for example, an expression that they rank pari passu. And you only get to them ranking pari passu if you cut the Gordian knot, as we have been describing, and what my learned friend's submission is is that Claim C might rank pari passu. That is what she was saying. In her skeleton she said it might rank pari passu, orally she went a step further and said Claim C will rank pari passu because Claim D can

accommodate Claim C at a pari passu level, and it is logical and sensible and reasonable for Claim C to be pari passu. If it was not pari passu it would be senior and that would not be a reasonable outcome of construction because it would lead to ineffectiveness. And that's what my learned friend was submitting to you. With respect, that is not really a proper way to construe these clauses.

LORD JUSTICE LEWISON: Can I ask you another question -- sorry, I'm still having difficulty.

MR PHILLIPS: My Lord, this is the nub of it.

LORD JUSTICE LEWISON: I'm still having difficulty with this definition. Let's suppose that somebody lends Lehmans some money. It's not for regulatory capital, it's just a straightforward loan. So it's a debt. It doesn't say it's pari passu at anything in particular, it's just a loan. Now presumably it would be a senior liability.

MR PHILIPPS: Absolutely, it's an unsubordinated debt which is precisely the sort of debt the regulatory capital is there to support.

LORD JUSTICE LEWISON: Right. That must be right. But it's not an excluded liability.

MR PHILIPPS: Well, no, because it's not junior.

LORD JUSTICE LEWISON: Because it's not junior, correct.

MR PHILIPPS: Yes.

LORD JUSTICE LEWISON: So --

MR PHILIPPS: And it's not subordinated, because it's unsubordinated it is senior.

LORD JUSTICE LEWISON: Right.

MR PHILIPPS: It can't rank pari passu with the subordinated debt unless it subordinates itself to the same level. That's the point. You have a definition that identifies that you are not senior if you have subordinated yourself to the same level that you rank pari passu. It's very unlikely that commercial debt is going to be subordinated to the level of regulatory capital. So -- yes.

Does that help, my Lord?

So what you can't do -- which is what my learned friend is trying to do -- is say that if someone has subordinated themselves to the same level, so that they rank pari passu with the subordinated notes, they rank senior. It just doesn't work. You don't get to step 1, because if you have ranked yourself senior that way you haven't ranked yourself to the same level in pari passu. And you can't keep bouncing around picking on a particular ... okay.

I'm being told off. My Lords, it is of course ironic that in arguing for Claim C being pari passu in Claim D, which is businesslike, to use the language of

my Lady Lady Justice Asplin(?), the effect is that Claim C becomes junior to D. As I have indicated, my Lord, that is what we think you are talking about with the "now you see it, now you don't". It has no fixed point of reference.

We say Claim C cannot rank junior to Claim D as a consequence of Claim D containing pari passu language, which Claim C only gets into by ranking pari passu. And critically GP1 have not identified an expression of juniority that makes Claim D junior to C as a matter of contractual expression; and there is an obvious flaw. The Sub-Debt cannot rank junior to the Sub-Notes because of the possibility they may rank pari passu. To rank junior the Sub-Debt must be an excluded liability in the Sub-Notes and there must be sufficient expression of juniority. And you don't have that.

Can I turn to my learned friend's core argument on the pari passu wording. Can we just pick up bundle 1 and go to tab 17, and in paragraph 21 ...

LADY JUSTICE ASPLIN: Sorry, we are in the skeleton, yes?

MR PHILIPPS: Yes, it's my learned friend Ms Hilliard's skeleton. I will try to do this quickly. Paragraph 21, where what my learned friend does is that she divides the argument into three steps. If we look first at step 1, which is 21(1), she says that from the

perspective of the Sub-Debts GP1 says the Sub-Notes is a senior liability; as I have indicated, consistent with the judge's analysis and we agree.

Step 2 is in 21(2). There it's said:

"From the perspective of the Sub-Notes it is not immediately apparent whether they purport to subordinate themselves to the Sub-Debts. However it is immediately apparent that they are not purporting to be as deeply subordinated to the Sub-Debts for the following reasons."

It's really here that the difficulties arise, they are hedging their bets. They say that it's far from clear into which definitional category the Sub-Notes fall and in (1) they say that the Sub-Debts are not expressed to be senior to the Sub-Notes. So they recognise that there's no feature of the Sub-Debt will constitute sufficient expression of juniority, and my learned friend confirmed that yesterday in the first part of her address.

LORD JUSTICE LEWISON: And you agree with that?

MR PHILIPPS: Yes. And in (2) she agrees:

"It does not follow from the fact that another instrument is not expressed to be junior that the Sub-Notes must be subordinated to it."

Well that may be true in a sense but it's

irrelevant. In order for the Sub-Notes to be senior to the Sub-Debt, as my learned friend contends, the Sub-Debt must be expressed to be junior to it. It goes on to say that's because there's another option of pari passu ranking.

Then in (3) they argue:

"From the perspective of the Sub-Notes therefore it could accommodate the Sub-Debts on a pari passu ranking."

The argument depends on -- it's the possibility of a pari passu ranking can be entertained.

My learned friend yesterday said that it would be sensible for Claim C actually to rank pari passu instead of ranking Claim C senior in Claim D. She said it's the sensible option, I'm quoting, "it's logical", she described it as reasonable, and in that way she said that one could avoid circuity. But, with respect, it's just mere assertion. It's the possibility that it might be pari passu. So it's either pari passu or it isn't; and it isn't. And if it is pari passu it's not senior.

Can I just give you three reasons why the approach to step 2 of the argument is wrong. In summary, the Sub-Notes and the Sub-Debt could at best be pari passu but if they are pari passu they are pari passu. The Sub-Debt doesn't rank junior to the Sub-Notes because

they might rank pari passu. That's the problem. Three points: "now see it, now you don't"; cannot be right to say that C engages the pari passu wording in D whether tentatively or in any other way only to be disapplied in favour of seniority; two debts. For Claim C to rank pari passu with D, that requires them both to rank at the same level and it's very difficult so see what my learned friend means when she assumes that C and D rank pari passu tentatively only from claim D's perspective.

Then the final point is there's a false dilemma, when my learned friend said why should as a matter of construction the court conclude that Claim C is a senior liability, according to the terms of Claim D, when that will create an endless loop when there's an alternative solution which is C being a subordinated liability pari passu with D.

The choice isn't between an endless loop and the pari passu wording, my learned friend accepts that pari passu is the result of a loop. And a choice between pari passu and pari passu as a result of a loop can't result in a choice of seniority.

I'm sorry, it's an awful lot of ways of looking at the same point which is you are either pari passu or you are not. And if you pari passu and you fall within the definition you can't then be senior.

Step 3. It is wrong that Claim C is pari passu from Claim D's perspective, which of course is the starting point. But even if my learned friend Ms Hilliard is right that you get to a stage where Claim D is senior in Claim C, but Claim C is a subordinated liability in Claim D, it does not follow that the correct resolution is for D to rank senior. She explained it yesterday, for your Lordship's reference it was at page 45, the underpinning to that argument was in paragraph 198 of the judgment, which to make any sense of this we have to look at. That's at tab 22 at 407. This is 198. And would you mind just casting why you eyes over 198 again, please. It's a difficult paragraph to follow. The judge appears to be saying where one debt subordinates itself to another but from the other's perspective they rank pari passu then the contest is between a subordinated creditor and an unsubordinated creditor and the effect should be given to the one effective subordination provision.

I should just say --

LORD JUSTICE LEWISON: Are you paraphrasing?

MR PHILIPPS: Yes.

LORD JUSTICE LEWISON: All right.

MR PHILIPPS: I'm sorry, my Lord, I didn't give you enough time to read it.

Two points. The first point I should make actually is that no party made submissions to this effect at all to the learned judge.

But first, we do not accept that two debts can actually rank pari passu only from the perspective of one of the debts; which is an underlying core of this particular reasoning. It makes no sense to treat one of the two debts as being unsubordinated.

Secondly, with respect, this is no rule at all. If pari passu is the outcome dictated by one set of subordination provisions that's the outcome which should be given effect to bearing in mind the operation of the statutory scheme. In those circumstances it cannot be said that the instruments have agreed to derogate from the pari passu principle.

And the judge's analysis with a priority dispute between a subordinated creditor and an unsubordinated creditor -- which was, as I have said, not advanced at trial and, with respect, is wrong.

Can I move on to summarise why GP1's appeal should fail and then I'll move on to Claim F.

GP1's case turns wholly on the pari passu wording. The question for your Lordships is: does the pari passu wording in the Sub-Notes have the effect of causing the Sub-Notes to rank senior to the Sub-Debt? The first

reason why GP1's appeal on ground 1 fails is that it depends on the Sub-Debt ranking pari passu to prove it ranks junior. If Claim C is a subordinated liability in Claim D on the basis that the pari passu wording is in fact engaged, then this can only be because the debts are entitled to prove at the same time and do rank pari passu under Rule 14.12. That is what actually ranking pari passu means. It is a state of fact.

LORD JUSTICE LEWISON: You say the argument is self-contradictory.

MR PHILIPPS: Yes, it is, my Lord. If the pari passu wording is engaged the pari passu ranking can't result in something different. As your Lordship says, it's self-contradictory. If Claim C is not a subordinated liability in Claim D on the basis that the wording is not engaged it is necessarily a senior liability, as your Lordship has just seen, because it's just that carve-out. And the pari passu wording is either engaged, in which case a pari passu outcome between C and D will follow, or it is not in which case the result is necessarily the same as the priority dispute between C1, C2 and C3.

The second reason is that GP1 misconstrues the definition of an excluded liability in D which requires it to identify an expression of juniority in Claim C.

And, I mean, GP1 acknowledged that the Sub-Debts do not express themselves to rank junior. GP1 fails to identify any wording in C that might constitute an expression of juniority. The definition of excluded liabilities requires the reasonable reader to look for the requisite expression of juniority.

Third point, there are only three more, GP1's approach involves a convoluted cross-referral exercise back and forth between C and D only to reach the equivocal conclusion of a tentative pari passu ranking or that Claim C might be an excluded liability.

Fourth, GP1 are wrong to say that the Sub-Debt cannot tolerate other instruments on a pari passu basis and your Lordships have seen that you could have pari passu ranking without pari passu language.

Fifth, GP1's case that the pari passu wording has lessened its degree of subordination relative to the standard form is, as your Lordships know, inconsistent with the FSA waiver.

Can I move on to Claim F, which is GP1's logical device. This is the hypothetical Claim F, as a logical tool for reserving the priority dispute in favour of Claim D. It's an unhelpful device. The short point is if there is a particular ranking between C and D then neither Claims F or G can by their own terms change that

ranking as the holders of neither C nor D would have consented. The argument goes, as I understand it, that because Claim F could validly express itself to be pari passu with D, and at the same time express itself to be ahead of C, this reveals a gap into which the hypothetical Claim F can slot which demonstrates how C and D must rank. The short answer is that if C and D in fact rank pari passu it makes no difference to their ranking that Claim F has expressed itself to rank pari passu with one and senior to the other. All it does is establish that Claim F is aiming for a gap that isn't there.

GP1's argument just assumes the conclusion it wants to reach.

Three points. First, we don't agree with paragraph 39(2). It's obviously not correct that Claim C is expressed to be junior to anything, that fails to account for the definition of excluded liabilities. Second, a new Claim F could not make GP1 rank ahead of Claim C if it didn't already. Third, it is a meaningless construct. So adopting the assumptions and assuming GP1 is correct, that one creditor can agree to rank senior to another, you could posit Claim G which does something different, which is what we have done and, again, the supposed gap just wouldn't prove

anything.

Can I then move on to ground 3(a). Obviously we are not addressing the dividend stopper. I am conscious that my Lord Lord Justice Lewison floated the suggestion that it might be prayed in aid to assist my learned friend Ms Hilliard's argument. Her argument has always been a purely textual argument, as your Lordships know, on behalf of GP1 and of course she did not rely on this argument.

Can we just look at Deutsche Bank's grounds which is in CB114 at 195.

LORD JUSTICE LEWISON: It's ground 3A we're looking at now, is it?

MR PHILIPPS: Ground 3(a), my Lord.

The argument is that:

"The judge erred in concluding that the ranking for the purposes of simple contractual subordination is to be applied to the operation of the contingent debt subordination provisions in the Sub-Debt and the PLC Sub-Notes. The learned judge ought to have concluded that, regardless of when the respective creditors are entitled to proof of their claims, the contingency to claim in the Sub-Notes can be satisfied without taking into account any liability of PLC under the Sub-Debt."

So the argument is that you could pay the Sub-Notes

without taking into account the Sub-Debt.

It is now run in light of the judge's approach to the implementation of subordination and it assumes that although C is not a subordinated liability for the purposes of the definitional wording in D it is a subordinated liability for the purposes of the solvency condition. And the argument goes that this avoids the impasse on Claim D's solvency condition but not on Claim C's solvency condition resulting in Claim D getting paid ahead of Claim C. In other words, this assumes that your Lordships agree that the judge was right to salami slice the provisions into different parts which, as we have indicated, we think is a wrong approach.

Your Lordships should note that the argument is directly inconsistent with GP1's ground 2 which argues that the judge erred by treating the subordination provisions as being comprised of those two mechanisms, the contingent debt mechanism and a simple contractual provision.

I'm asked to remind you that PLC takes the same view.

Deutsche Bank's argument is built on the notion there might be an inconsistent ranking outcome between two subordination mechanisms in the same subordination

provision:

"Although the debts prove at the same time and the debts rank pari passu, the operation of the contingent debt mechanism as a freestanding subordination mechanism results in D being paid in priority to C. If the judge was wrong to treat the Sub-Debt on the Sub-Notes as including a contingent debt subordination mechanism this ground doesn't arise."

So if we are right about that, this ground doesn't arise.

My learned friend argues that the judge erred in resolving an impasse on the contingent debt mechanism by following the pari passu outcome dictated by the simple contractual mechanism. And as to this a claim cannot both be a present provable debt, which may only be proved after senior liabilities, and also a contingent debt provable which may be proved at any time. You can't be both. That's not possible.

The effect of the judge's reasoning is that the simple contractual subordination in C and D is ineffective and in that particular instance such that they prove at the same time and rank pari passu. It makes no sense at all to treat them as being subject to further contingency which has no regard to the pari passu outcome dictated by the earlier part of the

clause. And if the judge was wrong in his resolution of the impasse on the contingent debt mechanism, then there would be a material issue regarding the payment of Claims A(i), A(ii) and A(iii).

Then paragraph 65 of my learned friend's skeleton, Deutsche Bank argue that a circularity does not arise in the context of the contingent debt subordination provisions in Claim D but it does on Claim C. The key assumption is that your Lordships need to read subordinated liabilities in Claim D as not including Claim C for the definitional wording but reading it as a subordinated liability for the purposes of the contingent debt mechanism.

My Lords, that is what you get from 65(3) of the skeleton where they say:

"Claim C does not fall to be taken into account when testing the solvency condition for payment ...(Reading to the words)... Claim D. This is because of the different definition of subordinated liability in the Sub-Notes. For the purposes of the solvency condition to payment in Sub-Note C is a subordinated liability which ranks or is expressed to rank pari passu."

LORD JUSTICE HENDERSON: Sorry, what is the paragraph in the skeleton?

MR PHILLIPS: It is 65(3), my Lord.

LORD JUSTICE HENDERSON: It only goes up to paragraph 53 if I'm looking at the right document.

LADY JUSTICE ASPLIN: Deutsche Bank.

MR PHILIPPS: Sorry, I have moved on, imperceptibly, to ground 3(a) which is the remaining Deutsche Bank --

LORD JUSTICE HENDERSON: I'm so sorry.

MR PHILLIPS: No, no, it's entirely my fault. Yes, if you just cast your eye over 65(3) but then the argument, with respect, is patently absurd because what it assumes is that the defined term subordinated liability can be read inconsistently across the same provision. They want it to be read differently in the context of the conditionality, if I can call it that, to the definitions. If Claim C is a subordinated liability in Claim D then it is so for all purposes and Claim C and D rank pari passu. It's not possible to say that they only rank pari passu for purposes of the solvency condition.

If you look at 23(6) in Deutsche Bank's skeleton, it reveals the inconsistencies in Deutsche's argument. Three lines down, it says:

"However, the PLC Sub-Notes are senior liabilities for the purpose of the Sub-Debt and therefore the two cannot rank or be treated as ranking pari passu. Thus, the PLC Sub-Debt Claim C cannot therefore be

a subordinated liability from the perspective of the Sub-Notes either."

So that applies to its argument under 3(a) as well. As the judge found, Deutsche Bank agrees as a matter of wording:

"Claim C is a senior liability. On the express terms of Claim D that cannot be disregarded for purposes of the solvency condition."

It's really as simple as that. In terms of an answer to 3(a).

My Lords, and my Lady, may I go on to partial release. Do your Lordships have any other questions on the ranking issues before I get heavily submerged into partial release?

LORD JUSTICE LEWISON: No, thank you.

MR PHILIPPS: I'm very grateful. I'm turning to Deutsche Bank's partial release argument. Your Lordships and your Ladyship are right that there is no case that considers the impact of a release of a guarantor on the creditor's claim against the debtor. In order to answer that question we will look at the relevant authorities both outside and inside an insolvency to ask this question: does the release of a surety's right of subrogation make any difference to a creditor's right to sue or prove? And my Lords, and my Lady, the answer is

it does not.

LORD JUSTICE LEWISON: Just two preliminaries, if I may. It's common ground, is it, that by the Settlement Agreement the right to indemnity from the principal debtor was released?

MR PHILIPPS: Yes.

LORD JUSTICE LEWISON: I think it's also common ground, tell me if it's not, that the rule against double proof is a judge made rule which you don't find anywhere in Insolvency Rules themselves.

MR PHILIPPS: Correct. Now may I deal with some preliminaries, my Lord?

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: My Lord, if you don't mind me putting it this way, this really is a matter of real public importance, this particular point. So forgive me if I take it very carefully.

There are two relationships. First, there is the relationship between the debtor and the creditor. The debtor owes the creditor 100 per cent of the debt. The creditor can always sue for the debt, if entitled under the contract of course. Inside an insolvency the creditor can prove for the debt. Sums paid by the debtor to the creditor reduce the amount outstanding on the debt.

The second relationship is the relationship between the creditor and the surety. The creditor has taken a form of security for the debt due from the debtor. The security is in the form of a guarantee. The surety contracts to pay the creditor up to 100 per cent of the debt. But it may contract to pay less of the debt. The surety has a secondary liability, by which the surety has contracted to pay any shortfall in the sum paid by the debtor to the creditor. As I will show you, the distinction between the primary and secondary liabilities is critical. If the surety pays 100 per cent of the debt the surety is entitled to stand in the shoes of the creditor and pursue the debtor. Until that point there is no direct relationship between the surety and the debtor. It is a relationship that arises by way of subrogation.

LORD JUSTICE LEWISON: So does it follow that if the surety pays to the creditor -- choose my words carefully -- an amount equivalent to full amount of the debt that discharges the debt?

MR PHILIPPS: No.

LORD JUSTICE LEWISON: The debt is not discharged?

MR PHILIPPS: You have to analyse the individual contracts. The surety owes no direct debt to the creditor. Now we'll come through all of this but it's really important

that we are rigid about the relationships, my Lord, if you will bear with me. Until that point the surety cannot sue the defendant. Until the surety has paid the creditor he cannot sue the debtor -- sorry, I said defendant.

It is only when the surety has discharged the debt that the surety is entitled to sue the debtor.

LORD JUSTICE LEWISON: I haven't understood that because I just asked you whether if you paid the whole lot it discharged the debt and you said no.

MR PHILIPPS: Well, to whom?

LORD JUSTICE LEWISON: Then you say it's not until the surety discharges the debt.

MR PHILLIPS: Well, the surety is paying the creditor.

LORD JUSTICE LEWISON: I thought the whole point was the surety can't discharge the debt.

MR PHILIPPS: No, no, no. We have to get this absolutely right and I am sorry if I'm being unclear. The surety pays the creditor. When the surety pays the creditor the surety by right of subrogation can then go against the debtor.

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: Until that point the surety has no claim against the debtor and no direct relationship to the debtor. And I think your Lordship --

LORD JUSTICE LEWISON: I find that hard to understand.
MR PHILIPPS: That's pretty fundamental. The surety has entered into a contract with the creditor. The surety hasn't entered into contract with the debtor.
LORD JUSTICE LEWISON: I follow. But outside insolvency, outside insolvency, if the debtor contracts a debt to the creditor of 100 and the surety pays 50 --
MR PHILIPPS: To whom?
LORD JUSTICE LEWISON: To the creditor.
MR PHILIPPS: Yes.
LORD JUSTICE LEWISON: The surety surely has a right to be indemnified by the debtor for 50?
MR PHILIPPS: No.
LORD JUSTICE LEWISON: No?
MR PHILIPPS: No, no. The right to subrogation hasn't arisen yet and your Lordship will see how this works through.
LORD JUSTICE LEWISON: So if the surety pays 50 and the debtor pays 50 --
MR PHILIPPS: To whom, sorry, my Lord?
LORD JUSTICE LEWISON: To the creditor. They pay half each to the creditor, is the surety then subrogated? Could he then claim his 50 from the debtor?
MR PHILIPPS: Yes.
LORD JUSTICE LEWISON: Why?

LADY JUSTICE ASPLIN: Why?
MR PHILIPPS: Because the creditor's claim has been discharged.
LORD JUSTICE LEWISON: Well, it hasn't, you say, because a surety can't discharge the creditor's claim.
MR PHILIPPS: I'm sorry. Can we do this in stages because, actually, it's very dangerous if I get confused because of your Lordship's questions. I am not smart enough to be able necessarily to do it. Can I just do this in stages, it's really important. The right of subrogation does not arise until the surety has paid the sum that it has agreed to pay the creditor, because he then by way of subrogation steps into the creditor's shoes.
LADY JUSTICE ASPLIN: So you are saying if the surety pays 50 instead of 100 he has no right of subrogation against the debtor, in which case you would be barmy, if you were a surety, to pay anything other than the whole amount (inaudible).
MR PHILIPPS: Well, you can agree that you will be guaranteeing for £50 and if that is the contract between you and the creditor then your right of subrogation will arise.
LADY JUSTICE ASPLIN: Yes, but if the debt is 100 and you have agreed as surety to give a guarantee for 100, but you make part-payment, then you are in no man's land is

what you are saying.

MR PHILIPPS: Well, you have no claim against -- I am going to come on to the consequences because the creditor doesn't just sit there and have the 50 and then get 100 from the debtor and goes, whoopsie-doops, I've just made a huge profit.

Remember, this is a form of security. It is a form of security to the creditor for the debt due from the debtor. But yes, if you only pay £50 your right to subrogation has not arisen until such time as when -- when the whole lot has been paid the creditor must account to the surety for any sum that the surety has overpaid.

LORD JUSTICE HENDERSON: What is the nature of that rule which prevents any right of, so to speak, subrogation arising pro tanto at an earlier stage? Is it a rule of law, a rule of -- I can't --

MR PHILIPPS: Yes, these are all rules of law.

LORD JUSTICE HENDERSON: I know --

MR PHILIPPS: I'll take you through all the cases.

LORD JUSTICE HENDERSON: Is it judge made law? Where do we find -- we will find --

MR PHILIPPS: Yes, you are going to find all of this and there are lots of very exciting books about guarantees. But the point I'm on at the moment is you have to bear

in mind you have two different relationships.

LORD JUSTICE HENDERSON: Quite.

MR PHILIPPS: And it's fundamental, if you don't mind me putting -- it's really fundamental.

LORD JUSTICE HENDERSON: Yes.

MR PHILIPPS: The point I think I just made is it is only when the surety has discharged the debt, in other words paid the creditor, that the surety is entitled then to sue the debtor. The debtor still owes the debt but the creditor has been paid under his guarantee, his security. So the surety then steps in and he sues the debtor. The right of subrogation of course only arises if there is at that point a debt due from the debtor to creditor because otherwise there is nothing to be subrogated to. It's the right of subrogation that results in the surety standing in the debtor's shoes.

LORD JUSTICE LEWISON: Well ...

MR PHILIPPS: I'm going to come on to the 100 per cent point because it is all absolutely crystal clear and not a problem. But, please, let me get to that.

The answer to my Lord Lord Justice Henderson's question, which was at page 154, about why there is this superstructure, is because there are two contractual relationships and a right of subrogation that only arises if the surety discharges his liability to the

creditor in full. My Lord Lord Justice Henderson's comment that it would make more sense to say you can just reduce the debt pro tanto doesn't work and it doesn't work because it turns a secondary liability into a primary liability; and that benefits the debtor and the debtor's creditors at the expense of the surety who has made the payment. But if that payment --

LORD JUSTICE LEWISON: Sorry, say that again.

MR PHILIPPS: It benefits the debtor and the debtor's creditors at the expense of the surety. So if the surety pays the debtor directly --

LADY JUSTICE ASPLIN: Pays the creditor.

MR PHILIPPS: No, no -- I was going to the point that my Lord made yesterday, that it discharged the debt and I'm just explaining why that doesn't work. And the reason -- forgive me. The reason why it doesn't work is that it benefits the debtor because if it discharges the debt, and it's the surety who has discharged the debt, the surety has paid the money that lost his right of subrogation to sue the debtor. Ordinarily what the surety should do is you pay the creditor and then you stand in the shoes of the creditor and you pursue the debtor for whatever the debtor owes. But you don't just reduce the debt due from the debtor pro tanto because of a payment by the surety because that treats that

secondary liability as a primary liability as discharging in whole or in part the debt due from the debtor to the creditor, which is the right the surety gains by way of subrogation if he makes that payment. That is the answer to your Lordship's question. I'm sorry --

LORD JUSTICE HENDERSON: Does it then mean the passages we were looking at yesterday in the judgments of Lord Justice Hoffmann, Lord Justice Dillon, and probably others, are just plain wrong?

MR PHILIPPS: They are dealing with a completely different point. No, I'm sorry -- the reason why they are dealing with a completely different point is they were concerned with the question of whether or not there was a primary liability because that would have given set-off to the directors in MS Fashions. I will take you to it, I will show you it was not because it was guarantee liability that was being paid. And the case actually says the precise opposite because it says that if it was a guarantee liability it would have been a contingent liability and not available for set-off.

I will come back to it, I absolutely promise. It is a very important point that we get right.

The next proposition is the debtor can never be liable for more than 100 per cent of the debt. The

rules ensure that. Once the debtor has paid 100 per cent of the debt, the debt is discharged. No more than 100 per cent can ever be proved in the debtor's insolvency, and that is where the rule against double proof kicks in. You can never prove more than 100 per cent for the same debt. The rule against double proof, my Lord, is often described as the rule against two proofs for the same debt.

The creditor can never receive more than 100 per cent. If the creditor receives more than 100 per cent, because both the debtor and the surety have made payments to the creditor, the creditor must account to the surety for the balance. The reason for that is the surety's is a secondary liability. The surety is not liable for anything other than a deficiency in what the debtor has paid the creditor.

The surety can never be liable for more than the amount the surety has contracted to pay. If they pay the creditor 100 per cent of the debt that they owe, they are liable for no more. Because the liability of the surety is a secondary liability, when the surety discharges the liability to the creditor they step into the creditor's shoes and are entitled to pursue the debtor up to 100 per cent of the debtor's outstanding liability.

LORD JUSTICE LEWISON: Can I just ask a question I'm sorry --

MR PHILIPPS: Of course. I'm sorry I keep saying please don't, it's just it's very complicated.

LORD JUSTICE LEWISON: I follow. Let us suppose that the debtor owes 100, and it's payable in two instalments of 50. A surety guarantees the second instalment only. The debtor pays the first 50 and fails to pay the second 50. The surety pays it. Is he subrogated to the creditor rights for the 50 that he has paid?

MR PHILIPPS: The surety is subrogated to the creditor's rights to the second 50 from the debtor.

LORD JUSTICE LEWISON: Right. Now suppose the debtor owes 100 and the surety guarantees up to a limit of 50. The debtor pays 50 and the surety pays 50. It has paid as much to the debtor as he agreed to be liable for. Is he now subrogated to the creditor's rights?

MR PHILIPPS: He can then -- yes, and he can sue the debtor for the outstanding 50. Because that is the sum that the surety has paid the creditor, it's the outstanding 50. So he stands in the creditor's shoes by way of subrogation and he sues the debtor for the second 50. The creditor keeps the first 50, that's part of the agreement between him and the debtor.

LORD JUSTICE LEWISON: Right. If the debtor paid nothing

and the surety paid 50, which is all he agreed to be liable for, you say he's not subrogated to any rights that the creditor might have(?), outside insolvency?

MR PHILIPPS: If he's agreed with the creditor that his guarantee is a guarantee of £50.

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: Then he is subrogated and he can sue the debtor for £50.

LORD JUSTICE LEWISON: Yes.

LADY JUSTICE ASPLIN: What you were saying earlier was if in fact he had agreed to pay 100, surety to creditor, and he's only paid 50, then not.

MR PHILLIPS: No, exactly, because that's the agreement between the surety --

LADY JUSTICE ASPLIN: It's the nature of the agreement.

MR PHILIPPS: Quite. When we look at the cases, what your Lordships are going to see is the competition that they are concerned about. It's competition between creditor and the surety, and we will see that.

The fact of the creditor's rights against the surety, which of course is the creditor's security interest if you like, is a matter for the contract between the creditor and the surety. As a matter of fact under the terms of the Settlement Agreement in our case, I will show you, the creditor has agreed it will

never receive more than 100 per cent and I will show you that.

The position is that the debtor remains liable for up to 100 per cent, whatever the liability is. The estate cannot pay more than the dividend it would have paid on whatever is outstanding, up to 100 per cent. The creditor is unable to recover more than 100 per cent, and in our case that is because the Settlement Agreement provides they will not receive more than 100 per cent and it provides that any surplus over 100 per cent is repaid to the surety. The surety has made payment but has released its right to indemnity, which it is entitled to do. It has a right to indemnity, it has a right of subrogation. It's entitled to release those rights.

To the extent that the creditor has received more than other creditors -- and this is actually quite an important point. I can't remember who said it, but the question is: well, that's not very equity it means that a creditor with a guarantee receives more than all the other creditors, doesn't that infringe a pari passu principle? And absolutely not. The reason why the creditor has received 100 more than the other creditors in that case is because he took a security in the form of a guarantee and the surplus over and above the

dividend on 100 per cent of the outstanding debt has come from the guarantee, which is why you take guarantees. He is in the position of a secured debt. It's not -- this is important -- because the creditor has received more of the debtor's estate than it should have received. It still received precisely the same dividend, precisely the same as everyone else, but has a right of guarantee and if it receives some more money under it's guarantee that's why it took the guarantee.

LORD JUSTICE HENDERSON: This is obviously an important point. One might have thought, or at least this is obviously relevant, perhaps one of the main reasons you take a guarantee is because you think it's a stronger covenant or for various reasons you want to have two people to call on rather than one. That is a separate point from whether it actually operates as a security in addition, and you are saying yes it does.

MR PHILIPPS: Both are true. We will see in some of the cases that there are primary and guarantee liabilities.

The flaw in the discussion between my learned friend and the court yesterday is that it did not properly identify the competition that the cases are concerned with. The cases are not concerned with a competition to a larger slice of the debtor's estate. They are concerned with a competition between the creditor and

the surety to the same slice of the debtor's estate. The question of a larger slice concerns only the extent to which the surety makes a contribution to the creditor.

Now, if I can summarise the arguments and the order in which we will take them. There are four points that we wish to develop. First, there is what my learned friend called the general rule outside of an insolvency. We disagree that the general rule outside of an insolvency is that a part-payment by a surety prevents the creditor suing a solvent principal debtor for the whole amount of the principal debt. To the contrary, the creditor is entitled to sue for the whole amount of the debt but with an obligation to reimburse the surety once the creditor recovers in full or, to be more specific, for any sums the creditor recovers over and above the 100 per cent because the surety has guaranteed the debt. If 100 per cent is received the surety no longer has anything that he has guaranteed.

This general principle can be seen running through the decisions in Sass, Ulster v Lambe and the Australian decision in Westpac. Those cases are not the cases relied on by Deutsche Bank and represent the general rule.

Second, is what Deutsche Bank calls the impact of

insolvency. As to the general rule inside insolvency we say that this is the rule in Re Sass which has been good law for 125 years. We will also take your Lordships to two of the cases that were referred to in Sass and your Lordships will see it's a longer historical route. The rule exists to ensure maximisation of recoveries by the creditor and to prevent the unjust enrichment of the debtor and by implication other creditors.

My Lord Lord Justice Lewison asked if there was authority for the core proposition that the creditor can prove for 100 per cent. It is the application of the basic principles, which I'm taking your Lordship through. D owes the debtor -- the debtor owes the creditor 100 per cent throughout.

LORD JUSTICE LEWISON: I don't think I questioned the right to prove. I think I was asking about authority that entitled the creditor to sue the debtor for 100 per cent when part of --

MR PHILIPPS: When part had been paid. I misunderstood.

LORD JUSTICE LEWISON: Outside insolvency. I don't question the rule against double proof that says a creditor can prove for 100 even if a surety has paid 50.

MR PHILIPPS: I will deal with it both inside and outside, and I apologise if I misunderstood your Lordship's question.

The third point is what my learned friend called the impact of the release, which of course is the nub of Deutsche Bank's argument. We say that the release by LBHI in its capacity as a surety of its indemnity claim against PLC does not alter the analysis. The claim against the debtor is uneffective as (a) the rule outside and inside insolvency are one and the same and (b) a waiver by a surety of its indemnity claim does not alter the creditor's primary claim against the debtor and does not alter the creditor's right to prove. And that is the same inside and outside of an insolvency.

Fourth, there is the relevance of clause 7(f). I will come to that at the end. It's a very short point that was taken on appeal for the first time, but I can deal with that very quickly.

Can I therefore start with the general rule outside of an insolvency, my Lords. The foundation stone of Deutsche Bank's argument is what it describes as a general principle outside insolvency that payment by a surety will discharge pro tanto the debt due by the principal debtor to the creditor.

For your Lordships' reference, that is paragraph 69(i) to (iii), and 72 to 80 of their skeleton.

We rely upon a number of cases, but the first case

that I want to look at is Re Sass. I'm going to come to Re Sass twice during the course of the analysis. Can we take up A1/1 at tab 1. I want to go for these purposes to pages 11 to 12. Can I tell you, as I have indicated, we will return to Sass in more detail with we look at the position inside an insolvency. For present purposes I am looking at the dicta of Mr Justice Vaughan Williams on the position outside of an insolvency on page 11.

LORD JUSTICE LEWISON: Yes, the second sentence.

MR PHILIPPS: Yes:

"I think that the common law right of the bank here was to sue the debtor for the whole amount that was due from him to them irrespective of the sum which was paid by the surety unless that amounted to 20 shillings in the pound."

That is absolutely correct as a statement of the general principle. It establishes the orthodox position outside of an insolvency. It has, as I have indicated, been good law for 125 years. It is frankly one of these poor cases -- it is one of the first cases that as a practitioner in this area that you will learn. It's an application of the principles I started out with: the creditor has a claim against the debtor for 100 per cent of the contract, with the surety it's a secondary liability, and it's only when the surety has paid the

creditor the full amount of the surety's liability under the contract between the surety --

LORD JUSTICE LEWISON: I understand that's your position. If it's the common law then presumably Mr Justice Vaughan Williams didn't invent it.

MR PHILIPPS: Absolutely and that is exactly what we are going to now. There are two of the cases cited in Sass that I would like to take your Lordships to, if I may. I'm hoping that they have made their way into your Lordships' authorities --

LORD JUSTICE LEWISON: A separate clip.

MR PHILIPPS: Splendid, as long as your Lordships have it. The first of the authorities that I wish to look at is Midland Banking Co v Chambers. As a Victorian authority it is thankfully relatively short, but can I start by taking your Lordships through the headnote:

"The bank permitted the customer to overdraw his account upon having a guarantee from a surety to the extent of £300."

I should have said this is 1869 and I should have said it's Court of Appeal.

"... to the extent of £300 which guarantee provided that all dividends, compositions and payments received on account of the customer should be applied as payments in gross."

Then if I can pick it up four lines down:

"Afterwards the customer compounded with his creditors by a deed [which is one of the ways in which insolvency was dealt with in that time] which provided for the administration of the assets as a bankruptcy. His banking account was overdrawn £410. The mortgage was realised. The surety paid the bank the £300 secured by it.

Held: affirming the decision of the Vice-Chancellor, that the bank was not restricted to proof for the balance of £110 but was entitled to receive the dividends on the whole £410, not receiving the whole, including the £300, more than 20 shillings in the pound."

If I can then take you over the page, you can pick up the facts in the third paragraph down on the left-hand side.

LORD JUSTICE LEWISON: At the time of the execution?

MR PHILIPPS: Yes, my Lord. Cast your eye over that, you can see the numbers. And you can see that Mr Thorpe paid over £300 in discharge of his guarantee.

Then, picking it up further town:

"... the trustees contending that they were entitled to proof for only £110 being the balance due from Mercer after deducting the £300."

And so on:

"... Mr Vice-Chancellor Malins made a declaration in the trustee's appeal."

Then on page 400, if I could pick up the judgment of Lord Justice Selwyn. I will pick up the second sentence. The two questions:

"The other as to the effect of Thorpe having been fully paid by means of his counter-security:

"It is settled by Thornton v McKeown(?) and other cases that where a surety who is liable for part of the debt is paid the whole of what he is liable for he is entitled to stand in the place of the creditor to that extent against the estate of the bankrupt debtor."

Which, my Lady, answers your Ladyship's question:

"The surety may, however, in his contract of suretyship agree to waive his right for the benefit of the creditor and the question is whether the surety did so in the present case. I am of the opinion that the clause in the latter part of the guarantee was intended to exclude the surety from the right to have a share in the benefit of the proof and to allow the creditor to receive the full amount of dividend."

As I indicated to your Lordships and your Ladyship, what the contract is between the creditor and the surety is a matter for the agreement between them:

"This being so, there only remains the question of whether the position of the creditor is affected by if fact that the surety that has been fully paid by means of the security given him by the debtor."

Then over the page, where you can see Lord Justice Giffard:

"I quite agree with the opinion of the Vice-Chancellor and do not think there is any reasonable doubt as to the meaning of the guarantee for it in terms first to dividends received from the principal debtor which must apply to the dividends from his estate."

Then, further down:

"Such payment stands in the same footing as if it were made by ...(Reading to the words)... out of his own money and furnishes no ground for reducing the proof."

And there you see the roots of the concept that there is a difference between the primary liability and the secondary reliability and the secondary liability makes no difference. What it establishes is that where a surety has made a part-payment and has waived his right to subrogation there is nothing to prevent the creditor from claiming the full amount of the proof against the principal debtor. You will see that the facts in this case are actually very similar to what has happened in the present case, because pursuant to the

2011 Settlement Agreement LBHI released and waived its right to subrogation.

You will also see that the holding in Midland, that in effect the bank was not entitled to receive more than 100 pence in the pound, goes to the questions posed by my Lord Lord Justice Henderson, at pages 143 and 144 of the transcript, as to how to avoid the risk of effectively the creditors as a whole getting too much -- I think I have answered that point because it's as a result of security owned -- and if they do whether this has to be held on trust. The case establishes that while the creditor is entitled to prove for the full amount of its proof it should not receive more than 100 pence in the pound where the guarantor has waived subrogation rights.

My Lord, you were rightly concerned about the creditor receiving more than its fair share. But rather than reducing the proof and the creditor still proving, the creditor can still prove for the full amount.

LORD JUSTICE HENDERSON: I think my concern was partly it seemed like a rather clumsy mechanism -- and of course the creditor can't end up with more than 100. It seems a rather round about way to ensuring that objective if he actually gets more than 100 and then you have this trust mechanism which was supposed to deal with the

problem. That seems like a commercially rather round about and unsatisfactory way of dealing with the point, to which I suppose your answer is you say that's a necessary consequence of drawing the correct distinction between the primary and the secondary liabilities.

MR PHILIPPS: Exactly, my Lord, that is exactly the point and it is because there are two --

LORD JUSTICE HENDERSON: It doesn't really alter my feeling of disquiet about that being what the law requires but I do see the point -- I see the force of your argument.

MR PHILIPPS: Well, yes. I mean, there are two separate relationships. Once one has dealt with the debtor and the creditor, one is then looking at the creditor and the creditor turns round and looks to see: how much was outstanding on my guarantee? The surety is entitled to say: you have now been overpaid, can I have rest back please. He has only guaranteed it up to 100 per cent.

I quite understand your Lordship's point as a matter of mechanics, but conceptually there is absolutely nothing wrong with that.

Can I then take you to the second authority, please, my Lords. As the second authority I hope you have National Provincial Bank of England in Re Rees(?). Your Lordship should be aware that the analysis is

similar to Midland, and Midland was cited by the successful appellants in this case. I have indicated to your Lordship both of these are recited in Re Sass. If I could start with the headnote:

"A customer gave to his bankers as security for the balance which might from time to time be due from him to them the joint and several bond for £1,000 of himself and his surety, the liability of the surety being expressly limited to £500. There was a proviso in the bond that only dividends received by the bankers in the bankruptcy of the customer should not so far as concerned the surety go in discharge of his liability but the banker should notwithstanding be entitled to recover on the bond against the surety to the full extent of £500 or so much thereof as should together with the dividends amount to 20 shillings in the pound on the debt due by the customer to the bankers.

"The customer filed a liquidation petition and the bankers proved for the debt due to them. Afterwards the surety paid the bankers £500 and he then proved in the liquidation for £500."

And it was held in Court of Appeal, go down to Court of Appeal holding:

"The bankers were entitled to retain their proof for the full amount."

And if we could go over to internal page 101 -- I'm so sorry, I've just noticed the time. May I finish the authorities?

LORD JUSTICE LEWISON: Yes.

MR PHILIPPS: Thank you. On page 101:

"After proof in bankruptcy has been made it cannot be reduced by using a payment received by the creditor from a third party. The effect of the peculiar form of the bond is that the surety sells to the creditor the right which he would otherwise have had to stand in his shoes and have the benefit of the proof to the extent of the payment he has made."

Then Lord Justice James says:

"I think the order ...(Reading to the words)... It appears to me that both the learned judges must have been under some misapprehension as to facts."

If I can pick it up from middle of the page, do you see a part that says, "It is not that he was surety only for £500"? This is a point that we see running through a number of the guarantee cases:

"It is not that he was surety only for £500, he was surety for the whole debt with that limitation. Although the ultimate liability could be enforced against him, he being surety for the whole he was only to be called upon to the extent of £500. He had no

equity arising out of any reduction of the ultimate balance if the principal debtor had paid part of the debt. Of course the bank had a right, if they chose, not to put the bond in force until the whole thing had been wound up, to say: the ultimate balance due to us is more than £500, pay us the £500. That would be their right. It does not signify in what mode or by what steps that ultimate balance due to them was to be ascertained. Therefore, independently of the proviso, it seems to me their right would be the same."

You can see, again, it's the secondary right:

"The sureties who had paid a portion of the debt would or might have been ..."

This is a quote from Lord Justice Knight Bruce in Hope:

"The sureties who had paid a portion of the debt would or might have been entitled to the dividends on that portion if there had been no such proviso. By the proviso they in effect sell their right in these dividends to the creditor. So in the present case the surety has chosen to contract himself out of a possible equity. In the plainest most simple terms, he can have no right to intercept any dividend which would otherwise be payable to the principal creditor."

And then Lord Justice Cotton(?):

"The proviso clearly points out that that is so and the surety is not to take advantage of any payments made from time to time by the principal debtor. It is to be liable, though not to a greater extent than £500, therefore is not entitled to hold the bank as accountable to him for any dividend they may receive to the principal debtor's estate ...(Reading to the words)... further to proof."

And it's the beginning of the competition that I have referred to and we will see it in other cases. The competition that they are concerned about is between creditor and surety. The position of the estate stays the same:

"But as in Midland, in Rees the surety had waived its right to subrogation. Accordingly, they would not be competing in the debtor's estate with the creditor and as such there was nothing to prevent the creditor from claiming against the debtor for the full amount of the proof without having to reduce it or take account of sums received under the guarantee."

Now, those two cases were cited in Sass and they form the basis of Mr Justice Vaughan William's approach.

My Lords, is that a convenient moment?

LORD JUSTICE LEWISON: Yes, thank you. 2.05 pm.

(1.05 pm)

(The short adjournment)

(2.05 pm)

LORD JUSTICE LEWISON: Yes, Mr Phillips.

MR PHILLIPS: May we move on to Ulster v Lambe, please, which we will find in authorities bundle 1 at tab 5, which is internal page 79.

My Lords, if you could cast your eyes over the headnote.

LORD JUSTICE LEWISON: Yes.

LORD JUSTICE HENDERSON: So sorry, give me the reference again. My fault.

MR PHILLIPS: Yes, it's authorities bundle 1, tab 5.

My Lords, you can see that there was indebtedness to the bank and there was a guarantee of the whole debt. There was part payment by the sureties, not of the whole debt. The bank sued the debtor for whole amount. And it was held that the payments by the sureties, since they did not discharge the whole debt guarantee, did not discharge pro tanto the liability of the defendant.

If I can just take you to a couple of passages from the judgments. If we could move forward to internal page 164, lines 23 and following, where Mr Justice Lowry stated the facts and continued:

"The principles governing this type of case are

discussed in LS Reece [which we've seen] ...(Reading to the words)... and are well illustrated by the judgment of ...(Reading to the words)... Vaughan Williams, as he then was, in Re Sass."

He then moves on to the question whether the guarantee is of the whole debt or part of the debt. And of course, the reason why that matters, as your Lordship knows, is that the right of subrogation does not arise until the sureties have discharged their entire liability to the creditor.

Then if we can go forward to 166, line 23, and if you would be kind enough to read through to -- well, in this section, actually, let me tell you what I'm doing first.

In this section the judge considered the contrary argument based on McKinnon's trustee. That is what he's doing in this section. And if I could start with 168 at line 21, because you'll see that at line 21 there's the end of a quote. I'm going to go back to the quote, but he says:

"I respectfully adopt the statement of principle, and even if the observations in the McKinnon case point away from the following in Re Sass I prefer the reasoning ...(Reading to the words)... which is a salutary reminder of the importance of the terms of the

contract in a particular case."

And the reasoning is in the passage that starts at 167 at line 34, through to 168 at line 21. That I would ask your Lordships, please, to cast your eyes over.

If I can just tell you, the question is whether the surety has the right to interfere with(?) the credit's right to rank for the full amount of the debt. And if the surety hasn't fulfilled the whole of his obligation, he is not entitled to come into competition with the creditor, which is why I said to your Lordships earlier that the competition they are concerned about is between the surety and the creditor, coming into competition and going for the debtor.

LORD JUSTICE LEWISON: The quotation is from Harvey, is that right, not McKinnon?

MR PHILLIPS: That is absolutely right, my Lord. You can see there references to McKinnon and further up the page 167, but then the point is dealt with through the quote from the Harvey case, and that is the point that Mr Justice Lowry agrees with.

(Pause).

LORD JUSTICE LEWISON: Yes. The theme that has run through all these cases that you showed us on this point so far is that it's all a question of construction of the guarantee. And I'm conscious of the fact that we

haven't actually seen the guarantee. I'm not even sure it's in the bundle.

MR PHILLIPS: For the purposes of this, no, but I will show you the Settlement Agreement, and that is what's happened to the contract between the creditor and surety. But I'm going to come back to that, my Lord. I will come back to that on the facts of this case.

Can I just pick up on page 169 at line 16, which is Mr Justice Lowry's conclusion. Your Lordships will see that what he says is:

"The true principle is that where the entire debt is guaranteed with or without a limit, the creditor can pursue the principal debtor or claim in his bankruptcy for the full amount of the debt despite any payments on foot of that guarantee, whether they are made before or after the principal debtor's bankruptcy, provided those payments in the aggregate fall short of the full amount of the debt.

"The benefit to the guarantor is that money recovered in excess of the full amount of the debt is held in trust for him. The rights of the other creditors of the principal debtor are not infringed since the bank is at all times entitled to rank equally with other unsecured creditors in the principal debtor's bankruptcy, and has, independently of this right,

contracted to receive from the guarantor payment to supplement the dividend on the entire debt.

"If the entire debt is discharged, the creditor has no further interest and the guarantor stands in his shoes."

And my Lord, that is a very neat summary of what the position is in relation to guarantees:

"If the principal debtor remains solvent, the question of justice among his creditors does not arise."

So provided the payments in aggregate fall short of the full amount, because it's not until the surety has discharged his liability to the creditor, the right of subrogation then arises.

Then in the clip there should be an extract from Chitty, which I think is notionally down as authorities bundle 5, tab 92, but I think you might have it in the clip that was sent to you this morning.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: Excellent. There are two extracts from Chitty. The second extract, I think, my Lord, is the extract your Lordship referred to yesterday, but I want to show your Lordship the extract at 45.078, which is on page 2952. This is, my Lords, what Chitty says:

"Where a guarantee, whether continuing or for a particular transaction, is given subject to a limit on

the amount for which the surety may be held liable, one important question of construction often causes difficulty. This is whether the surety is guaranteed the whole liability or debt, though his own liability is for the limited amount, or whether he has guaranteed only part of the liability of the debt."

And that is because that determines whether his right of subrogation arises:

"The distinction is important, principally where the debtor or the surety becomes bankrupt. If the surety has guaranteed only part of the debt, he pays the creditor the amount for which he is liable and, in the event of the debtor's bankruptcy, the creditor can only prove against the bankrupt's trustee for the balance of the debt, whereas a surety can prove against the bankrupt's trustee for the amount he has paid.

"Similarly, where it is the surety himself who becomes bankrupt, the creditor can only prove against his trustee for part of the debt which he has guaranteed. On the other hand, where the surety has guaranteed the whole debt, though subject to a limit on his liability, the position is different. In the event, the creditor can prove for the whole debt against the bankrupt debtor even though the surety has paid under his guarantee and the surety has no right of proof of

his own, at least until the creditor ...(Reading to the words)... 100 pence in the pound.

"Similarly, if the surety is bankrupt and has guaranteed the whole debt, the creditor can prove against his trustee for the whole amount, though he cannot, of course, recover more than 100 pence in the pound.

"Even where no bankruptcy is involved, the distinction may sometimes be important, for it seems that the creditor can recover judgment against the debtor for the whole debt even though the surety has paid under his guarantee, unless the guarantee is for part of the debt alone. If the creditor recovers more than the balance remaining unpaid, he must account for the surplus to the surety."

And if you look at the note, 410 --

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: (Inaudible) Lambe.

May I then move, in the same authorities bundle 1, to tab 15, please. This is Westpac Banking Corporation v Gollin.

LORD JUSTICE LEWISON: Just pause there. You have also given us 45.084 in this clip. Do you say that's wrong. That was the passage I had in mind.

MR PHILLIPS: Yes, that's the passage you have in mind. We

are going to show your Lordship why, in a moment, it doesn't apply.

LORD JUSTICE LEWISON: That may be right, but what Chitty says is:

"Where a surety enters a contract at the request of a principal debtor, it's clear that payment of the debt discharges the debt as between principal creditor and principal. The surety cannot sue the principal debtor for an amount of debt which the creditor has already received."

That, you say, is not right?

MR PHILLIPS: No, it's not right. This is right. That isn't right. They're both in the same book.

Now, whether this is a case of Homer nodding or not I can't help. But what I can do is show your Lordship the authorities and show your Lordship the extract from Chitty, which you have.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: So Westpac, if I may.

LORD JUSTICE LEWISON: Yes. Where was that?

MR PHILLIPS: Westpac is in authorities bundle 1, tab 15 at 259.

LORD JUSTICE LEWISON: This is Mr Justice Tadgell.

MR PHILLIPS: I'm not going to labour the case but it's a decision of the Supreme Court of Victoria. If I may

just have a quick look at paragraph 1. The single short question is:

"It is whether the debt claimed should be admitted to proof to the extent to which it remained unpaid out of the funds of the debtor company at the commencement of the winding up or whether there should be a reduction to the extent of payments made to the creditor by a guarantor of the debt before the commencement of the winding up."

And then if we can go on to 263 at the top, four lines down you will note that that is where they --

LORD JUSTICE LEWISON: I think actually you need to look at 261, just by the second hole punch, where he says:

"The cardinal submission for the liquidator was that if before he accrues a creditor is paid part of his indebtedness either by the debtor or by a guarantor, then the payment extinguishes the debt pro tanto."

That is the argument he is dealing with.

MR PHILLIPS: Yes. And your Lordship will see that the answer is no. And the essential reason for this is -- going back to the top of 2063, the reason for this is that when the principal debtor is bankrupt, the surety is paid ...(Reading to the words)... comes potentially into competition."

Again, it's a reference to that competition, which

I just wanted you to see. But then at 263 at the bottom, having dealt with the authorities:

"These authorities form part of a considerable body of support ...(Reading to the words)... that a creditor who proves in the bankruptcy of the debtor need not deduct from the amount of his proof any sum paid to him by a guarantor on foot with a whole monies guarantee, so long as any part of the guaranteed debt remains unpaid by the bankrupt estate. The conclusion was precisely expressed by Mr Justice Vaughan Williams ..."

Then there is a reference to Lord Justice Lawrence in Fenton, when he said -- and perhaps you could cast your eyes over the page to the Lord Justice's quote.

Your Lordships will pick up that he refers to Re Sass.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: And then, my Lords, along similar lines at the top of 268 at the top, this was essentially the view adopted by Lord Justice Vaughan Williams in Re Sass. And picking it up at the bottom, at the bottom of 268 is the passage that's picked up in Ulster v Lambe where he talks about the principles and he says:

"I respectfully ..."

That's the passage in Ulster v Lambe.

Then over to 270, in the bottom paragraph:

"The single exception among the authorities so far as I'm aware that has applied the reasoning of the cases dealing with negotiable instruments in the case of ...(Reading to the words)... guarantees McKinnon, ...(Reading to the words)... with a view to terminating his liabilities ...(Reading to the words)... principal debtor. The creditor sought to prove in the bankruptcy for the whole of its debt without deducting what had been received from the cautioner. The Court of Session held that the deduction should be made from the proof.

"There were other facts, not now relevant, but in any event went to defeat the creditor's attempt to resist the reduction to proof. The court went on, however, to say that the payment by the cautioner having been made before the sequestration of the debtor's estate extinguished the debt pro tanto, thereby necessarily reducing the amount for which the creditor could prove. The court treated the matter as covered by the early authority of Hamilton v Cuthbertson ...(Reading to the words)... was held not to be a relevant distinguishing feature."

Then there is a quote from Lord Salvesen. And then picking up the last six lines:

"To take that approach in the case of a whole monies guarantee is to leave out of account the terms of the

guarantor's obligation ..."

In other words, to guarantee all of the sum due:

"... and the creditor's corresponding right not to suffer competition from the guarantor. It is not, in my view, in accord with the authorities to which I have referred. Mr Justice Lowry ...(Reading to the words)... took the same view of McKinnon's case and declined to follow it. I respectfully adopt his criticism and take the same course."

And just at the bottom you can see just above the break:

"If, therefore, the guarantee ...(Reading to the words)... is entitled between themselves to prove for the whole ..."

And so on.

Now, this body of case law represents the orthodox position and it draws support from all the leading textbooks on the law of guarantee, including Legal Problems of Credit and Security, which was formerly edited by Sir Roy Goode and now edited by Professor Gullifer, The Modern Contract of Guarantee, which is O'Donovan and Phillips, and The Law of Guarantees, which is Andrews and Millett. I'm going to show you that if I may.

Could we take up authorities bundle 4, tab 72.

I wanted to look at internal 414, and six lines down if your Lordships --

LORD JUSTICE LEWISON: This is Gullifer.

MR PHILLIPS: Yes. I just wanted to pick it up six lines down where it starts:

"Although every case ultimately depends on the construction of the agreement, the general rule outside insolvency --

LADY JUSTICE ASPLIN: I'm sorry, I don't have it. I'm on page 414.

MR PHILLIPS: Which is in the bundle at 2382.

LADY JUSTICE ASPLIN: Yes. Then you were reading from --

MR PHILLIPS: Six lines down.

LADY JUSTICE ASPLIN: Thank you. I'm sorry.

MR PHILLIPS: No, no, it's my fault, my Lady.

"Although every case ultimately depends on the construction of the agreement, the general rule outside insolvency appears to be that a part-payment by the surety does not prevent the creditor suing a solvent principal debtor for the whole amount of the debt."

As your Lordships have seen and my Lord Lord Justice Lewison just put it to me, it depends upon whether the contract of guarantee entitles the surety to compete with the creditor.

LORD JUSTICE HENDERSON: It's also perhaps worth noting what

the learned authors say on page 412 at the top, saying really what "a difficult and austere" subject this is:

"For some reason, conflicting authorities and obscure reasoning seem endemic ...(Reading to the words)... bankruptcy cases."

Et cetera, suggesting this is a notoriously difficult minefield rather than the absolutely clear propositions that you are suggesting rule the position.

MR PHILLIPS: Well, I hope that I will shine enough light on it that your Lordship will agree that this is indeed clear.

LORD JUSTICE HENDERSON: Fine.

MR PHILLIPS: I don't say that lightly at all. Then it carries on:

"If the creditor recovers in full from the principal debtor he is obliged to reimburse the surety. Support for this view comes from Ulster v Lambe where the debtor was solvent, as well as dicta from the insolvency case of Re Sass."

I'm going to leave that there for now. But the surety is not entitled to compete until it has discharged its liability to the creditor and the right of subrogation arises. That is proposition one gets from all of this.

Then tab 75. This The Modern Contract of Guarantee.

I just wanted to go to 2422 and -- it's 10.51:

"Lowry specifically disapproved McKinnon's trustee ...(Reading to the words)... submitted that this view should be preferred. The decision in Ulster Bank appears to be correct because, in accordance with the principles outlined in the previous section, if the guarantee is of the whole of the principal's indebtedness the creditor is entitled at all times to treat the entire debt as owing."

It's worth noting that that is the fundamental principle:

"And there remains an outstanding obligation on guarantor to see that the whole debt is paid. It should be irrelevant whether the guarantor makes payment before or after the bankruptcy."

I just now want to turn to cases relied on by my learned friend, Milverton and MS Fashions, and I will deal with them chronologically. The first is Milverton, but before I turn them up, three preliminary points:

Milverton has only been cited in England once in the 26 years since it was decided, and for your note that was a case called Romain v Scuba, which is not in the authorities bundle because it's not on point.

LORD JUSTICE LEWISON: About limitation.

MR PHILLIPS: My Lord, you are ahead of me.

The so-called general principle it supports is not referred to in any of the leading textbooks. And like the commentators and academics, we agree that this is a case specific to leases, where the obligation of the guarantor is the same as that of the tenant, and it is of no general application.

LORD JUSTICE LEWISON: I must say, I don't understand that. I don't see why the guarantor's obligation on the lease should be different from any other guarantors.

MR PHILLIPS: It's because it's a principal liability. The way in which it's dealt with --

LORD JUSTICE LEWISON: Why?

MR PHILLIPS: Well, we will see.

LORD JUSTICE HENDERSON: It's nearly always going to be direct covenant between the guarantor and the creditor, so why does that not turn it into a primary liability --

MR PHILLIPS: With respect, no, there isn't.

LORD JUSTICE HENDERSON: Isn't there?

MR PHILLIPS: Again, you have to separate the principal liability, which is in the contract between the debtor and the creditor, and the secondary liability between the creditor and the guarantor.

The guarantor might have a direct liability but that is a separate question, and then you are enforcing the primary liability between the guarantor and the debtor.

LADY JUSTICE ASPLIN: Guarantor and the creditor.
MR PHILLIPS: Oh, sorry --
LORD JUSTICE HENDERSON: Sorry, perhaps I'm missing something, but surely there is always going to be a contract between the creditor and the guarantor from whom the creditor has acquired the guarantee?
MR PHILLIPS: I'm sorry, I misunderstood your Lordship's question.
LORD JUSTICE HENDERSON: So why does that not give rise to a primary liability as between the two of them?
MR PHILLIPS: You have to look at the liability and see whether or not it is primary or secondary. It's a primary liability -- if you enter into an agreement, which is what you get in Milverton, where you say -- and we have the six individuals, you all contract with the creditor that you will all pay the rent and you will all do the other things that are contained in the guarantee, that is a primary liability.

If you enter into a contract with the creditor whereby you say, 'If the debtor does not pay you, I will pay you', that's a contract to guarantee and is secondary as opposed to primary.

LORD JUSTICE HENDERSON: I see.
MR PHILLIPS: That is the difference. And actually that's the difference, that's one of the important differences

in MS Fashions --

LORD JUSTICE LEWISON: I understand that. But why is there some special rule for leases? That I don't understand.

MR PHILLIPS: My Lord, all I can say is that on the facts in Milverton, on the contracts, it was a primary liability. The authors have all then said, well, it's a problem that arises in leases because it's a primary liability.

I agree with your Lordship. If you have a primary liability you have a primary liability. But I do not practice in landlord and tenant work, and I do not profess to be able to tell you, well, this is a feature of landlord and tenant, and before your Lordship that is the last thing I'm going to try to do.

I take your Lordship's point, but I'm not one of the academics. And it doesn't matter for present purposes whether it's specific to leases.

Right.

LORD JUSTICE LEWISON: Yes. You were going to Milverton.

MR PHILLIPS: Moving on to Milverton, which is in tab 19.

My Lords, I think your Lordships have seen the headnote.

LADY JUSTICE ASPLIN: Sorry, I'm behind you. If you give me a moment, I'd be grateful.

MR PHILLIPS: Apologies. Authorities bundle 1, tab 19.

LADY JUSTICE ASPLIN: Thank you.

MR PHILLIPS: If I can take it that your Lordships have seen

the headnote, can I move to Lord Justice Glidewell at page 3. Lord Justice Glidewell gave the first judgment and it starts at page 3.

LORD JUSTICE LEWISON: Before we go there, can we just look at the headnote, three lines down:

"The licence contained a surety covenant by DB that MT would pay the rent and perform the covenants."

MR PHILLIPS: And perform the covenants.

LORD JUSTICE LEWISON: Yes, but that's a guarantee, and that is a straightforward common-or-garden guarantee. It's not a primary liability at all.

MR PHILLIPS: Yes, it is. As long as they are performing the covenants, that is primary. And --

LORD JUSTICE LEWISON: But he's covenanting that MT would do that, not that he would.

MR PHILLIPS: Surety covenant by DB that MT --

LORD JUSTICE LEWISON: By DB that MT would pay the rent and perform the covenant. That's a classic 'see to it' guarantee.

MR PHILLIPS: "The term further assigned pursuant to the licence ..."

LORD JUSTICE LEWISON: And then there's a covenant for indemnity, which is also a secondary liability. So I can't see where you get this primary liability from.

MR PHILLIPS: You'll see it from Lord Justice Glidewell's

judgment. So you will see it, my Lord. But can I start with Lord Justice Glidewell.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: At page 3. He says:

"This appeal concerns the question whether a lessor who has received from a guarantor of the lessee's covenant to pay rent a payment in consideration of his releasing the guarantor from his obligations under the contract for guarantee is obliged to give credit for that payment in seeking to enforce against the lessee whether the original lessee or a lessee by assignment ...(Reading to the words).. to pay rent and make other payments."

So that's recording the question. And in relation to the facts, your Lordships have probably picked this up:

"The instalment of rent due for Michaelmas Day 1991 was not paid. Wilcox and Beverage entered into a deed of release with the landlord whereby the landlord agreed that upon receipt of the 50,348 from guarantors they would be released from all their obligations."

My Lord, one of the points that your Lordships should pick up is of course the guarantors had ongoing obligations to pay the rent, and you'll see that:

"Wilcox and Beverage paid their 50,000-odd. The

tenant was sued for the outstanding rent and pleaded that the landlord had received that 50,000."

If we can look further down, where it says, "September 10, 1981":

"The licence, which was under seal, was expressed to have been made at the request of Mr Donald ..."

I'm sorry, this is the fourth paragraph on page 347. I'm still in 347.

LORD JUSTICE LEWISON: I see, yes.

MR PHILLIPS: So September 10:

"The licence, which was under seal, was expressed to have been made of the request of Mr Bailey and contained a guarantee by Mr Bailey that the assignee Marketing Trends should pay the rents reserved and perform the covenants contained in the lease and provided that if the assignee should make default in payment of the rent or its observation of the covenants the surety will pay and make good to the lessors on demand of losses, damages, costs [and so on].

"The clause also expressly provided ..."

And I think, my Lord, this is the answer to your Lordship's question:

"... that the covenant on the part of the surety shall be deemed to impose upon the surety the same obligations as if the lease had been granted direct to

the surety as tenant."

And your Lordship will see that that is significant.

If I can go to 351, which is page 7 internally, to Lord Justice Hoffmann's judgment.

Lord Justice Hoffmann, if you have the bottom of 351, said:

"Under the terms of the lease and the two licences to assign there were six persons liable to pay the rent and observe the covenants."

So there were six obligors. And over the page the fifth part starts in the middle of the page:

"But this is not how Lord Justice Russell puts it. He said that the guarantor had not paid rent. It was true, he said, that the payments were made because the tenant failed to pay the rent, but in law they were nothing but payments under the guarantee in satisfaction of the third party's contractual obligation. This distinction between the rent payable by the tenant and the contractual obligation of the guarantor cannot, in my judgment, survive in the decision in P&A Swift Investments. Lord Templeman said:

"A surety for a tenant is a quasi tenant who volunteers to be a substitute or twelfth man for the tenant's team ..."

I promise I didn't have that in mind:

"... and is subject to the same rules and regulations as the player he replaces. In other words, there is a single set of obligations to pay the rent and perform the covenants, owed by both tenant and guarantor. This was the view of Mr Justice Megarry in Hawkins v Hawkins, with which I respectfully agree."

LORD JUSTICE LEWISON: You say that's right, do you?

MR PHILLIPS: Yes, my Lord. And my Lord, your Lordship has seen --

LORD JUSTICE LEWISON: A couple of questions arise out of that. First of all, the statement from Lord Templeman in P&A Swift is directed to guarantors, sureties, not to somebody who is a principal obligor. It just says a surety, so it's not anything to do with landlord and tenant law. This is the position of the surety.

The second observation is that, in Hawkins, which Lord Justice Hoffmann likes, Mr Justice Megarry said, "A debt is a debt, whoever pays it".

MR PHILLIPS: That is a concept I completely understand.

I think the point in Milverton, my Lord, arises out of what this clause expressly provided, and it's that passage which I showed to your Lordship.

Now, whether this applies to all landlord and tenant cases matters not.

LORD JUSTICE LEWISON: It's not a question of whether it

applies to all landlord and tenant cases. Does it apply to all cases where the surety covenants or agrees with the creditor as principal debtor? Which many, many surety covenants do.

MR PHILLIPS: Yes. Well, no, if they're a principal debtor they are a principal debtor, and that payment will discharge the debt. But it's because it's a principal debtor. It's not the guarantor paying the creditor that discharges the debt. It's because you have a direct principal debtor relationship between the surety and the debtor.

LORD JUSTICE LEWISON: So if the surety also covenants as principal debtor, then payment by the surety does discharge the debt, either wholly or pro tanto.

MR PHILLIPS: Yes, because that's another payment qua surety. If one's looking at the triangular relationship, surety, creditor, debtor, you have another line there. And it's pursuant to that obligation, which is a direct obligation from a surety to the debtor.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: Right. So the reason why this is important is that whilst payment by a primary obligor discharges the debt to the extent of the payment, payment by a surety only gives rise to an obligation upon the creditor to reimburse the surety if and to the extent that the

debtor repays in full.

And qua surety, the payment will always be to the creditor. The debtor will also pay the creditor. And if the creditor receives more than 100 per cent he accounts to the secondary obligor because the creditor in that situation did not need to rely on the full extent of his guarantee.

And that's the nature of a secondary liability. They are only liable if the primary obligor does not satisfy the liability. If the primary obligor does, there's no liability at all.

LORD JUSTICE LEWISON: Can we just go back for a moment to Lord Justice Glidewell. The question he posed to himself on page 5 between two hole punches was:

"Does payment by a surety of an instalment of a lessee's rent discharge the lessee's obligation to pay the same rent?"

So that's a question posed in quite general terms.

MR PHILLIPS: Yes.

LORD JUSTICE LEWISON: And he answers that on the next page in the last line of the sidelined paragraph:

"If a lessor does recover a sum from any one of the three, the rent has been paid. The other two cease to be liable, but they are still liable for further rent."

MR PHILLIPS: Yes, for the further rent going forward.
LORD JUSTICE LEWISON: Yes. And Lord Justice Kennedy agrees with Lord Justice Glidewell.
MR PHILLIPS: Yes, that's because that's a primary obligor paying for the obligation.
LORD JUSTICE LEWISON: That's not the question he asked himself. He asked whether a payment by a surety discharges the rent.
MR PHILLIPS: It's interesting, because often you see in some of the cases loose descriptions. And the payment that is being made on this contract in this case is by a primary obligor.
LORD JUSTICE LEWISON: Right.
LORD JUSTICE HENDERSON: Do you then say the same about the passage cited from Lord Templeman:

"It appears to be a general ...(Reading to the words)... surety. ...(Reading to the words)... with quasi ...(Reading to the words)... volunteers to be a substitute ..."

Et cetera. Do you say that really the analogy is only correct if --
MR PHILLIPS: If they become a primary obligee --
LORD JUSTICE HENDERSON: If there is a primary covenant by the surety.
MR PHILLIPS: Yes.

LORD JUSTICE HENDERSON: Again, that is simply not what Lord Templeman says, but.

MR PHILLIPS: But that is right, my Lord. That is --

LORD JUSTICE HENDERSON: You say it's right, but it is (inaudible) distinguished judge has said so.

MR PHILLIPS: No, your Lordship is picking on sentences without the full relationship context.

LORD JUSTICE HENDERSON: Yes.

MR PHILLIPS: There are two points: the primary obligor point and the appropriation to specific payments point. And those two points were identified in the textbooks, and in the same vein the Supreme Court of Singapore has said that Milverton is a case specific, with a specific exception, to the general rule. And I don't -- whether it applies only in a leasehold context matters not. It's a question of whether it's a primary obligor.

But I just want to show you two of the textbooks. Can I take you to authorities bundle 4 at tab 72. I'm taking you back to Goode & Gullifer, On Legal Problems with Credit and Security. I'm going to 2382 again. And this time, because it's the same passage --

LORD JUSTICE LEWISON: Sorry, where are we going?

MR PHILLIPS: Are you on page 414, my Lord? Tab 72. This is a later bit of the same passage. My Lords, it's about 15 lines down, and the word on the right-hand side

"the", "the other cases cited by Fisher", is Milverton. And I just want to pick up:

"In that case the Court of Appeal decided that payment of rent by a surety discharged the lessee's obligation to pay the same rent, but arguably this is not of more general application, as first in the landlord and tenant situation there's a single set of obligations to pay the rent and perform the covenants owed by both tenant and guarantor, and secondly it is at least arguable that the payment of the rent was payment in full of that particular obligation related to that particular period.

"If it is right that even outside insolvency the creditor does not need to give credit for part-payment by the surety in ...(Reading to the words)... the debtor, the main plank in Mr Justice Fisher's argument, namely that the rule should be the same outside and within an insolvency, falls away."

So that was the first of them. Now, whether -- but your Lordship gets the point. It's the primary obligation point. And then in tab 75, which is again The Modern Contract of Guarantee, and it's on 242A and it's just the footnote, footnote 193.

LADY JUSTICE ASPLIN: Sorry, I'm in the right tab but then which page am I going to?

MR PHILLIPS: 2424A, my Lady.

LADY JUSTICE ASPLIN: Thank you.

MR PHILLIPS: My apologies.

LADY JUSTICE ASPLIN: No.

MR PHILLIPS: Footnote 193. I want to pick it up near the middle:

"The reasoning in Milverton can certainly be interpreted that way ...(Reading to the words)... decisions could be confined by reference to these factors:

"One, the defendant seeking to reduce its liability to the original lessee was not strictly in the position of a guarantor vis-á-vis the defaulting assignee in respect of whose liability payments have been made by others.

"Two, the other paying parties had a higher degree of responsibility for liability than the original lessee.

"Three, it might be argued that some of the payments had been appropriated to a divisible obligation or particular instalment of rent, so as wholly to discharge that obligation."

Then it refers to Goode & Gullifer. So my Lords, and my Lady, MS Fashions.

That is in authorities bundle 1 at tab 60.

LORD JUSTICE LEWISON: I hadn't understood the first of O'Donovan's points:

"A defendant wishing to seek to reduce his liability to the original lessee was not ..."

So the landlord sues the original lessee, is that right, in Milverton? Who in the view(?) of the world was the original tenant.

MR PHILLIPS: My Lord, the reason is that the "sureties", if I can put them in inverted commas, were primary obligors. That is the point he is making as well.

LORD JUSTICE LEWISON: No, he's making a different point, with respect.

MR PHILLIPS: Sorry.

LORD JUSTICE LEWISON: O'Donovan and Philips are making the point that it was the original tenant. It obviously was a primary obligor when the lease was granted to it as original tenant. That's the point he's making.

MR PHILLIPS: Yes. I see that.

LORD JUSTICE LEWISON: And that's what happened, was it? I'll go back to look at it.

MR PHILLIPS: But then he moves on to the other paying parties. It may be that that part of there analysis --

LORD JUSTICE LEWISON: (inaudible) understand his first point.

MR PHILLIPS: I understand, my Lord. I'm sorry if that is

not helpful.

LORD JUSTICE LEWISON: Anyway, I will go back over it again. So we are going to MS Fashions.

MR PHILLIPS: I want to go to MS Fashions, if I may. That is in authorities bundle 1 at tab 16. It starts at 273.

My Lords, can we start with the headnote.

LORD JUSTICE LEWISON: You did say you were going to take these in chronological order but in fact MS Fashions precedes Milverton.

MR PHILLIPS: That is a perfectly fair criticism, my Lord.

LORD JUSTICE LEWISON: Sorry?

MR PHILLIPS: Your Lordship's criticism is perfectly fair.

LORD JUSTICE LEWISON: It's not a criticism, but MS Fashions was decided in 1993 and Milverton in 1994.

MR PHILLIPS: The one point that I can take from that is that Milverton didn't cite MS Fashions.

Now, if we may, let's look at MS Fashions. Looking at the headnote as it's very important that we are grounded in the underlying facts. Between 84 and 89, three company directors each signed as a principal debtor an agreement with the bank whereby as a guarantee for repayment of loans by the bank to the company [which was MS Fashions] the bank could withdraw money from his deposit account ..."

That's the director's deposit account. The debt due

from BCCI to the director. The bank is BCCI. And that is why all this arises:

"... with the bank towards satisfaction of the company's debts due to BCCI."

So BCCI owes the directors debts on their deposits, and the company MS Fashions owed BCCI money:

"In 1992 the bank was compulsorily wound up. The directors in the company issued ...(Reading to the words)... seeking declarations that directors were entitled, pursuant to rule 490 of the Insolvency Rules, to set off ..."

I'm sure your Lordships are familiar with rule 490:

"... the sums in their deposit accounts against the companies' respective liabilities to the bank."

So you have the three company directors. They have signed a guarantee arrangement as a principal debtor. The company could withdraw money from their deposit accounts in satisfaction of the company's debts. And it's the key point, or one of the key points, that they are principal debtors, and I'll explain why:

"If they were principal debtors, sums due from the bank to them [on those deposits] will be the subject of set-off and would automatically reduce the sums due from the company to BCCI.

If they were sureties that had given charges over

their deposits, there would be no set-off because it would be a principal obligation due from the bank against a contingent obligation -- sorry, principal obligation due to the bank. And it would be a contingent obligation due -- no, I'm sorry, I was right.

LORD JUSTICE LEWISON: Contingent obligation from the bank --

MR PHILLIPS: From the bank, against the debt.

And that would not have been mutual dealing. That was the point.

"The directors sought to set off the sums due from the bank in their deposit accounts against the company MS Fashions' liability to BCCI."

Existing cross-claims arising out of mutual dealings result in an automatic set-off under rule 490. And if we then pick up the headnote, dismissing the appeals:

"Where there were existing cross-claims arising out of mutual dealings before the commencement of the winding of up the company."

Because as your Lordships know, the set-off is taken at the commencement of the winding up:

"Rule 490 of the Insolvency Rules took effect so as to bring about a set-off ...(Reading to the words)... where a liability had been entered into by the principal

debtor there was a primary liability not contingent on the making of a demand in writing ..."

Which is why I said to your Lordships it would have been contingent liability:

"And could constitute a valid cross-claim for purposes of the rule. And that accordingly the indebtedness of the companies [that was MS Fashions] as at the date of the winding up of the bank had been extinguished or reduced by the amounts which on that date were standing to the credit of the directors on their deposit accounts."

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: And Mr Justice Hoffmann -- he may have been Lord Justice Hoffmann at that point -- at first instance said therefore there was a set-off, and the Court of Appeal agreed.

If I can go to 430 at --

LORD JUSTICE LEWISON: I think he heard the motion as Mr Justice and by the time he gave judgment he had become Lord Justice.

MR PHILLIPS: They were lucky that he had not become Lord Hoffmann.

If I could just pick up in Lord Justice Hoffmann's judgment, 430, at letter C:

"On the insolvency of the bank, can the director set

off his claim for the return of his deposit against his liability to pay the company's debt so that the debt is wholly or pro tanto extinguished."

And of course the debt that the directors wanted to set off was liability of BCI to the directors. That is why they wanted a set-off, because otherwise they would have been relying on whatever dividend they would have got. That is what the directors wanted to do. And of course, on a set-off it would count as 100 per cent. If they could not set off they'd get a dividend from BCCI, and MS Fashions would still have to pay 100 per cent of the debt it owed to BCCI.

Then on 431B to C, the directors signed a document which said that they were principal debtors and it says:

"Thus, a common feature of all three cases appears to be that the director signed the document saying that his liability to pay company's debt was to be as a principal debtor."

And then further down, just above E:

"On the other hand, I think it is a tenable view that such charges over deposit can be analysed as the creation of a liability on the part of the chargor to the company's debt, not exceeding the amount of the deposit, which can be set off against BCCI's liability to repay the deposit. It seems to me that the reference

to the liability of the depositor as being that of a principal debtor should be as a matter of construction taken to have that effect."

Then at 435, if I may, H. In this passage Lord Justice Hoffmann explained why, if they had been guarantors, there wouldn't have been a set-off:

"If the relationship between BCCI and the directors was governed only by the standard form of guarantees, I think that there would be no answer to the submission that the liability of the directors remains contingent. All the guarantees in the BCCI standard form require a demand in writing ...(Reading to the words)... any liability arises in the part of the guarantor."

And then over the page at D to F, just above letter D:

"In my judgment, the principal debtor clauses have the effect of creating primary liability for the purposes of the rule [that's this rule in set-off] that is debt is not contingent upon demand."

Picking it up two lines down:

"It is true that for some purposes the courts will look to the underlying reality of the suretyship relationship rather than the formal agreement that liability is to be as principal debtor. But this is only for the purpose of protecting the surety's

equitable rights against the principal debtor, in giving effect to such consequences as may affect the creditor, such as the surety's right to take securities and the rule against double proof. Otherwise, there's no reason why creditor and surety should not make whatever terms they choose."

And then going forward to 439A to B, this is Lord Justice Hoffmann's conclusions and the declaration:

"Finally, Mr Thomas said that although rule 490 might result in a set-off between BCCI and the director, this did not amount to payment of the debt owed by company ...(Reading to the words)... gave the director a complete or pro tanto defence. This, I think, ignores the fact that the directors' set-off operates in respect of the same debt ..."

That's what you need, you need mutuality of (inaudible).

"... as that owed by the company. If, as I think it must be, the set-off is equivalent to payment by the director, then I think it must operate also to extinguish to the same extent the debt owed by the company.

"I will therefore declare that the indebtedness of each of the companies as at the date of the winding up ..."

As at the date of the winding up because this is by virtue of the operation of the set-off rule in 490:

"... has been extinguished or reduced by the amount which on that date was standing to the credit of the directors on their respective deposit accounts."

My Lords, the reason why Lord Justice Hoffmann declared that the indebtedness had been extinguished is because there is a mandatory and automatic set-off where there are mutual debts or mutual dealings, that occurs on the winding up. That is what happened in this case and that is what Lord Justice Hoffmann --

LORD JUSTICE LEWISON: I understand that, but doesn't the reasoning go like this:

The debt owed by the surety is not a contingent debt, because it's a primary obligation. Therefore set-off applies.

MR PHILLIPS: Yes, because you can have mutual dealings.

LORD JUSTICE LEWISON: Set-off is equivalent to payment. Well, that's what he says:

"If, as I think it must be, the set-off is equivalent to payment. And set-off, being equivalent to payment by the director, extinguishes the company's debt pro tanto."

MR PHILLIPS: No, my Lord, with respect, you have inserted a layer of reasoning that is not there.

LORD JUSTICE LEWISON: What have I inserted?
MR PHILLIPS: What you have inserted is: the set-off equals a payment, therefore it extinguishes the debt.
The debt is automatically extinguished by rule 490.
LORD JUSTICE LEWISON: Why?
MR PHILLIPS: Because that's what the rule says.
LORD JUSTICE LEWISON: Well, is it not because, as Lord Justice Hoffmann says, set-off is equivalent to payment?
MR PHILLIPS: No.
LORD JUSTICE LEWISON: So that's wrong?
MR PHILLIPS: It's not wrong, my Lord. One can see why you would describe it as payment. That's not the reason why it extinguishes the debt. A debt is extinguished when set-off occurs under 490 automatically. You can't contract out of it. And it happens at the winding up.
LORD JUSTICE LEWISON: I understand that. But that's how set-off works. It's equivalent to payment. I mean, leave aside rule 490, just take common-or-garden equitable set-off outside insolvency. If you have a set-off, it extinguishes or reduces the debt. That is how it works. Hanak v Green. Mrs Hanak sues Mr Green for building works, and he has a cross-claim and --
MR PHILLIPS: My Lord, your Lordship may wish to insert that particular step. But it doesn't matter, because the

crucial point in this is: the reason why there was a set-off, and whether it's because there's a payment or whether it's just the rule, is because they were primary obligors. And if they had been guarantors it wouldn't have been a set-off --

LORD JUSTICE LEWISON: I understand that, but we are dealing with an actual payment here, our case, are we not?

MR PHILLIPS: Well, we are going to look at the facts in due course, but it's really important that your Lordships appreciate that there is an absolutely core fundamental difference between payments by principals and payments by sureties. And this case is not a payment by a surety qua surety.

LORD JUSTICE LEWISON: Right.

MR PHILLIPS: And that is really important.

LADY JUSTICE ASPLIN: Because they were primary obligors, which is up front.

MR PHILLIPS: Yes, it is, my Lady. Just to make it -- it is not because payment by a guarantor extinguished the debt. And that was not the ratio of the case. And that is important because we say that there are obiter dicta that are not binding on this court. And if they were, I suspect that the criticisms and doubts about the three lines of Lord Justice Dillon by the likes of Professor Gullifer and Andrews and Millett would never

have been written.

So a really important point, my Lord. We are not construing all these academics but they are [overspeaking] --

LORD JUSTICE LEWISON: No, no, but academics are perfectly at liberty to say the Supreme Court gets things wrong. Of course they are entitled to ...

MR PHILLIPS: My Lord, for present purpose, if the debt from the directors had been by way of guarantee it would have been a contingent debt and --

LORD JUSTICE LEWISON: That I understand.

MR PHILLIPS: Really important.

Then can I go on to 446A to B.

LORD JUSTICE HENDERSON: Before we get there, do we get any help from the -- I haven't read it yet, I'm afraid yet -- from the report of the argument? After all, we have Sumption QC and Mark Hasgood(?) appearing for the directors. I think we might get some enlightenment.

MR PHILLIPS: What happened was, is that there was an ex parte interlocutory injunction in which all of those individuals appeared. It went to Millett. It went to the Court of Appeal. And then this is the considered case. But I will come on to that.

When we look at Lord Justice Dillon's statement, which I know that you have, they take it out of context,

because this was not an extinguishment because a guarantor had made a payment. And that's what I wanted your Lordships to have understood. And what Lord Justice Dillon says there, that cannot be --

LORD JUSTICE LEWISON: Where are you looking?

MR PHILLIPS: Cannot be the ratio.

LORD JUSTICE LEWISON: Which page are you looking at?

MR PHILLIPS: It's the statement that has been looked at, which is 448 above D:

"If there's a set-off between Mr Amir and Mr Ahmed and BCCI that must automatically reduce or extinguish the indebtedness to BCCI ...(Reading to the words)... statutory set-off is not something which BCCI can place ...(Reading to the words)... operates to reduce or extinguish the liability of the guarantor."

Now, it wasn't operated to reduce the liability of the guarantor qua guarantor. It was operating to reduce or extinguish the liability qua principal.

LADY JUSTICE ASPLIN: And you would say that that paragraph which is at DE is qualified by what is said above it at BC:

"Therefore we have a situation in which, though the situation is tripartite rather than bipartite ...(Reading to the words)... immediately enforceable [et cetera] there is a debt presently due from each of

the companies to BCCI and equally due ...(Reading to the words)... as principal debtor."

MR PHILLIPS: Yes, my Lady.

LADY JUSTICE ASPLIN: And you say that qualifies what is said above --

MR PHILLIPS: Absolutely, my Lady. And what my learned friends are relying on is the use of the word "guarantor" by Lord Justice Dillon. And with the greatest respect, when Lord Justice Dillon used the word "guarantor" he was not describing a qua guarantor.

LORD JUSTICE HENDERSON: Well, isn't another way of putting it to say that one has to, as it were, read into his penultimate sentence "a guarantor" in sort of open brackets "qua principal debtor" close brackets, or something like that?

That would, as my Lady says, pick up the point which has been made very clearly at letter B above.

MR PHILLIPS: Yes, my Lord.

May I then just turn to the other two bits of the history, which should be in authorities bundle 5, at 91. I hope, my Lords, that you have -- it may be in my little clip.

LADY JUSTICE ASPLIN: That's Mr Justice Millett, MS Fashions.

MR PHILLIPS: Yes. This is the report of Mr Justice Millett

and then Lord Justices Wolff and Scott. And the first thing I wanted to show to your Lordships is the dates of the two decisions.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: This all happened on the same day, because what had happened was that BCCI in liquidation had appointed receivers over MS Fashions based upon the debt due from MS Fashions to BCCI. And the directors ran along and sought an injunction restraining the receivers from acting. So this all happened very quickly.

And if you just go to 281 you can see those who appeared and were instructed before Mr Justice Millett. And the same you can see on page 284. I just wanted to pick up on 284, just above E where Lord Justice Scott says:

"The argument before Mr Justice Millett and before us raises a short point of law concerning the effect of rule 490 of the Insolvency Rules."

And then if I can go forward --

LORD JUSTICE LEWISON: He makes the principal debtor point.

MR PHILLIPS: Sorry, I'm very grateful to my learned junior, who was trying to prompt me to point that out to your Lordships. But you got the point.

LORD JUSTICE HENDERSON: Sorry, where is it we find that?

MR PHILLIPS: That is on 284 at the bottom.

[overspeaking] --

G -- or H:

"The principal debtor will on demand ..."

And so on. Then on 287. If I could pick it up at H where he says, picking up the second sentence:

"It is correct that the release of a surety does not discharge a principal debtor. Nothing but payment does this. I would accept also that BCCI can, if it wishes, release the guarantee and still enforce its securities against the companies. That does not seem to me to be the point raised by the facts of the present case. It is plain enough that payment by the surety ...(Reading to the words)... not only releases the surety but also discharges or reduces, as the case may be, the liability to the creditor of the principal debtor ...(Reading to the words)... the set-off effect of 490 in reducing Mr Sawar's(?) liability to BCCI corresponds to the payment of a corresponding amount ..."

Which of course is the point -- I take that.

Then over the page, just above D:

"I think this is case ..."

I think that is the passage that my Lord Lord Justice Lewison was referring to yesterday. But I think it's important that we then look at 288 just above D. He says:

"I think this is a case in which leave should be granted to Mr Sawar ...(Reading to the words)... seek a declaration that the amount of the debt ..."

LORD JUSTICE LEWISON: Sorry, where are you?

MR PHILLIPS: 288.

LORD JUSTICE LEWISON: Yes, I see.

MR PHILLIPS: Just above D:

"I think this is a case in which leave should be granted."

So this is a leave application:

"... should be granted ...(Reading to the words)... that the amount of the debt which they owe has been reduced by the operation of 490 to the extent that the sum stands as a credit in ...(Reading to the words)... deposit account at BCCI at the date that BCCI went into liquidation. If it had been left to me now to rule as a matter of law on the matter, what I have already said indicates the conclusion to which I would have come. But this is only an application for leave. It is not the full hearing of the issue, although it was necessary for us to form a view on the issue, having regard to the manner in which it was dealt with below by Mr Justice Millett ..."

Who had refused to intervene.

So your Lordships should note, no cases were cited

to the courts according to the report. There are no cases cited. If you look at 284 you can see there's no reference to any cases having been cited. You can see that it all happened in a tearing rush. You can see Lord Justice Scott's expression that this is only a leave application. So one cannot fairly put particular weight on the way in which Lord Justice Scott described the issue.

LORD JUSTICE LEWISON: Do you want to say anything about Lord Justice Woolf at 289 between G, or H:

"Once there's been set-off, the company has been paid. That means that not only is the guarantor or joint principal discharged ...(Reading to the words)... but so also is any other debtor who is liable in relation to the same ..."

MR PHILLIPS: I think, my Lord, you have the majority behind the proposition that set-off constitutes a payment. I don't want to push the point. I'd always thought of it as automatic operation of rule 490. But it doesn't matter. That's one reason why I don't want to push it.

So just to make a few points just to pull MS Fashions together. MS Fashions concerned principal debtors. Your Lordship should note that the Court of Appeal, of course, was not shown Re Sass, although given that the extinguishment of the debt was

because of rule 490, that's not as big an issue as it might have been, because they were principal obligors rather than guarantors as well, of course.

There are comments in the textbooks that I should just show you. Authorities bundle 4/72. Again, I'm going back to Goode & Gullifer. That is on 414. The point I wanted to pick up was just after -- in the middle of the paragraph that we have looked at, and it's just after the quote that we were looking at from Lord Justice Dillon in MS Fashions:

"Neither Re Sass nor Ulster v Lambe was cited to the Court of Appeal in that case."

LORD JUSTICE LEWISON: Ulster Bank was of course cited to Lord Justice Hoffmann.

MR PHILLIPS: Yes, it was. My Lord, absolutely. The other point was on 71 in the Law of Guarantees. This is Andrews and Millett. I just wanted to go to 2377. It's just footnote 53 where Andrews and Millett make the same point we've just -- and they say at the end:

"This remark, it is respectfully submitted, should be treated with some caution."

And our respectful submission is, yes, but I think that, my Lord, your Lordships, and my Lady, you now understand why that statement was made and what the context was.

LORD JUSTICE HENDERSON: Sorry, which footnote was that?
MR PHILLIPS: Footnote 53, my Lord.
LORD JUSTICE HENDERSON: Thank you.
LORD JUSTICE LEWISON: Yes.
MR PHILLIPS: The last -- again, it's in the little clip if that assists your Lordship. In the clip you should find explanation of this case from "The Modern Contract of Guarantee". And they explain the case in its proper insolvency set-off context. It may assist your Lordships when you come to consider the case for the purposes of your Lordships' judgment.
LORD JUSTICE LEWISON: This is 11/110 and following, is it? Is that what you are referring to?
MR PHILLIPS: Yes.
LORD JUSTICE LEWISON: 11/101 and following.
MR PHILLIPS: The next authority is Stotter v Equiticorp, which is in authorities bundle 26 at 491. But looking at the time, I'm going to just give you a couple of points if I may.
LORD JUSTICE LEWISON: Tab number again?
MR PHILLIPS: It is authorities bundle 26.
LADY JUSTICE ASPLIN: Authorities bundle 1.
MR PHILLIPS: 1/26.
LORD JUSTICE LEWISON: You have Mr Justice McMurdo as well.
MR PHILLIPS: This is Fisher in the High Court of Auckland.

LORD JUSTICE LEWISON: And you have McMurdo back in Australia.

MR PHILLIPS: Yes. What I wanted to do was -- as your Lordships know, the case held that a creditor's proof in the liquidation had to be reduced by the amount received from the surety before the onset of liquidation. And it relies on McKinnon and Rowlatt and Lord Justice Dillon and Milverton, many of those points that your Lordship has seen, without properly analysing those points.

If you have -- sorry to flip about. I just wanted to show you textbook material on this.

LORD JUSTICE LEWISON: Can I just ask you a question before we go there.

MR PHILLIPS: Yes, of course.

LORD JUSTICE LEWISON: You have been submitting that, properly understood, both MS Fashions and Milverton are explicable on the basis that the surety was in fact a principal debtor.

MR PHILLIPS: Yes.

LORD JUSTICE LEWISON: And on that hypothesis, I think you accept that a part-payment does discharge the debt pro tanto.

MR PHILLIPS: Yes.

LORD JUSTICE LEWISON: Again, on that hypothesis that the

debt is discharged pro tanto, what is the impact on the right to prove, if any?

MR PHILLIPS: Well, the debt -- you can only prove for the balance left after the payment.

LORD JUSTICE LEWISON: So if the debt is discharged pro tanto then the creditor can only prove for the balance; is that right?

MR PHILLIPS: Yes, because you have two individuals who were liable to pay the debt, and one has paid it.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: And the creditor can only claim up to 100 per cent from his principal debtors. They can only claim if you have two principal debtors.

LORD JUSTICE LEWISON: So if he has two principal debtors and they owe 100 between them, and one pays 50, the creditor can only prove for the other 50.

MR PHILLIPS: There's only 50 left.

LORD JUSTICE LEWISON: And if he only gets a penny in the pound, that's just tough.

MR PHILLIPS: Yes. And if he's got a guarantee then the guarantor might have to pay the other 49. And if the guarantor pays 50, then the guarantor can step into his shoes, put in the proof, and he gets the 1p in the pound.

Tab 75 at 2425. Authorities bundle 4, tab 75, 2425.

It's 1081. It refers to Mr Justice Fisher and then says:

"With respect, the reason why the creditor stands to receive more than the other ...(Reading to the words)... creditors in the liquidation is because that is the basis on which the financial accommodation was provided to the principal debtor, on the basis on which the guarantee was taken, and in any event the creditor does not receive a proportionally higher dividend on its debt. It is just that the principal debt is not reduced by the pre-liquidation payment, so that the amount on which the creditor's dividend is calculated is the gross ...(Reading to the words)... amount of the debt. This is a consequence of the creditor's right of appropriation. In any event, the creditor is not entitled to receive more than 100 per cent in the pound, and if it does so, it will hold a surplus on trust for the paying surety."

So again, I think your Lordships are seeing the structure of how this works.

And as far as Stotter is concerned, if you could just go to tab 71, page 2371. It's on 2371 and it's the last few lines of 13.010, where he says:

"There are, however, competing policy considerations which offer reasons to be cautious about accepting

Mr Justice Fisher's view to ...(Reading to the words)... furthermore it is hard to see why there should be such fundamental distinction between payments made by the surety prior to the insolvency and those made after the insolvency has supervened. There is also a powerful case for saying that the guarantee is for the whole of the debt and the creditor is entitled to treat the surety as having not fulfilled his obligation until he has seen to it that the entire debt has been paid."

Then in tab 72, back to Goode, on 2382 again. This is a different part of the page, I'm pleased to say. After the break, Professor Goode moves on to Mr Justice Fisher, and then five lines up from the end:

"The policy argument against the result in Stotter is also strong since it creates a distinction between payment made by the surety before liquidation for which ...(Reading to the words)... to give credit and those made after which he does not ...(Reading to the words)... made a payment. However, as pointed out above, payments made by the person primarily liable do not fall within the rule in Sass.

"It is submitted, therefore, that the position in English law remains that partial payments by a ...(Reading to the words)... surety do not reduce the amount for which the creditor can prove. By partial

payments is meant payments of less than the total indebtedness to which the guarantee relates. If the creditor has misguidedly taken a guarantee covering only part of the debt as opposed to ...(Reading to the words)... full indebtedness to limit of liability then on paying that part the surety becomes entitled to lodge a proof himself in respect of the part so paid."

Again, we agree.

My Lords, just in relation to the public trustee at Queensland, which is Mr Justice McMurdo, our submission on that is that this is all of a piece.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: And so rounding it up -- I'm sorry, I felt I needed to deal with --

LORD JUSTICE LEWISON: No, no, you are quite right.

MR PHILLIPS: There is no inconsistency between the position outside and inside an insolvency. And at step one of the analysis the position outside of a winding up is that it is possible to sue for the full amount even if there's been a payment by a surety. If the surety pays 100 per cent of its liability, the right of subrogation means they step into the creditor's shoes to the extent of their liability. And that is what the rules are.

Can I then move on to the impact of insolvency, and the rule inside an insolvency is the same as the rule

outside an insolvency. And before we do so, we will flag up one point on the facts in this case, which is that no payments were actually made on the LBHI guarantee pre insolvency. They were all made post-insolvency. Just so that your Lordships are aware of that. The reference is CB119/3.20.

Then if I can just go back to Re Sass, because I now want to deal with the insolvency part of the case. That's back in authorities bundle 1 at page 9.

LORD JUSTICE LEWISON: Sass, did you say?

MR PHILLIPS: Yes. Page 9, tab 1. Your Lordships have seen the headnote. Your Lordships know the facts. I just want to go to internal page 15. And your Lordships can see the marked passage:

"The surety has a right to ..."

Your Lordships I think have seen that.

And the court held, as your Lordships know, the creditor may prove for the full amount of their claim. That is the same as the position pre-insolvency, notwithstanding the payments made in respect of the claim by a guarantor, unless and until it's repaid in full.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: And then I'll just give you the references. Sorry, I should do this properly. Authorities bundle 4

at tab 71 again, on page 2369, and I wanted to pick it up five lines in. Do your Lordships see the words in the middle of the page "The basis for the rule".

LADY JUSTICE ASPLIN: I'm sorry, I'm on 2369.

MR PHILLIPS: Then 13.007.

LADY JUSTICE ASPLIN: "The basis for the rule".

MR PHILLIPS: Yes.

"The basis for the rule is that the surety has undertaken to be responsible for the full sum guarantee, including whatever may remain due to the creditor after receipt of dividends and the principal's insolvency. He cannot prove nor correctly receive a dividend in competition with the creditor for a right of indemnity."

And then in Rowlatt, which is in tab 69, and this is 2357, in 11/002, just above the break at the bottom, four lines up, the words "The better view".

LORD JUSTICE LEWISON: Yes. They don't like Stotter.

MR PHILLIPS: They don't like it either.

So that brings us to the impact of release, which is step 3 of the analysis. And Deutsche Bank's point boils down to one argument, which runs as follows:

LBHI has released its right of indemnity altogether. That means the rule against double proof is not engaged. There are no competing interests at play between the

senior creditor and the junior creditor, the surety. That means Re Sass can not apply. If it did apply, there is a risk of overcompensation of the creditor and this would be contrary to the pari passu principle, and accordingly the general principle outside insolvency should apply.

My Lords, before we get into this, because I think your Lordships can already see the answers to these various points, but before we get into this, one complaint my learned friend made was that the learned judge had not dealt with the point. And in fairness to the judge I think your Lordships should be aware that this point took on a new and much increased significance in a note produced by Deutsche Bank a week after the hearing had finished. That's at SB2, tab 18.

Now, on the point of substance, the argument is based on two major flaws: first, there will be no risk of overcompensation if the rule in Re Sass is applied. The estate of the debtor is still liable to 100 per cent. That has not changed. The surety is liable up to the extent of their guarantee, and of course if the creditor recovered more than other creditors it is because they took a form of security.

But LBHI is not entitled to take more than 100 pence in the pound, which I'll come back to, and it makes no

sense to disapply the rule in Re Sass, actually I would put it more widely than the rule in Re Sass, it is just the rule in the context of guarantees outside and inside of an insolvency.

So the first flaw is they do not recognise that it is the surety's claim to be subrogated to the creditor's claim that is being released. It is that claim, the secondary liability, that is what has been released. The competition avoided by the rules that --

LORD JUSTICE LEWISON: What has been released? I thought the claim to indemnity from the principal debtor had been released.

MR PHILLIPS: Yes. Against the surety. I've been on my feet for too long I think.

LORD JUSTICE LEWISON: Under normal principles if a surety pays what he's guaranteed, when the principal debtor has failed to pay, he the surety is entitled to an indemnity from the principal debtor.

MR PHILLIPS: Yes, that has been released.

LORD JUSTICE LEWISON: That is what's been released.

MR PHILLIPS: Yes, I'm so sorry. Yes. But what you can't have is any competition between the surety and the creditor. And the release by the surety ensures there will be no competition in any event. The creditor can and always has been able to prove for the whole debt and

there is no reason to interfere with the ordinary operation of the rules.

LORD JUSTICE LEWISON: Well, suppose that the debt is 100. The surety pays 50. The creditor proves for 100 and recovers a dividend of 60p in the pound, so he now has in his hands 110. What is the obligation he has to account for that 10 to anybody? The surety no longer has a claim, because he's released it.

MR PHILLIPS: Under the Settlement Agreement he has to pay it back.

LORD JUSTICE LEWISON: Ah.

MR PHILLIPS: I am going to show you that. Because as part of this release you have the obligation to repay if they did recover more than 10 per cent, but I do need to show you that, I'm aware of that.

If I can first of all just look at the position with estate. The creditors are faced with a proof for a total of 100 per cent of the debt so there's no risk of over-compensation of LBHI out of the estate and there's no infringement of the pari passu principle. So there is that.

But then on the facts, and I need to show you core bundle 5, tab 57, this is the Settlement Agreement which as your Lordships will have picked up from the judgment is governed by New York law, but fortunately --

LORD JUSTICE LEWISON: That's why it's so difficult to understand.

MR PHILLIPS: Well my Lords I, amongst others, had the pleasure of cross-examining experts of New York law so no comment.

But anyway at 204 ...

LORD JUSTICE LEWISON: Clause?

MR PHILLIPS: Clause 204, which is on page 1315. Sorry, did I not give you the page?

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: What it provides -- I'll just work through it:

"On the effective date each applicable UK affiliate shall have allowed the claims against the applicable debtor in the applicable classes in the aggregate amounts ..."

Then:

"Notwithstanding anything to the contrary on the plan or this agreement with respect to each UK affiliate claim for which the applicable class is settled each applicable UK affiliate agrees that if at any time such UK affiliate receives distributions on account of a UK affiliate claim [which is what we are talking about] that combined with any distributions received by UK affiliate on account of the relevant primary claim exceed the amount of the primary claim such UK affiliate

shall remit from time to time any such excess distributions to LBHI ..."

That is not in our capacity:

"... within seven business days of receipt thereof and such remitted excess distributions shall not be subject to reduction, avoidance, re-characterisation, reconsideration, recoveries ..."

And so on and so forth. But the short point is, any excess received over the primary claim then has to be remitted back.

So that's on that side. The claims against the estate are the same, the creditor can't be overcompensated. And on the other side if the rule wasn't applied there would be an unfair windfall to PLC as the debtor because of LBHI's reduced proof, because estate would not be faced with the proof for 100 per cent of the claim. So there would be a windfall, but the other way.

LORD JUSTICE LEWISON: To the estate.

MR PHILLIPS: To the estate. There's absolutely no reason not to permit a proof for 100 per cent of the claim.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: The other fundamental problem with my learned friend's propositions is that the rule outside and inside insolvency is the same, and even if we were wrong

about the application of Re Sass the default position is the same anyway, as I hope I have demonstrated to your Lordships.

LORD JUSTICE LEWISON: I think you both agree that the rule is the same inside and outside, you just disagree what the rule is.

MR PHILLIPS: I think they say it's different, but for my purposes I've shown your Lordships what the rule is and we say it's the same throughout and we say that Re Sass is the application of the rule in an insolvency situation.

LORD JUSTICE LEWISON: Yes.

MR PHILLIPS: Which brings me to clause 7(f), which was the point advanced by my learned friend Mr Fisher and I will be thankfully very short.

My learned friend described the submission as an observation. For your Lordships' notes we dealt with this in paragraphs 107 to 111 of our skeleton. We've made a procedural point but I don't think your Lordships are going to be too troubled by it in the context of an observation. And we've made a substantive point. Can I just make a few short points. Clause 7(f) says -- and your Lordships have seen it:

"The lender will not without prior consent of the FSA take or enforce any security guarantee or

indemnity ..."

And so on:

"... upon obtaining or enforcing a security guarantee or indemnity, undertaking to hold the same or any proceeds on trust for the borrower."

We understood from the skeleton that my learned friends were making a point about set-off which we explained was flawed because you are dealing with a trust claim as against a debt claim. But my learned friend orally made a point about the underlying economics of the arrangement, given that it's (a) hypothetical, (b) new and (c) just an observation I would respectfully leave it there.

LORD JUSTICE LEWISON: All right.

MR PHILLIPS: My Lords, with huge apologies again for taking up more of your time, do your Lordships have any other questions?

LORD JUSTICE LEWISON: No, thank you very much.

MR PHILIPPS: Thank you very much.

LORD JUSTICE LEWISON: Who is next? Ms Hilliard.

Submissions in reply by MS HILLIARD

MS HILLIARD: Yes, I have a right of reply, my Lord. I have seven short points in reply.

First, a response to Mr Phillips' suggestion that, or assertion, actually, that our argument is illusory,

or that we are trying to argue that a pari passu solution becomes a senior ranking per deem(?). This, as we understand it, is a variation of the point that my Lord you made, you put to me yesterday, about there being a 'now you see it, now you don't' quality about our argument.

Our answer to that is as follows: firstly, it has to be firmly borne and clearly borne in mind that the effect of the different definitions is that first, C is subordinated to everything, other than more junior excluded liabilities. If another instrument in this case, D, is not more junior, it must be senior; secondly, D is subordinated to everything other than more junior excluded liabilities and pari passu subordinated liabilities. So it follows that, thirdly, three, the class of things that C is subordinated to is wider than the class of things that D is subordinated to; or putting it another way, the class of senior liabilities from C's perspective is wider than the class of senior liabilities from D's perspective.

Next, the relevant conclusion that one takes from a construction of Claim D is that it does not express itself to be junior to Claim C. The fact that Claim D from its perspective would see Claim C as pari passu is just a step along the road to that conclusion. But it's

not the conclusion.

So if you view the conclusion of the interpretation exercise Claim D is being that Claim C actually ranks pari passu, which is what Mr Phillips says our argument was, then the 'now you see it, now you don't' objection does we accept have some force. Because we know that Claim C does not end up ranking pari passu. But that's not the right conclusion to draw from our interpretation of Claim D, our construction of Claim D. The construction of the subordination clause is in Claim D is only to identify, and nothing more, which other debts Claim D ranks behind. Subject to that, whether or not other debts ultimately rank pari passu or alongside Claim D -- and I think we explain probably too many times yesterday -- is not within Claim D's gift. It depends on what the terms of the other instruments say about itself. And in the event of inconsistency between the two instruments the legal methods of dealing with that inconsistency.

So the mischaracterisation of our argument by Mr Phillips is when he says that we say that D and C must rank pari passu. We in fact say from D's perspective it would treat C as ranking pari passu. We stressed yesterday the outcome of the subordination exercise from Claim D's perspective is only that it's

not subordinated to Claim C. The outcome of the subordination exercise from Claim C's perspective is that it is subordinated to Claim D. And both those two statements will be true if Claim D ranks ahead of Claim C. And there's no 'now you see it, now you don't' about that. That's the outcome.

So when my Lord Lord Justice Lewison suggested to Mr Phillips yesterday that his argument was that our argument was self-contradictory because it involved a pari passu outcome leading to a D ranking senior outcome, Mr Phillips agreed with that, agreed that that what was his argument was, but as I've explained that's wrong, that's not our argument because we do not say that there is a pari passu ranking, there is an actual pari passu ranking, only that from Claim D's perspective it would treat Claim C as pari passu.

I have to say in any event Mr Phillips' own position also suffers from the same problem because his position is that he says that because Claim C views Claim D as senior, Claim C ends up ranking pari passu with Claim D, but senior.

On any view there's going to be something of an inconsistency in the way that Claim C and Claim D view each other, but we say that the outcome of that is an entirely and always consistent one, in in terms

subordination, C is expressed to be subordinated to D but not vice versa.

That's the first point.

Second and relatedly, Mr Phillips' argument that there is a circularity in the simple contractual mechanism which should be addressed by a pari passu outcome creates, we say, a yet further problem when one comes to apply the solvency conditions in the PLC Sub-Debts. That's effectively Deutsche Bank's ground 3(a) argument. But Mr Phillips was wrong to suggest that we, GP1, accepted, without more, that the solvency condition did not affect our analysis. It only doesn't affect the analysis if our construction is right. If Mr Phillips' preferred outcome is correct then it does create a problem with the solvency condition and Mr Phillips didn't have any solution for resolving it. We can deal with this very quickly if we just want to look at Claim C in the sum of 4.5 billion. You probably remember the terms of the Claim C Sub-Debt. But if you want to turn it up it's volume 3, tab 43, page 757. Relevantly clause 5.1 provides that the rights of LBHI, in respect of the subordinated liabilities, liabilities under Claim C itself, are subordinated to the senior liabilities, all liabilities except subordinated liabilities and excluded liabilities; and accordingly,

so it follows, payment of any amount of the subordinated liabilities, ie liabilities under Claim C itself, is conditional upon PLC being solvent at the time of and immediately after payment. And the application of clause 5.2 means that PLC would only be solvent if it's able to pay all other liabilities other than subordinated liabilities, liabilities under Claim C itself, in full, disregarding for our purposes the excluded liabilities.

Now if one accepts Mr Phillips' proposition, and we proceed upon the basis that the statement of subordination to senior liabilities creates a circularity that reverts to a pari passu ranking by some form of default legal rule, then that solution presents a further problem under that insolvency condition in Claim C. Because if Claim D ranks pari passu with Claim C under the Sub-Debts then Claim C cannot be paid on the terms of the instrument because the solvency condition will not be met. And the reason for this of course is because the solvency condition in claim C can only be met by disregarding excluded liabilities and liabilities under Claim C itself, the subordinated liabilities under the terms of Claim C.

So a pari passu competing debt at senior level, which is where Mr Phillips would have Claim D rank, is

not a subordinated liability under Claim C or an excluded liability. On that basis, payment of claim C cannot be paid unless Claim D could be paid first before the payment of Claim C. So if Mr Phillips is right a pari passu ranking with C will necessitate yet a further exercise in impasse-breaking in order to explain and justify why a debt that ranks pari passu cannot be paid pari passu.

Now, Mr Phillips seem to suggest that this could be solved by having Claim C treat Claim D as being within the definition of subordinated liability in Claim C. But that requires the implication of entirely new words in Claim C which are not present at all in Claim C, that are present in Claim D. And we say that this analysis serves to reinforce the sense of the construction that we have advanced, it's the other side of the same coin. Once it's recognised that Claim D, properly construed, does not subordinate itself to Claim C an outcome which replaces one perceived impasse with another perceived impasse simply doesn't arise.

So our construction is the only construction which properly allows "accordingly" to mean "in consequence", it follows that in both agreements.

LORD JUSTICE LEWISON: I haven't got quite my head around this one. We are looking at clause 5.1.

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: So:

"The rights of a lender are subordinated to the senior liabilities and accordingly payment of any amount of the subordinated liabilities is conditional upon ..."

Then we go to which --

MS HILLIARD: Sorry, over the page to 758, which says 1(b):

"... the borrower being solvent at the time ..."

LORD JUSTICE LEWISON: I see.

MS HILLIARD: Because the first bit is outside of an insolvency.

LORD JUSTICE LEWISON: Yes.

MS HILLIARD: So the borrower being solvent at the time or immediately after the payment. Then 5(2):

"For the purposes of subparagraph (1)(b) above the borrow should be solvent if it is able to pay its liabilities other than the subordinated liabilities in full disregarding excluded liabilities."

LORD JUSTICE LEWISON: Right. So the point is that if Claim D is not subordinated it's pari passu, then it has to be paid.

MS HILLIARD: Yes. Yes. And so what you would have to do is you would have to create another sort of impasse-breaking mechanism to allow the debts to be paid.

LORD JUSTICE LEWISON: Right.

MS HILLIARD: So all I was saying is if we accept Mr Phillips' proposition and we proceed upon the basis that the statement of subordination to senior liabilities creates the circularity that reverts to a pari passu ranking by some form of default legal rule then that solution, as I say, presents this further problem under the insolvency condition in Claim C because it means that if Claim D ranks pari passu then Claim C can't be paid on the terms of the instrument because the solvency condition will not be met.

I think Mr Phillips' suggestion was that this problem could be solved by having Claim C treat Claim D as within the definition of subordinated liability in Claim C. But as I say, that would require the implication of new words in Claim C which are not present in Claim C but are present in Claim D. That's why we say ours is the only construction which really works because once it's recognised that Claim D properly construed doesn't subordinate itself to Claim C an outcome which replaces one impasse with another just simply doesn't arise.

The third point, it was unclear at the end of Mr Phillips' submissions the extent to which he continue to rely on the default rule under Rule 14.12 but to the

extent reliance remained I think it was in echoing the comments made yesterday by my Lord Lord Justice Henderson as to whether D's perception of C as a pari passu debt arises as a matter of construction or because construction runs out and it's necessary to have recourse to some other legal principle.

We say there's no need -- and that's really the whole point of our submission -- is that there is no need to get to a default rule. And I think that we were there on a sort of earlier iteration of our arguments, we thought, okay, we will use the default rule. But actually when you look at these instruments you don't run out of construction opportunities because the construction works.

And an approach which requires reliance on a default rule, such as that suggested by my Lord Lord Justice Henderson, requires this two-stage process. First of all, it requires construction of Claim D that treats C as a senior liability, which was the judge's conclusion and the one that Mr Phillips invites you to endorse; and second, it needs a recognition that that can't work, because in that event Claim D ranking with Claim C would create a circularity and that therefore the only solution is to treat the debts as pari passu, either under the default rule or on the policy ground we

suggested, or via some other legal mechanism.

And what we say is it would be peculiar to require this hypothetical two-stage process where D on its own terms can land on a workable solution in one stage as a matter of construction. One doesn't have to go through all these sort of legal mechanisms because we can do it by construing the documents. Or to make the same point another way, it would be an absurd construction of Claim D which led to a circularity problem when there was available a construction that didn't. I mean, generally the law seeks to avoid absurd solutions, particularly when there is a perfectly principled and logical alternative available. And to go back to our second point in this context, it's that by solving the problem as a matter of construction that you avoid giving rise to the further problem that the solvency condition in Claim C would still not be met. That problem is only avoided if one reaches the conclusion that D on a proper construction does not subordinate itself to C. And if one reaches the a conclusion that D on a proper construction does subordinate itself to C, so the opposite, then one is driven to solve the circularity by some form of legal default. You just create a further problem, in that Claim C's solvency condition can't be met and so some

1 further remedy is required.
2 The fourth point is that Mr Phillips submitted that
3 no reason has ever been identified for C and D to rank
4 other than pari passu. Our answer to that is no reason
5 has ever been identified why C and D should not rank
6 other than pari passu. If Mr Beltrami is right, and we
7 say he is, on his construction of amended B, amended B
8 ranks below A -- amended B ranks with A other than
9 pari passu, B ranks below A.
10 Secondly, our response is no one ever appears to
11 have thought about the relative ranking of subordinated
12 debt and it's not suggested that it was. And if no
13 reason has ever been identified for C and D to rank
14 other than pari passu that fact, we say, goes absolutely
15 nowhere and certainly nowhere near to leading to
16 a pari passu outcome. It just means that one should not
17 be surprised if the consequences of the language used
18 when it comes to ranking do not have a readily
19 discernible rationale.
20 LORD JUSTICE LEWISON: I thought Ms Tolaney did suggest
21 a reason which wasn't entirely tied up with the dividend
22 stopper argument, which is that the issue under Claim D
23 is designed to bring in outside money.
24 MS HILLIARD: Yes -- I'm happy to support Ms Tolaney. When
25 I introduced the case I obviously did explain that the

ECAPS investors provided -- the structure was all designed to attract third party, invest the money to funnel it up to the limited partnerships and then to purchase the notes. And that that structure was -- it wasn't a happenstance, it was purposely put together with the limited partnership having agreed to purchase the notes --

LORD JUSTICE LEWISON: Yes.

MS HILLIARD: -- even before the prospectus went out. So yes, that would be a reason to -- well, it would be more of a reason to put D above C than C above D, bearing in mind that the C debts are totally internal to the Lehman Group. And as I say, I'm happy to sort of row myself towards Ms Tolaney on that. I do say that our construction argument though, if you like -- Ms Tolaney's argument supports our construction argument, so in other words if our construction argument didn't work on its own the point that Ms Tolaney has made wouldn't be enough, but taken together it does give our construction argument more force I think.

LORD JUSTICE LEWISON: Yes. Right.

MS HILLIARD: Fifth, Mr Phillips placed great emphasis on the specific sanction of FSA in relation to the departure from the Standard Form 10.6 when putting in place the PLC Sub-Notes. This again, we say, goes

nowhere. It seems to be an argument that the draftsperson or FSA subjectively intended the form of the notes to be the same as the debts. There's no rectification claim. And even if that's subjective intention were admissible, and I have to say I struggle to see that there is evidence of any intention, but if it was admissible it's of no use as an aid of construction, given the judge's finding.

LORD JUSTICE LEWISON: It's not relied on.

MS HILLIARD: No, It's not relied on.

LORD JUSTICE LEWISON: It's not relied on as subjective intention. What is being said is: here is a departure from the Standard Form, that can only happen legally, in regulatory terms, if the FSA has sanctioned the departure, the FSA's sanction is public, public document and therefore available to anybody who's buying into these notes. The FSA sanction says: well you can depart but there must be no less subordination than the standard form, ie than Claim C, if you are right then there is this less subordination than Claim C, therefore you should interpret Claim D so as to conform with the regulatory framework. That's the way the argument goes as I understand it.

MS HILLIARD: Yes. I've momentarily lost my reference but the judge actually did deal with this in his judgment.

And he said, and we'll find the reference, he did actually say: look, in relation interestingly enough to the Sub-Debts, because the Sub-Debts complies all fours with Form 10.6, and what he said, this is at paragraph 326. It starts at paragraph 322, "Regulatory irregularity?", page 454, tab 22 of core bundle 2. This is obviously dealing with the PLC Sub-Debt Agreements, "are very similar to the LBHI2 Sub-Debt Agreements which comprise Claim A." And he goes on at paragraph 323:

"On the other hand these differences ..."

He refers to "differences":

"... are sufficient to render the PLC Sub-Debt Agreements non-standard when considered in relation to the form followed by the LBHI2 Sub-Debt Agreements."

That form, it will be recalled, was laid down in IPRU(INV)10, so-called.

"The reason for the failure to follow in all respects the standard form was explored in cross-examination of Ms Hutcherson by Ms Hilliard QC. Ms Hutcherson, entirely unsurprisingly, could give no direct evidence as to why this might be the case. She did however, seek to explain why this might be the case, and her first explanation was that an error had been made. Her second was that this might have been a case where the standard forms did not have to be used.

"325. Both explanations are possible. The fact is that someone in the Lehman Group took IPRU(INV) FORM 10.6, and then varied it or caused it to be varied in a manner beyond that permitted if (i) the regulatory capital regime applied; and (ii) this was intended to be regulatory capital. As I have noted, the standard form envisaged only that the Section B variable terms could and would be altered,291 and these changes went beyond that.

"Whilst it is possible that a standard form for regulatory capital was used -- albeit with some changes -- in a case where the standard form was not in fact required, it seems to me more likely that changes were made in circumstances where the standard form should have been adhered to, but was not."

"I raised this point so that I can dismiss it for the purposes of this judgment, even assuming the form of the PLC Sub-Debt agreements ..."

Remember that's the PLC Sub-Debts not the notes:

"... was deficient, the most that this could have done was rendered what the Lehman Group intended as regulatory capital not regulatory capital. Obviously, that would or might be serious in the regulatory context, but any such deficiency would sound only in the regulatory context and would not otherwise affect the

obligations arising under the PLC Sub-Debt Agreements.292 In short, the rules regarding regulatory capital, and their potential breach, have no bearing on the questions of subordination that I must address."

LORD JUSTICE LEWISON: Is that right though?

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: If contract is made, intending to give effect to a regulatory scheme, or a legal scheme for that matter, and it could be interpreted so as to conform with the scheme and could be interpreted so as not to conform with the scheme, wouldn't a court interpret it if possible so as to conform?

MS HILLIARD: Well, first of all the actual FSA letter I think on any view is somewhat unhelpful and ambiguous.

LORD JUSTICE LEWISON: Never mind the particular facts. The judge says: regulatory consequences have no bearing on the question of subordination; ie they cannot affect my interpretation of the agreement. And I'm questioning that as a statement of principle.

MS HILLIARD: My Lord, yes, I think they can't have any bearing because the agreement, the agreement is not with the FSA, the agreement is with LP1 and PLC. So I mean, the FSA might be saying, you know: you have to have these terms in your agreement. But if the notes that are issued to LP1 don't have those provisions the idea

that LP1 would not be entitled to enforce the provisions of the notes because of something that a regulatory authority said would be somewhat surprising.

LORD JUSTICE LEWISON: So your submission is that regulatory compliance has no bearing on interpretation?

MS HILLIARD: No, my Lord, because I think -- regulatory compliance is coming quite close to -- bearing in mind that it's the FSA for this argument is saying, this is what we require, is actually coming close to the subjective intention of a party that isn't even a party to the agreement.

I think really the way to put it is that this is the tail wagging the dog, if the wording did not achieve -- assuming that was what the FSA wanted -- it did not achieve that which FSA and Allen & Overy meant it to, then it doesn't mean that the wording does not mean what it means.

LORD JUSTICE LEWISON: I understand that.

MS HILLIARD: It might mean that the FSA's rules were breached.

LORD JUSTICE LEWISON: Of course the parties' rights and obligations are in the end governed by the contract.

MS HILLIARD: Yes.

LORD JUSTICE LEWISON: All I'm questioning is the judge's statement that the regulatory background is irrelevant.

MS HILLIARD: Well, I do not see the relevance of the regulatory background to the enforcement of the obligations.

LORD JUSTICE LEWISON: Right.

MS HILLIARD: Just to make my point good in relation to the waiver, which is what Mr Phillips was relying on. The FSA waiver letter acknowledges the possibility that the agreement might not in all fours comply with what the FSA want it to comply with. Because the FSA waiver letter requires the FSA to be notified if anyone spots a problem with the terms of the waiver.

So the FSA isn't saying, look, you know, if these terms don't comply with what we require as a matter of regulation we won't regard them as enforceable, or we'll take some action to stop these provisions being enforced. The most that the letter goes to is requiring someone who picks up a problem to notify the FSA.

And what I say in terms of the waiver letter is it's -- looking at what the FSA was saying it's very unlikely that when the FSA use those words would have been thinking that the ranking that we are pushing for created any difficulties from a regulatory perspective. Because whilst the wording, we say, ranks the Sub-Notes above the Sub-Debts, it ranked behind all the other already-paid unsubordinated liabilities. And that, we

say, is all that the FSA cared about. Why should they have had any concern about where subordinated liabilities ranked --

LORD JUSTICE LEWISON: We have the judge's finding to that effect.

MS HILLIARD: Yes. I mean there's absolutely no room in the construction of the Sub-Notes and the debt for a gap in which some unsubordinated debt accidentally gets sandwiched between Claim D above and Claim C below.

LORD JUSTICE LEWISON: So your point is that when the waiver says that there must be no less subordination than the standard form, what it means is no less subordination vis-a-vis unsubordinated debt.

MS HILLIARD: Exactly. Exactly. And that must follow, my Lord, because as I say, there is absolutely not -- why should the FSA be worried about where subordinated liabilities ranked between themselves? That wasn't their concern.

LORD JUSTICE LEWISON: Yes. Right.

MS HILLIARD: Subordination isn't to a fixed level, it's always relative. And whilst Mr Phillips characterises the outcome as Claim D not subordinating itself to the same level as Claim C, it's equally consistent to view the result as being Claim D subordinating itself to the same level as C, but then C, which it does, expressly

relegating itself down a further rung.

The instruments are welded together at what might be described as a "Form 10-6 bracket" but it does not mean that everything in that bracket needs to rank pari passu.

LORD JUSTICE LEWISON: Yes.

MS HILLIARD: And indeed the forms themselves, the Sub-Debt forms, don't permit a pari passu ranking. So the FSA can't be taken to have intended all Form 10 C debt to rank pari passu because their instruments don't actually permit that. In short, and to the extent that it's relevant at all, what FSA, as I say, mean by the same level of subordination is, as I've said, it's subordination but subordination to unsubordinated debt.

LORD JUSTICE LEWISON: No, you've said that.

MS HILLIARD: And finally, on this topic for completeness -- I'm getting there. I will finish today.

LORD JUSTICE LEWISON: Well, you have two more points to go and we still have Ms Tolaney to come --

MS HILLIARD: But they're not very long. They're short.

LORD JUSTICE LEWISON: So I think we will probably call it a day there --

MS HILLIARD: Very well.

LORD JUSTICE LEWISON: -- and start again tomorrow.

Ms Tolaney, I think you have 45 minutes, is

that right?

MS TOLANEY: I have, my Lord.

LORD JUSTICE LEWISON: Right. 10.30 tomorrow.

(4.18 pm)

(The hearing adjourned until the following day at 10.30 am)

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