A3/2020/1810, A3/2020/1811

CR-2008-000026

IN THE COURT OF APPEAL

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

BUSINESS AND PROPERTY COURTS OF ENGLAND AND WALES
COMPANIES COURT (CHD)

IN THE MATTER OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N:

(1) THE JOINT LIQUIDATORS OF LB GP NO 1 LIMITED (IN LIQUIDATION)
(2) DEUTSCHE BANK A.G. (LONDON BRANCH)

Appellants

-AND-

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS HOLDINGS PLC (IN ADMINISTRATION)
(2) LEHMAN BROTHERS HOLDINGS INC.

Respondents

REPLACEMENT RESPONDENT'S SKELETON ARGUMENT ON BEHALF OF LBHI

1 MARCH 2021

A. INTRODUCTION

1. As regards the PLC Priority Dispute, the Judge held that: (a) the PLC Sub-Debt ("**Claim C**")[1] and (b) the PLC Sub-Notes ("**Claim D**") rank *pari passu* for distribution. As regards the Claim C partial discharge argument (the "**Partial Release Argument**"), the Judge held that LBHI's claims under the PLC Sub-Debt have not been reduced, discharged or diminished by virtue of any payments in respect of guarantee claims.

2. For the reasons below,[2] the Judge's conclusions in relation to the PLC Priority Dispute and the Partial Release Argument were correct, and the appeals in relation to paragraphs 6 and 7 of the Order dated 24 July 2020 (the "**July Order**" **[C2/24]**) should be dismissed.

B. EXECUTIVE SUMMARY

3. As with the LBHI2 Priority Dispute, the priority issues arising out of the PLC Application **[C2/31/506]** involve the interaction of subordination provisions in two sets of dated subordinated debts, which the Judge found were both issued to provide the Lehman Group with regulatory capital. The PLC Sub-Debt **[C3/43-45]** was drawn on standard forms issued by the FSA, and the PLC Sub-Notes **[C3/46-49]** were (pursuant to the FSA's regulatory requirements) required to (and did) replicate the subordination provisions of those same standard forms as closely as possible.

4. The Judge found that this deliberate similarity in wording and structure between Claim C and Claim D's subordination provisions resulted in a "*circuity*" whereby each instrument is a senior liability vis-a-vis the other. He held (at [250]) that the subordination provisions in question were *ineffective* as between each other in that particular instance, such that the claims prove at the same time and rank *pari passu* pursuant to Rule 14.12 of the Insolvency Rules 2016 ("**IR16**"). LBHI contends that the Judge reached the correct conclusion for the reasons he gave.

[1] Save where expressly stated otherwise, the same defined terms as used in the Judgment **[C2/22]** are adopted herein. Similarly, save where expressly stated otherwise, paragraph numbers are references to paragraphs in the Judgment. GP1 and Deutsche Bank's appeal skeletons dated 18 January 2021 are respectively referred to as "**GP1Skel**" **[C1/17/234]** and "**DBSkel**" **[C1/18/254]**. SLP3's appeal skeleton dated 18 January 2021 in respect of the LBHI2 Priority Dispute is referred to as "**SLP3 AppSkel**" **[C1/7/56]**.

[2] There is a substantial degree of overlap between the PLC Priority Dispute and the LBHI2 Priority Dispute. Given the similarity of subject matter, where necessary (and to avoid repetition) LBHI will refer to and rely on the submissions already made in the SLP3 AppSkel.

5. GP1's grounds of appeal **[C1/12/180]** are addressed below in Section G. GP1 challenges the Judge's conclusion that the PLC Sub-Debt is, from the perspective of the PLC Sub-Notes, a Senior Liability. Instead, GP1 seeks to argue by reference to the *pari passu* wording in the PLC Sub-Notes that Claim C and Claim D *may* rank *pari passu*, such that Claim C is (on balance) junior to the PLC Sub-Notes. This argument is wrong. It cannot follow that if the PLC Sub-Debt and the PLC Sub-Notes rank *pari passu*, the result is for the PLC Sub-Notes to be senior to the PLC Sub-Debt. Put shortly, the PLC Sub-Debt cannot rank *junior* as a consequence of ranking *pari passu*. The argument is obviously flawed, and the appeal should be dismissed.

6. Deutsche Bank's grounds of appeal **[C1/14/194]** are addressed below at Section H. On appeal, Deutsche Bank seeks to rekindle its Dividend Stopper Argument. This is not an argument of construction: it proceeds by assertion and merely refers to broadly stated commercial considerations. At its core, Deutsche Bank criticises the Judge's *pari passu* conclusion as being erroneous because it does not follow from his own factual findings at trial, which Deutsche Bank argues militated in favour of Claim D being paid in priority to Claim C. In reality, leaving aside the threshold issue that Deutsche Bank has not obtained permission to advance the Dividend Stopper Argument on appeal, the argument misstates and/or is inconsistent with the Judge's factual findings. It also plainly misapplies the legal principles it seeks to pray in its aid. The Partial Release Argument similarly proceeds on an incorrect legal premise. The Deutsche Bank appeal should be dismissed.

7. Alternatively, the Judge could have reached the same conclusion based on LBHI's trial case, namely, that Claim C and Claim D are subordinated behind the same Senior Liabilities, they prove at the same time as each other and rank *pari passu* pursuant to Rule 14.12: see **Respondent's Notice: Same Senior Liabilities**, at Section I below.

C. BACKGROUND

8. The PLC Sub-Debt arises under three materially identical subordinated loan agreements entered into between PLC as borrower and LB Holdings as lender. The Judge found their purpose to be to provide regulatory capital to the Lehman Group (at [15]). The first and second loan agreements were entered into on 30 July 2004, whilst the third agreement was entered into on 31 October 2005 (at [16]). The claims on these agreements are referred to below as **Claim C(i), C(ii) and C(iii)**.

9. The PLC Sub-Debt agreements were all subject to Chapter 10 of IPRU(INV). The Judge noted that pursuant to IPRU(INV) Rule 10-63(2)(a), "*a subordinated loan had to be drawn up in accordance with the FSA's standard forms if it was to count as the regulated firm's financial resources*" (at [132(3)]). In Waterfall I, it was held that the purpose of FSA Standard Form 10 (which was also in issue in those proceedings) was to provide a "*uniform system of subordination*".[3]

10. Subordinated debts drawn up on or based on FSA Standard Form 10 "*may rank only as lower tier 2 or even tier 3 capital*", but are nonetheless to be treated as regulatory capital (Waterfall I per David Richards J at [60]). The evidence at trial was that the "*default setting*" and market expectation was that Lower Tier 2/Tier 3 capital would rank *pari passu*, which reflected the "*custom in the market as to how these instruments are regarded relative to each other*".[4]

11. Subsequently, by various assignments and transactions, the PLC Sub-Debt was assigned from LB Holdings ultimately to LBHI, which is the holder of Claim C (at [17]).

12. The PLC Sub-Notes arise under four sets of subordinated notes, which were issued by PLC to the Partnerships, of which GP1 is the general partner. The Judge also found their purpose to be to provide regulatory capital to the Lehman Group (at [19]). The first set was issued on 29 March 2005, the second on 19 September 2005 (subsequently consolidated with a third set issued on 26 October 2005), and the fourth set was issued on 20 February 2006. Accordingly, at the time the first set of the PLC Sub-Notes was issued, Claim C(i) and C(ii) were already in existence.

13. The PLC Sub-Notes were also subject to Chapter 10 of IPRU(INV). The Judge held that the PLC Sub-Notes "*were not in the standard form*" and "*required the specific sanction of the FSA*" (at [68]). That was a reference to IPRU(INV) Rule 10-63(2), which required a party wishing to use a form different to FSA Standard Form 10 to seek a modification or a waiver from the FSA. In this case, waiver applications were duly submitted to the FSA in respect of each series of the PLC Sub-Notes (the "**Waiver Applications**" **[S2/59/623]**).

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[3] Waterfall I (*HC*), David Richards J at [75]; and Waterfall I (*CA*), Moore Bick LJ at [246].

[4] See the evidence of Mr Miller, a partner in the capital markets team of A&O (Day 3, page 21.9-page 22.15) **[S2/53/559]**. A&O were instructed by LBIE to draft the PLC Sub-Notes (Miller 1, [8]) **[S1/2/25]**.

14. In summary, the Waiver Applications (see SLP3 Trial Submissions, [164]-[173] **[S1/8/142]**): (a) noted that the terms of the PLC Sub-Notes were materially identical to the standard terms contained in FSA Standard Form 10, subject to limited specific differences (in particular, the modification of the term "Subordinated Liabilities" so as to expressly include *pari passu* wording was said to "*better reflec[t] borrowing in a bond, rather than a loan format*" **[S2/60/636]**); and (b) explained that the PLC Sub-Notes were based on a precedent, in the form of a note issuance by Collins Stewart Tullett plc (which notes contained a materially identical definition of "Subordinated Liabilities" to that found in the PLC Sub-Notes).

15. In each case, the FSA granted a waiver direction approving the relevant Waiver Application, which was made publicly available on the FSA's website (the "**Waiver Direction**" **[S2/61/638]**) (see SLP3 Trial Submissions, [174]-[179] **[S1/8/146]**). Each Waiver Direction provided that "*the loan documents are in substance (if not in form) the same as form 10-6 except as set out in the following table*" and that "*[t]he definition of 'Subordinated Liabilities' may be changed to reflect borrowing in a bond rather than a loan*" **[S2/61/641]**. No other purpose was flagged to the regulator in relation to the slight modification of the "Subordinated Liabilities" definition in Claim D (upon which GP1's case hangs).

16. As observed by the Judge, the common thread of the instruments considered in the Judgment, including the PLC Sub-Debt and the PLC Sub-Notes, was that they 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"* (at [61(3)(b)]).

17. The ECAPS are preferred securities issued by the Partnerships, which constitute limited interests in the Partnerships (at [3(3)]). Deutsche Bank is the holder (through a Euroclear account) of ECAPS, from which it derives its indirect interest in these proceedings (at [19]). Its only direct claim against PLC is pursuant to the ECAPS Guarantees, which the parties agreed rank lower than Claim C and Claim D (at [21]).

D. THE JUDGE'S APPROACH TO THE NATURE OF SUBORDINATION

18. LBHI refers to and repeats the submissions at Section D of SLP3 AppSkel in relation to: (a) the Statutory Scheme (at [19] to [21]) and (b) Simple Contractual Subordination (at

[22] to [24]). LBHI refers to and repeats the submissions in relation to Contingent Debt Subordination (at [25]-[28]), save as follows.

19. GP1's Ground 2 contends that the Judge erred by treating contingent debt subordination as a free-standing mechanism which operates independently from simple contractual subordination. In contrast, Deutsche Bank's Ground 3A is predicated on there being a free-standing contingent debt subordination mechanism in Claim C and Claim D. LBHI agrees with GP1's appeal on this sub-issue. The Judge fell into error in relation to this both as a matter of insolvency law and binding authority:

(1) As a matter of insolvency law, the question as to whether a debt is contingent or not is a binary one. As the Judge said, where a debt is contingent "*the subordinated creditor continues to be entitled to prove in the insolvency, because contingent debts are provable*" (Judgment, at [96] and [111(1)]). Once a debt is proved, the creditor submits to the statutory scheme for proof. The officeholder must estimate the value of a contingent debt under Rule 14.14 IR16, which gives rise to the "*logical problem*" identified by Lord Neuberger in Waterfall I (at [68]). A debt cannot therefore be provable at any time as a contingent debt *and* at the same time be precluded from proving until after the Senior Creditors have been paid pursuant to a simple contractual subordination provision.

(2) As a matter of authority, the operation of the subordination in these instruments was conclusively determined by the Supreme Court in Waterfall I. It was held that both parts of the subordination provision should be read as achieving the same outcome, namely, specifying at what point the subordinated debt can prove. It was on this basis that Lord Neuberger expressly rejected the "contingent debt subordination" analysis in favour of simple contractual subordination: see [26] of SLP3 AppSkel.

E. THE INTERPRETATION OF CONTRACTS – RELEVANT PRINCIPLES

20. LBHI refers to and repeats Section E of SLP3 AppSkel.

F. PLC PRIORITY DISPUTE – THE JUDGE'S APPROACH

21. As regards the PLC Priority Dispute, the Judge correctly concluded that Claim C and Claim D rank *pari passu* for distribution. LBHI agrees with both the Judge's conclusion

on this issue and his analysis.

22. The Judge set out his broad methodology as regards priority disputes between two subordinated instruments at Judgment, [175]-[176]. LBHI refers to and repeats the description of the Judge's Three-Step Approach at [31] of SLP3 AppSkel.

Simple Contractual Subordination

<u>Claim C(i), C(ii) and C(iii)</u>

23. The Judge correctly applied this Three-Step Approach to Claim A(i), A(ii) and A(iii), and, by extension, that reasoning necessarily applies to the ranking of Claim C(i), C(ii) and C(iii), given that the subordination provisions are materially identical, having also been drawn up on FSA Standard Form 10.

24. The Judge noted that a circuity arises as result of Phrase **[1]** of FSA Standard Form 10 (at [151]), which he termed the "simple contractual subordination" provision. On the Judge's analysis, at both Step 1 and Step 2 of the Three-Step Approach he found that the other debts drawn up on FSA Standard Form 10 are Senior Liabilities from each other's perspectives; and, at Step 3, he concluded that an "*endless loop*" or "*infinite race to the bottom*"[5] arises as a result of the interaction between the subordination provisions (at [154] and [246]), which requires a further step.

25. The Judge addressed the circuity he had identified on the three agreements drawn up on FSA Standard Form 10 at [248]-[252]. As to this:

    (1) The Judge considered that the answer to resolving the circuity was "*obvious*": where different subordination provisions result in an infinite race to the bottom, the answer is that <u>as between those provisions</u>, as a matter of law, a *pari passu* approach should be adopted.

    (2) That is because the subordination does not work in that particular instance. The subordination provisions are *ineffective* between each other, and the default position pertains, i.e. ranking pursuant to the rules of legal subordination (at [250]).

[5] A simpler description than a "loop" or "race to the bottom" is a clash between the different instruments that appear on their face (on the Judge's construction) to each subordinate themselves to the other.

Accordingly, Claims C(i), C(ii) and C(iii) are entitled to prove at the same time and rank *pari passu* pursuant to Rule 14.12 IR16.

26. Both GP1 and Deutsche Bank accept that the Judge's conclusion as regards the *pari passu* ranking of Claim C(i), C(ii) and C(iii) is correct: GP1Skel, at [17]; and DBSkel, at [58].

27. LBHI's position is that both the Judge's conclusion and reasoning on the ranking of the PLC Sub-Debt *inter se* were correct. Alternatively, consistent with LBHI's trial case, the Judge could have reached the same conclusion by reasoning that agreements drawn up on either the same or very similar terms to FSA Standard Form 10 are subordinated to the same Senior Liabilities (and not each other), such that they prove at the same time and rank *pari passu*: see below Section I, **LBHI's Respondent's Notice: Same Senior Liabilities**.

<u>Claim C and Claim D</u>

28. As to the PLC Priority Dispute between Claim C and Claim D, the Judge held that:

(1) At Step 1, starting with Claim C, the rights under Claim D cannot constitute Subordinated Liabilities, as they do not arise under any of the agreements comprising Claim C (at [352]). Unless the rights under Claim D are Excluded Liabilities from the perspective of Claim C, they must be Senior Liabilities. As to this:

(a) The Judge proceeded to consider Claim D, but always from the perspective of Claim C. Claim D has exactly the same definition of Senior Liabilities as Claim C, save that there is a difference in the definition of Subordinated Liabilities.

(b) The Judge held that this definitional difference makes no difference to the outcome (at [356]).

(c) The Judge then held, by reference to his analysis of Claim A(i), Claim A(ii) and Claim A(iii) (at [151]), that Claim D is not an Excluded Liability for the purposes of Claim C (at [357]). By reference to [151(b)], the Judge therefore held that Claim D makes clear its subordination to what it terms Senior

Liabilities but that does not bring it within the class of Excluded Liabilities as that term is defined in Claim C.

(2) At Step 2, from the perspective of Claim D, the analysis is repeated with the same result such that each "*viewed through the prism of the other's subordination provisions – ranks as a Senior Liability*" (at [357]). In other words, there is no expression of juniority whatsoever in Claim C which might make it an Excluded Liability in Claim D.

(3) At Step 3, because of the similarity in the simple contractual subordination provisions, a meaningless outcome arises in the form of an endless loop (at [358]). A further step is needed. Given that the subordination provisions are ineffective "*in that particular instance*", Claim C and Claim D are entitled to prove at the same time and rank *pari passu* pursuant to Rule 14.12 IR16.

29. The Judge's analysis of the PLC Priority Dispute analysis was correct:

(1) It was rooted in the fundamental similarity (at [342] and [358]) between the subordination provisions of dated regulatory subordinated debts which were either (a) all drawn on the same standard forms or (b) required to replicate standard forms as closely as possible to qualify as regulatory capital.

(2) In the event that the interaction between their subordination provisions results in a meaningless outcome, the principled approach is to recognise that the two subordinated claims are entitled to prove at the same time and rank *pari passu* pursuant to Rule 14.12 IR16. That is the legal default for all provable debts.

Contingent Debt Subordination

30. The Judge held that all the instruments in question contained a simple subordination provision, which needed to be read cumulatively with the contingent debt subordination provision (at [335]). This was an error for the reasons set out above.

31. The Judge went on to apply his reasoning in relation to Claim A(i), A(ii) and A(iii) (at [253(3)-(4)]) to the contingent debt subordination provisions in Claims C and Claim D, with the effect that there was no difference to the outcome dictated by the simple contractual subordination provision, i.e. a *pari passu* ranking.

G. PLC PRIORITY DISPUTE – GP 1 APPEAL

Overview

32. GP1 contends that the PLC Sub-Notes rank for distribution ahead of the PLC Sub-Debts. In this regard, GP1's appeal (even on a cursory view) suffers from several serious shortcomings:

(1) First, the core of GP1's argument is that the PLC Sub-Debt is junior to the PLC Sub-Notes because the PLC Sub-Notes expressly envisage the existence of other *pari passu* subordinated debts (but the PLC Sub-Debts do not). That is obviously absurd (and wrong).

(2) Second, GP1 acknowledges that the PLC Sub-Debts do not express themselves to rank junior to the PLC Sub-Notes (GP1Skel, [21.2(i)]), but argues that they are "*in fact*" junior because they *might* "*tentatively*" (from the perspective of the PLC Sub-Notes) fall within the category of other *pari passu* subordinated debts. Again, it is clearly incorrect that a tentative *pari passu* ranking between the debts might somehow result in the PLC Sub-Debt ranking junior to the PLC Sub-Notes.

33. GP1 concedes (GP1Skel, [13]) that, in the event of a true "*symmetrical circularity*", the Judge was correct to conclude that the PLC Sub-Debts and the PLC Sub-Notes rank *pari passu*. For the reasons set out below, GP1's grounds of appeal fail to explain sufficiently why the Judge was wrong to conclude, on his analysis, that the PLC Sub-Debts were Senior Liabilities from the perspective of the PLC Sub-Notes and/or why his conclusion as to the "*symmetrical circularity*" between Claim C and Claim D was otherwise wrong.

Ground 1

34. GP1 sub-divides its Ground 1 into four parts but, in essence, its arguments amount to materially the same point: the inclusion of the additional wording "*and all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes*" in the definition of Subordinated Liabilities in the PLC Sub-Notes results in the PLC Sub-Notes ranking *above* the PLC Sub-Debt.

Grounds 1.1 and 1.2

35. There is a clear overlap between these two grounds, and they fall to be considered together. The building blocks of the argument are as follows:

(1) The PLC Sub-Debt does not admit the possibility of anything ranking *pari passu* with it (GP1Skel, at [16]). The PLC Sub-Notes are not "*expressed to be junior*" to the PLC Sub-Debts (GP1Skel, [21.2(i)]). Therefore, in relation to Step 1, and from the perspective of the PLC Sub-Debt, the PLC Sub-Notes are Senior Liabilities.

(2) In relation to Step 2, and from the perspective of the PLC Sub-Notes, GP1's case (GP1Skel, at [21.2]) is that "*it is not immediately apparent whether they purport to subordinate themselves to the PLC Sub-Debts*." In this regard:

(a) The PLC Sub-Debts are not expressed to be junior to the PLC Sub-Notes.

(b) However, there is a "*subtle, but key, distinction between the terms of the PLC Sub-Notes and the PLC Sub-Debts*" (GP1Skel, at [20]) in the form of Claim D's definition of Subordinated Liabilities.

(c) This means that the PLC Sub-Notes can "*accommodate*" the PLC Sub-Debt on a *pari passu* ranking, and there is a "*tentative pari passu ranking*" (GP1Skel, [21.2(iv)]) as between Claim C and Claim D.

(d) Accordingly, the PLC Sub-Debts cannot be Excluded Liabilities for the purposes of the PLC Sub-Notes (they are not expressed to rank junior); but GP1 is entirely equivocal as to whether the PLC Sub-Debts are in fact Subordinated Liabilities from the perspective of the PLC Sub-Notes (because they may rank *pari passu*).

36. The argument bears the hallmarks of reverse engineering and suffers from numerous analytical difficulties.

37. First, GP1's contention (GP1Skel, at [20]) that the *pari passu* wording in the PLC Sub-Notes' definition of Subordinated Liabilities is determinative is misconceived. This is because:

(1) If Claim C *is* a Subordinated Liability in Claim D, on the basis that it does in fact "*rank*" *pari passu* with Claim D,[6] 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 IR16. This would either be because their subordination provisions are ineffective as against each other, or because they are entitled to prove after the same senior liabilities. If so, that is the end of the matter, as Claim C and Claim D rank *pari passu*. It cannot follow that, if Claim C and Claim D rank *pari passu*, then in fact Claim C ranks junior to Claim D (see also below in relation to Ground 1.3).

(2) If Claim C is *not* a Subordinated Liability which does "*rank pari passu*"[7] with Claim D (such that the "*rank or are expressed to rank pari passu*" language is not engaged at all) then Claim C is necessarily a Senior Liability in Claim D. This follows from the structure of the term "Senior Liabilities" in Claim D. The result is the meaningless interaction which the Judge held (and GP1 agrees in principle, at [13]) would also result in a *pari passu* outcome.

38. On analysis, whichever route one goes down at Step 2 of GP1's argument, the outcome is a *pari passu* ranking between Claim C and Claim D.

39. Second, GP1 seeks to avoid this problem by referring to the mere possibility of a *pari passu* ranking, without accepting the obvious proposition that if Claim C and Claim D do rank *pari passu* by operation of law then that is the end of the matter: hence the new label of "*tentative pari passu ranking*". However, this inchoate approach to the actual status of Claim C is unsatisfactory: it is not open to GP1 to hedge its bets, without committing either way. The mere possibility of a *pari passu* ranking in Claim D has no bearing on the priority dispute (Judgment, at [356]), unless it is engaged, in which case the debts will in fact rank *pari passu*.

40. Third, GP1's argument appears to accept that there is nothing in the terms of Claim C which expresses it to be junior to Claim D: rather, GP1's case is that there is a textual feature in Claim D itself (an extended definition of Subordinated Liabilities) which promotes its position relative to Claim C (see in particular at [21.4(i)]). However, this

[6] It is common ground between the parties that the PLC Sub-Debts do not express themselves to rank *pari passu* with the PLC Sub-Notes.

[7] In this regard, the Judge was entitled to conclude as a matter of construction that, without more, the additional wording "*which rank….pari passu*" did not mean that Claim C was a Subordinated Liability.

would contravene the established rule of subordination that a creditor can only subordinate itself, and never promote itself: see Judgment, at [124(1)]; Ex Parte Mackay (1873) Ch App 643; Waterfall I at [66] per Lord Neuberger.

41. Fourth, the purpose of the extended definition of Subordinated Liabilities in the PLC Sub-Notes was related solely to the PLC Sub-Notes being in bond rather than loan form (and the FSA was informed of and approved the same). It was not the objective intention of the additional wording to alter or change the ranking of the PLC Sub-Notes as against other subordinated claims. The proposition that, by identifying liabilities that rank *pari passu*, the PLC Sub-Notes expressed themselves to be senior is absurd.

42. Fifth, the emphasis GP1 places on the extended definition of Subordinated Liabilities is gainsaid by the fact that: (a) the terms of the PLC Sub-Notes originate in FSA Standard Form 10, and (b) as GP1 has previously accepted, in order to obtain the FSA's Waiver Direction, Claim D's terms had to replicate FSA Standard Form 10 as closely as possible (see GP1 Position Paper at [73.2] **[C2/36/626]**). The attempt to rely on the modified Subordinated Liabilities definition in Claim D as being a substantive ranking departure from FSA Standard Form 10, despite that substantive departure never being raised with the FSA nor specifically approved in the FSA's publicly available Waiver Direction, is misconceived.

Ground 1.3

43. GP1 places heavy reliance on what it refers to as the Judge's "Rule 2"[8] (at [33.2], [36]). This is a reference to [198], where the Judge said there that where there is an inconsistency of outcome and only one operative subordination provision, then the position is analogous to the contest "*between a subordinated creditor and an unsubordinated creditor*" (original emphasis), and priority must be afforded to the subordination provision that is effective. From this, GP1 derives a principle (GP1Skel, at [12.2]) that where "*claim X expresses itself to be subordinated to claim Y, and claim Y says nothing about its degree of subordination to claim X, then claim Y will rank ahead of claim X*".

[8] This was not in fact a label used by the Judge, who did not set out this "Rule" as part of his methodology at [175]-[176].

44. LBHI's position is that the reasoning at [198] is difficult to follow, and erroneously treats the priority dispute between two subordinated debts as being (by analogy) between a subordinated debt and an unsubordinated debt.[9]

45. In any event, the Judge's statement at [198] is of no application to Claim C and Claim D. The Judge did *not* hold that Claim D says nothing about its degree of subordination to Claim C: rather he held that Claim C *was* a Senior Liability from Claim D's perspective (at [357]).

46. There is no logical basis for GP1's assertion that because "*the possibility of pari passu ranking remains*" in Claim D, it follows that "*Claim D says nothing meaningful about its subordination to Claim C*" (GP1Skel, at [36.2]). That is a *non sequitur*. The consequence would be that any subordinated debt with *pari passu* wording, such as FSA Standard Form 5,[10] would be treated as being ineffective and thus (on GP1's analysis) unsubordinated vis-a-vis FSA Standard Form 10. On the contrary, Claim D plainly does say something meaningful about its subordination in relation to Claim C: as the Judge held, Claim C is a Senior Liability in Claim D, resulting in a *pari passu* outcome.

47. Further, it is entirely unclear why, where (on GP1's analysis) Claim C ranks *pari passu* from the perspective of Claim D, the *pari passu* outcome is not to be preferred. In this regard, where the overall combined effect of the subordination provisions does not lead to a clear and unequivocal subordination of one debt to the other, the factual matrix strongly militates in favour of a *pari passu* outcome (for the reasons set out below at [81] and [85]; and see also Re Golden Key [2009] EWCA Civ 636 at [6]).

48. Finally, GP1 relies on Annex 1.i and 1.ii to its skeleton argument. These tables largely set out, in tabular form, the arguments referred to above, and contain the same notable errors. For example:

    (1) The approach to "Conjunctive Construction" is flawed (for all the reasons set out in SLP3 AppSkel at [37]-[44]).

    (2) The argument is entirely reliant on which instrument the reader starts with. For example, if the reader started the same analysis with Claim D, Claim C would be a

[9] See in this regard, SLP3 AppSkel at [37]-[44].
[10] See SLP3 AppSkel at [13] in relation to FSA Standard Form 5.

Senior Liability for the purposes of Claim D, such that Claim D would be an Excluded Liability for the purposes of Claim C. The end result is for *Claim C* to rank senior. This underscores GP1's flawed methodology.

Ground 1.4

49. GP1 posits a hypothetical subordinated "Claim F" which it relies on as a "*logical tool*" for resolving the PLC Priority Dispute in favour of Claim D.

50. The argument goes that because (a) Claim F could express itself to be *pari passu* with Claim D and at the same time express itself to rank *ahead* of Claim C (GP1Skel, at [5.2]), then (b) this reveals a 'gap' into which the hypothetical Claim F might slot, which (c) in turn demonstrates how Claim C and Claim D "*must rank*" (GP1 Skel, at [40]). As to this:

    (1) The Claim F tool is a meaningless construct, which assumes the conclusion it seeks to prove.

    (2) One could equally posit a "Claim G" which expressly ranks itself junior to Claim C, and senior to Claim D. Both of those possibilities are self-evidently permissible on the terms of Claim C (which contemplates more junior Excluded Liabilities) and the terms of Claim D (which contemplates Senior Liabilities). The 'gap' into which Claim G slots would reveal nothing about the relative ranking of Claim C and Claim D, because it is a fiction which depends on the terms of Claim G.

Ground 2

51. GP1's Ground 2 is to the effect that the Judge erred in concluding that Claim C and Claim D contained *both* a simple contractual subordination provision and a contingent debt subordination provision. GP1 appeals the Judge's decision on this sub-issue on the basis that the subordination clauses in fact comprise a single contractual subordination term and the word "*accordingly*" should have been construed consistent with such a construction (GP1Skel, at [41] ff.). LBHI agrees with the arguments raised in GP1's Ground 2, for the reasons set out above and more fully in SLP3 AppSkel, [47]-[50].

H. PLC PRIORITY DISPUTE – DEUTSCHE BANK APPEAL

Overview

52. Deutsche Bank also contends that the PLC Sub-Notes rank for distribution ahead of the PLC Sub-Debts.

53. Deutsche Bank's Ground 3 is an argument that there were strong commercial reasons for Claim D to be paid in priority to Claim C (DBSkel, at [14]), which ought to lead the Court to "*break the circularity*" which, in contrast to GP1, Deutsche Bank accepts arises as between Claim C and Claim D (DBSkel, at [22]). LBHI's position in relation to Deutsche Bank's Ground 3 can be summarised as follows:

    (1) Ground 3 is based on the "Dividend Stopper Argument" ([365]-[377]), which cannot reasonably be said to be an argument of construction at all. Deutsche Bank's Dividend Stopper Argument was specifically denied permission to appeal by the Judge pursuant to paragraph 17 of the July Order **[C2/24/487]**. Deutsche Bank has not sought permission to appeal from the Court of Appeal.

    (2) In any event, the Judge was plainly right in dismissing the Dividend Stopper Argument, which he held went (at best) to the factual matrix. He correctly concluded that the argument was not only "*not supported by*", it was in fact "*contradicted by*" the <u>documentary evidence</u>; and disbelieved Mr Katz's evidence. Deutsche Bank's attempts to re-characterise the Judge's clear findings of fact in this regard as supporting its Dividend Stopper Argument should be rejected.

    (3) Further, the argument is based on a number of further false premises.

    (4) Finally, the contrived legal mechanisms which Deutsche Bank attempts to superimpose on to the Dividend Stopper Argument to justify its argument that the PLC Sub-Notes rank above the PLC Sub-Debt are misconceived and of no application here.

The Judge's Treatment of the Dividend Stopper

54. Deutsche Bank (DBSkel, at [14]) contends that the answer to the PLC Priority Dispute is "*obvious*" and that it was "*conclusively determined by the Judge's factual findings at trial: there were strong commercial reasons for Claim D to be paid in priority to Claim*

C, and no suggestion of any commercial or other reason why the parties would (objectively) have intended any other ranking".

55. The essence of the argument is that, were it not for the Judge's erroneous conflation of the parties' subjective intentions and the "*objective inferences to be drawn from the contracts themselves*" (DBSkel, at [52]), there would have been a large measure of agreement between its case and the Judge's findings: see e.g. DBSkel, at [22] and [47].

56. When tested against the Judgment, these broad assertions are plainly unfounded. The Judge specifically considered (and rejected) the argument that there was any relevant background evidence which supported an objective intention for the PLC Sub-Notes to rank above the PLC Sub-Debt. Indeed, the Judge held that the evidence before the Court contradicted this thesis. In this regard:

   (1) The Judge described the Dividend Stopper Argument in his introduction (Judgment, [32.2]) by reference to Deutsche Bank's Trial Submissions, [29]-[30] **[S1/11/270]**.[11]

   (2) Despite Deutsche Bank's contention on appeal that the Judge confused subjective and objective intention (DBSkel, at [48]-[52]), it is clear the Judge approached the Dividend Stopper Argument (Judgment, at [366]) as an argument based on the factual matrix: see at [367] and [368].

   (3) The Judge addressed the ECAPS at [366]. In relation to this:

      (a) He explained that, under the terms of ECAPS, GP1 (as general partner) had considerable discretion in issuing a "No Payment Notice", which he found was for tax efficiency reasons.

      (b) The discretion to issue a No Payment Notice was limited as a matter of commercial reality by the Dividend Stopper (which was provided for in Clause 18(1) of the Limited Partnership Agreements). This would act "*as a kind of (commercial assurance) to ECAPS holders that Distributions would, in fact, be made*."

[11] This section is entitled "The Commercial Context Relevant to Both Applications": see at [28]-[66].

(c) LBHI could only go to lengths to avoid triggering the Dividend Stopper in a solvent situation, and the point of the Dividend Stopper was to create a commercial incentive on LBHI to ensure that PLC could pay.

(4) In the absence of any contemporaneous documentary evidence supporting the Dividend Stopper Argument, the only materials relied upon by Deutsche Bank were the terms of the ECAPS and the written/oral evidence of Mr Katz. The Judge addressed Mr Katz's evidence at [370]-[374]. In relation to this:

(a) At its core, the evidence was that "*I recall that the PLC Note (being the subordinated notes that provided cash-flows to the ECAPS issuer partnerships and their only contractual source of funds) would have been prioritised over PLC's other subordinated debt payments to entities in the Lehman group.*"

(b) The Judge disbelieved Mr Katz' evidence (giving a list of reasons at [373]) and found him to be "*over-dogmatic and cavalier with the truth*" (at [374]).

(c) Contrary to Deutsche Bank's case, he specifically found that the No Payment Notice and Dividend Stopper were framed with a view to the tax efficiency of the PLC Sub-Notes/the ECAPS, and <u>not relative priorities</u> (at [373]).

(d) Further, Deutsche Bank's thesis was "*never especially likely in all the circumstances*", it was "*not supported by contemporaneous evidence*" and "***it was in fact contradicted***[12] ***by such documentary evidence that did exist***" (at [374], emphasis added).

(5) Accordingly, the Judge held that the Dividend Stopper Argument failed on the facts, being contradicted by the documentary evidence (at [374]). He went on to note that even if it had been supported by clear evidence, it would have faced further "*enormous difficulties*" (at [376]) in that:

(a) The evidence would go to contradicting or varying the meaning of the instruments to which the Judge had attached a clear meaning.

[12] It is to be inferred that this is a reference to a draft heads of terms shown to Mr Katz in his cross-examination where the PLC Sub-Debts would have been prioritised over and would have been senior to the PLC Sub-Notes (and not vice versa).

(b) The Judge doubted that the evidence sought to be adduced by Deutsche Bank could even be regarded as material relevant to issues of construction. He considered that this material was, *par excellence*, material relating to the drafting history of documents that never crossed the line to be considered by other persons involved in the instruments being construed (in relation to which, LBHI was not a party to the PLC Sub-Debt or the PLC Sub-Notes).

57. Contrary to what is now suggested by Deutsche Bank, there can be little doubt that the Judge roundly rejected the Dividend Stopper Argument.

(1) No Permission to Appeal

58. A threshold question is whether Deutsche Bank has permission to appeal paragraph 7 of the July Order based on the Dividend Stopper Argument. LBHI's position is that it does not. Paragraph 17 of the July Order **[C2/24/487]** specifically refused permission to appeal the Dividend Stopper Argument. Deutsche Bank would have needed to seek permission to appeal the Dividend Stopper Argument from the Court of Appeal. It did not do so.

59. As to the three arguments raised by Deutsche Bank to pre-empt this issue at footnote 2 of its appeal skeleton: (a) the Judge did not misunderstand the Dividend Stopper Argument. He defined the Dividend Stopper Argument by reference to Deutsche Bank's own skeleton argument (at [32(2)] and [367]); (b) the Dividend Stopper Argument is not purely a matter of contractual interpretation. As the Judge correctly identified, the argument "*bears no reference to the terms of the words*" of the relevant agreements (which are the PLC Sub-Debts and the PLC Sub-Notes) and simply makes broad contentions on commerciality (at [368]) (which he in any event found were not made out); and (c) it is plainly wrong to suggest that the Judge intended for Deutsche Bank to advance the Dividend Stopper Argument on appeal. The Judge refused permission to appeal, and was emphatic at the Consequentials Hearing that he did not consider the Dividend Stopper Argument to be one of construction.[13]

[13] "*…just so we are clear, I just don't regard your dividend stopper argument as an argument of construction*" Consequentials Hearing Transcript, page 192/2-3 **[S2/58/616]**. See also page 193/4-7 **[S2/58/617]**.

(2) No basis on Judge's Findings for the Dividend Stopper Argument

60. Deutsche Bank's core contention at trial was that, as a result of the Dividend Stopper, *"it made sense to structure the subordinated debts of PLC in a way that permitted it (as a matter of legal right) to prioritise payments under the PLC Sub-Notes over payments under the PLC Sub-Debt*" (see DB Trial Submissions at [52] **[S1/11/277]**; and see [56] and [192] **[S1/11/288]**). In its appeal skeleton, Deutsche Bank repeats the same assertion, but adds that the Judge found conclusively in its favour that "*there were strong commercial reasons for Claim D to be paid in priority to Claim C*" (DBSkel at [14]).

61. This is incorrect for (at least) the following reasons:

(1) LBHI's position on the Dividend Stopper Argument at trial (as summarised by Deutsche Bank) was to "*deny that this incentive required any particular priority as between the subordinated debts in PLC*"[14] (DB Trial Submissions at [51] **[S1/11/277]**).

(2) LBHI's case was accepted by the Judge, who rejected Deutsche Bank's argument. He concluded that (a) the purpose of the PLC Sub-Debt and PLC Sub-Notes was to provide regulatory capital (at [15] and [18]) and (b) that the overriding considerations behind the PLC Sub-Notes and ECAPS were to make them as tax efficient as possible, and that this was why the Dividend Stopper and No Payment Notice were framed as such (at [373(2)]).

(3) Therefore, despite (a) Deutsche Bank's revisionist attempts to restate the Judge's findings, and (b) the assertion that he in effect found in its favour in respect of the Dividend Stopper Argument, the reality is that the Judge found that there was no objective evidence of an intention to prioritise.

62. Accordingly, there is no factual basis on which the Dividend Stopper Argument can be sustained on appeal, given that Deutsche Bank (at DBSkel, footnote 2) does not seek to challenge the factual findings made by the Judge.

[14] See Deutsche Bank Trial Submissions, at [51] **[S1/11/277]**.

(3) Deutsche Bank's False Factual Premise

63. There are critical flaws in Deutsche Bank's thesis that the prioritisation of Claim D over Claim C was the sole way to give effect to a commercial incentive created by the Dividend Stopper to ensure that GP1 did not issue a No Payment Notice.

64. First, the notion that absent the PLC Sub-Debt ranking below the PLC Sub-Notes PLC's ability to pay the PLC Sub-Notes would be "*competing*" (DBSkel, at [46]) with the PLC Sub-Debt is baseless and unsupported by any finding made by the Judge or any evidence whatsoever. The Judge was right not to make any such finding in circumstances where, as is plain from the agreements, interest on the PLC Sub-Debt was due monthly, whereas the distribution dates on the PLC Sub-Notes and on the ECAPS were scheduled annually.[15] There was never any material risk that a payment could not be made on the ECAPS because it was otherwise due on the PLC Sub-Debt.

65. Second, Deutsche Bank's argument assumes that in a solvent scenario, the "*only way to give effect to such a commercial incentive*" (at [47]) was if the PLC Sub-Debt were to be an Excluded Liability in the PLC Sub-Notes. The premise is also false. If Claim C were a Subordinated Liability in Claim D, then it would not have had to be taken into account as a Senior Liability for the purposes of the solvency condition. Accordingly, there was no absolute imperative for Claim C to rank junior to Claim D as an Excluded Liability to give effect to Deutsche Bank's commercial incentive (even if it existed).

(4) Deutsche Bank's Inapplicable Legal Mechanism

66. The legal machinery which Deutsche Bank seeks to superimpose onto the Dividend Stopper Argument is either of no application in this case, or is wholly misconceived. Deutsche Bank relies on (a) authorities relating to unforeseen or uncontemplated events;[16] and (b) the implication of a term in fact.

67. As to (a), *unforeseen events*, Deutsche Bank relies on a line of cases to the effect that if an event is unforeseen, the Court can have regard to what the parties would have intended in respect of the unforeseen event, but only where that intention is clear.

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[15] See in this regard the oral evidence of Mr Katz (Day 4, pages 22-29) **[S2/55/574]**.

[16] Bromarin AB v IMD Investments Ltd [1999] STC 301; Arnold v Britton [2015] AC 1619 at [22]; Pluczenik Diamond Co NV v W Nagel (A Firm) [2018] EWCA Civ 2640

68. First, in Pluczenik Diamond Co NV v W Nagel (A Firm) [2018] EWCA Civ 2640, the principle was said to be engaged where circumstances "*arise which the parties to a contract did not foresee* ***when the contract was made****....*" (emphasis added). The starting point is to consider whether the particular event was unforeseen at the time the contract was entered into. The unforeseen[17] event Deutsche Bank relies on is that PLC had issued or would issue other subordinated debt on FSA standard subordination terms to different creditors (DBSkel, at [27] and [38]).

69. The issuance of other FSA subordinated debt on the same FSA Standard Form 10 or a modified standard form was not an unforeseeable event in any real sense, such that the principle Deutsche Bank invokes is of no application here: (a) Claim C(i) and Claim C(ii) were already in existence when the first set of PLC Sub-Notes was issued; (b) FSA Standard Form 10 agreements were already in place between different entities at every level of the UK Lehman Group corporate chain; and (c) the PLC Sub-Notes expressly contemplated that other Subordinated Liabilities might "*rank pari passu*".

70. Second, the principle is only engaged where it is clear what the parties would have intended. In Arnold v Britton [2015] UKSC 36 at [22], Lord Neuberger stated that "*In such a case,* ***if it is clear what the parties would have intended, the court will give effect to that intention***" (emphasis added). As to this:

(1) Deutsche Bank has not made good its factual premise that "*the parties objectively would be taken to have intended that Claim D under the PLC Sub-Notes ranks in priority for payment ahead of Claim C under the PLC Sub-Debt*" (DBSkel, at [41]). That was rejected by the Judge and is based on a false premise as set out above at [63]-[65]. There is no basis to describe this as the parties' intention at all, much less their "*clear*" intention.

(2) The Judge found conclusively that the objective purpose of these agreements was to provide regulatory capital to the Lehman Group (at [15] and [18]). That being the case, consistent with market expectations and the imperative of creating a

[17] In Lloyds TSB Foundation for Scotland v Lloyds Banking Group plc [2013] UKSC 3, the context in which the contract came to be applied was agreed to be "*unthinkable*" (at [1]). Lord Mance stated at [23] that the "*question is how its language best operates in the fundamentally changed and entirely unforeseen circumstances in the light of the parties' original intentions and purposes* …".

uniform system of subordination, a *pari passu* ranking is the only outcome consistent with the contractual purpose identified by the Judge.

71. Third, the argument simply does not work linguistically, and is based on a fundamental contradiction:

(1) On whether Claim C is an Excluded Liability in Claim D, Deutsche Bank accepts that "*since neither the PLC Sub-Debt nor the PLC Sub-Notes are expressed to rank junior to the other, neither can be an Excluded Liability of the other*" (at [23(5)]). However, at the same time, it contends that the Court should "*construe the definition of the Excluded Liabilities in the PLC Sub-Notes as encompassing Claim C*" (at [61]). The argument is internally contradictory.

(2) The re-visitation of the meaning of "Excluded Liabilities" in Claim D is impermissible. The initial circularity posited by Deutsche Bank requires Claim C *not* to be an Excluded Liability in Claim D (see [23(5)]). That forms the basis of its argument that Claim C *is* in fact an Excluded Liability in Claim D. This is not so much an iterative approach to construction as one requiring the Court impermissibly to reach contradictory conclusions in respect of the same term.

72. As to (b), an *implied term*, the suggestion (at footnote 7) is that a term should be implied either into the definition of Excluded Liabilities in the PLC Sub-Notes and/or into the PLC Sub-Debt giving Claim D priority, based on materially the same reasons on which the Court is asked to re-interpret the term "Excluded Liabilities" in Claim D. As to this:

(1) As to the former, there are no grounds to imply such a term. Such a term is far from obvious and it is not necessary for the business efficacy of the contracts. The implication of the term posited by Deutsche Bank fails for the same reasons that the Judge dismissed the Dividend Stopper Argument (and see at [56] above).

(2) As to the latter, it would be surprising for an implied term positing another debt's seniority (here, Claim D) to be implied into a *standard form agreement* (AIB Group (UK) Ltd v Martin [2001] UKHL 63 at [7]); and see also Re Golden Key, above.

Ground 3A

73. Deutsche Bank's Ground 3A is predicated on four flawed assumptions, each of which is misconceived:

(1) That each of the subordinated instruments in question contain two distinct forms of contractual subordination, in the form of simple contractual subordination and contingent debt subordination (DBSkel, at [62(1)]);

(2) That whereas the simple contractual provisions give rise to an endless loop or meaningless outcome, it is nevertheless possible for the operation of contingent debt subordination to result in a different outcome (DBSkel, at [63]);

(3) That debts which are proved for at the same time may become payable at different points in time (DBSkel, at [64]); and

(4) That there is no impasse arising on the contingent debt subordination provision (DBSkel, at [65]).

74. As to (1) and (2), Deutsche Bank's position is undercut by GP1's Ground 2 of appeal. For the reasons stated above at [51], LBHI agrees with GP1 on this sub-issue. There is no basis to read the solvency condition following the word "*accordingly*" as having independent effect to the simple contractual subordination provision which precedes it.

75. As to (3), this is plainly incorrect as a matter of insolvency law. Dividends are payable at the same time on all debts admitted to proof irrespective of whether they are present, future or contingent. Once a debt is proved, it must be treated in accordance with the statutory scheme for proof and distributions outlined in SLP3 AppSkel Section D.

76. As to (4), the Judge held in terms that Claim C was not a "Subordinated Liability" within the meaning of Claim D. Accordingly, contrary to Deutsche Bank's contention, on the Judge's analysis, Claim C *does* fall to be taken into account for the purposes of Claim D's solvency condition. Accordingly, a materially similar impasse does arise on the contingent debt subordination provision in Claim D.

I. LBHI'S RESPONDENT'S NOTICE: SAME SENIOR LIABILITIES

Overview

77. Alternatively, as LBHI contended at trial, the similarity between the wording and structure of Claim C and Claim D's subordination provisions should have led the Judge to conclude that they are, on a proper construction, subordinated to the same Senior Liabilities, and not to each other. That is the obvious and principled outcome where the relative priority of two sets of dated subordinated debts, which were issued for the same regulatory purpose and subordinate themselves to all other liabilities, falls to be determined.

78. In the absence of clear and unequivocal language to the contrary, the Judge could have concluded that the default legal position pertains (described at [250]), and the subordinated creditors are entitled to prove their claims at the same time and rank *pari passu*.

79. Contrary to GP1's case, the express inclusion of *pari passu* wording in the PLC Sub-Notes does not result in a departure from that default legal position. Rather, the modified Subordinated Liabilities definition merely makes express what is necessarily possible under the PLC Sub-Debt, namely that the PLC Sub-Debt can rank *pari passu* with other subordinated debt (LBHI Trial Submissions at [220] **[S1/8/159]**).

80. The subordination categories in the PLC Sub-Debt and the PLC Sub-Notes are entirely symmetrical, leading to the conclusion that two sets of instruments are entitled to prove at the same time and rank *pari passu* pursuant to Rule 14.12 IR16.

(1) Pari Passu: Construction of Senior Liabilities

81. It was open to the Judge to hold that both Claim C and Claim D can prove at the same time as other subordinated debts and rank *pari passu* with them either as a matter of construction, including by construing the agreements (a) commercially/purposively (see Waterfall I (*SC*) at [64]) in the context of their regulatory backdrop and (b) with a view

to validating the operation of their subordination provisions,[18] or by necessary implication. As to this:

(1) As described in Waterfall I, the purpose of the FSA Standard Forms in issue was to provide a "*uniform system of subordination*" to ensure that subordinated creditors ranked behind all other creditors. The purpose of each "Subordinated Liability" was to protect "*customers and other stakeholders*" i.e. the Senior Liabilities "*and enable them to withstand loss*" (Waterfall I *(HC)* at [33]).

(2) It was no part of that purpose that multiple dated subordinated debts drawn up on FSA Standard Forms in materially similar terms should be prevented from proving at the same time as each other, after senior creditors had been paid (as the Judge acknowledged at [61(3)(c)]).

(3) As demonstrated by the facts of this case, the FSA Standard Forms were used at every point of the UK Lehman Group's capital structure, with multiple forms issued by the same Lehman Group borrower to the same Lehman Group lender, often on the same day. It is commercially implausible to suggest that such subordinated debts do not admit, as a matter of contract, the possibility of proving at the same time as each other and ranking *pari passu*.

(4) FSA Standard Form 5[19] (in force at the same time as FSA Standard Form 10) expressly envisaged that there might be other subordinated creditors of the Borrower with which the subordinated debts created by it might rank *pari passu*. It would be absurd if *pari passu* ranking were possible under one FSA Standard Form, but was impossible in relation to another FSA Standard Form in IPRU(INV) (i.e. FSA Standard Form 10) which was in use at the same time and was intended to achieve the same result.

(5) Both Claim C and Claim D were LT2/Tier 3 debt, which the market generally expected to rank *pari passu*.[20]

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[18] See in regard to (a) SLP3's Trial Submissions at [208], [213]-[214] **[S1/8/155-7]** in relation to the proper construction of FSA Standard Form 10; and in regard to (b) The Interpretation of Contracts, at [7.16].
[19] See SLP3 AppSkel at [13] in relation to FSA Standard Form 5 (which contained a subordination provision similar to the one found in the LBHI2 Sub-Notes).
[20] See the evidence of Mr Miller, a partner in the capital markets team of A&O (Day 3, page 21/8-page 22/15 **[S2/53/559]**).

82. Accordingly, the Judge could have gone on to hold that Claim C and Claim D are subordinated behind the same Senior Liabilities, and not to each other, with the consequence that they are entitled to prove at the same time. More specifically:

(1) Claim C and Claim D do not expressly cross-refer to each other. Both are entirely silent as to the other and they should be construed independently (SLP3 AppSkel [31]).

(2) The operative provisions under the PLC Sub-Debt and the PLC Sub-Notes are structured in materially the same way. The subordination categories which the instruments envisage are entirely symmetrical. Both Claim C and Claim D can prove alongside other subordinated debts for the reasons above (even absent their provisions being ineffective in that particular instance), at which point Rule 14.12 IR16 applies.

(3) The material similarity between the instruments' subordination categories should have led the Judge to conclude that these instruments are not subordinated to each other but below the same Senior Liabilities.

(4) When this material similarity is viewed against (a) the regulatory context, including the requirement that the PLC Sub-Notes replicate the PLC Sub-Debt as closely as possible and (b) the legal position under the statutory scheme which entitles provable debts to prove at any time and share in distributions *pari passu*, the Judge should have concluded that LBHI is entitled to prove for the full nominal amount of the PLC Sub-Debt at the same time as GP1 is entitled to prove in respect of the PLC Sub-Notes.

83. Accordingly, by operation of the IR16, LBHI's claims in respect of the PLC Sub-Debt and GP1's claims in respect of the PLC Sub-Notes rank *pari passu* and abate in equal proportions.

84. If the agreements cannot be read purposively so as to permit other subordinated debts ranking *pari passu*, then (in the alternative) a term falls to be implied on the grounds of obviousness and business efficacy: see <u>Marks and Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd</u> [2016] AC 742. The definition of "Subordinated Liabilities" extends by implication to other subordinated debts of PLC, which either do

rank or are expressed to rank *pari passu* with the PLC Sub-Debt. That term is both obvious and necessary[21] when viewed against the regulatory and factual backdrop referred to above. It can be tested in at least two ways:

(1) First, it is common ground that the PLC Sub-Debts were drawn up on materially similar terms to FSA Standard Form 10. It could not have been the objective intention of the draftsman that FSA Standard Form 10 subordinated instruments were so "*deeply subordinated*" (GP1Skel, [21.2]) that they necessarily fell to the "*bottom of the pile*". That is the necessary consequence of the "*race to the bottom*" analysis (and it is also inconsistent with the Judge's own findings on the regulatory context of FSA Standard Form 10 at Judgment, [61(3)(c)]).

(2) Second, if another dated subordinated debt expresses itself in terms to rank *pari passu* with the PLC Sub-Debts, can it seriously be said, from the perspective of the PLC Sub-Debts, that the other debt is nevertheless a Senior Liability? That, again, is the outcome of the "*bottom of the pile*" analysis.

(2) Pari Passu: Insufficient Regard by Judge to Factual Matrix

85. The above conclusions are supported by the admissible factual matrix, which includes the following (all of which would have been reasonably available to "*participants in the banking/financial services sector*" (Judgment, at [61])):

(1) The PLC Sub-Debt and the PLC Sub-Notes were all either LT2/Tier 3 regulatory capital, in circumstances where the prevailing custom within the market was that LT2/Tier 3 regulatory capital instruments ranked *pari passu* (unless there was clear and unequivocal language to the contrary).

(2) The Waiver Direction was a publicly available document **[S2/61/638]**. This explained that the inclusion of the additional wording in the definition of

[21] Deutsche Bank suggests an implied term in the definition of Subordinated Liabilities in Claim C to the effect that it includes: "*other tranches of debt between the same parties, on materially identical terms, issued for the same purpose*" (DBSkel, at [59(2)(iii)]). Pausing there, the PLC Sub-Notes *are* (a) on materially identical terms to the PLC Sub-Debt, as noted by the Judge, and (b) were, as the Judge found, issued for the same purpose as the PLC Sub-Debt (at [15] and [18]).

"Subordinated Liabilities" related to the *form* of the PLC Sub-Notes and not their subordination in substance.

J. PARTIAL RELEASE ARGUMENT

86. Deutsche Bank's second ground of appeal relates to the "Partial Release Argument". The Judge addressed this at Judgment, [288]-[304]. He concluded that the PLC Sub-Debt was not diminished or released in part as a consequence of partial payment made by LBHI (in its capacity as guarantor) to LB Holdings (in its capacity as original lender). The Judge was correct to so conclude.

87. LBHI's position (c.f. DBSkel, [69]) is that:

(1) Contrary to Deutsche Bank's starting point, the general rule *outside insolvency* is that a part payment by the surety does not prevent the creditor suing a solvent principal debtor for the whole amount of the principal debt.

(2) The general rule *within* insolvency is that a creditor is entitled to prove for the full amount of its debt in an insolvency of the principal debtor, notwithstanding that payments have been made by the surety.

(3) This is the rule in <u>Re Sass</u> [1896] 2 QB 12. The rule applies to ensure the maximisation of recoveries by the creditor and to avoid the unjust enrichment of the general body of creditors. The rule is to be distinguished from the rule against double proof, which prevents an aggregate proof in excess of 100 pence in the pound. The rule against double proof does not arise in this case because LBHI's indemnity has been released: however, this does not affect the application of the rule in <u>Re Sass</u>.

(4) The Partial Release Argument contravenes the rule in <u>Re Sass</u>. Its commercial outcome would be that LBHI would be unable to prove for the full amount, and PLC's aggregate liability as debtor would be reduced below 100 pence in the pound. If LBHI cannot prove as surety at all and cannot prove as creditor for the full amount, that would result in unjust enrichment to the PLC Sub-Notes (in which DB is interested). This is the very outcome the rule in <u>Re Sass</u> is intended to avoid.

(5) Even if the rule in Re Sass does not apply, and the position reverts to the position *outside* of insolvency, LBHI's part payment in its capacity as guarantor does not prevent LBHI from being able to pursue its full claim as creditor against PLC under the PLC Sub-Debt.

Factual Background

88. The relevant facts are as follows:

(1) Under Section 2.04 of the Settlement Agreement dated 24 October 2011 **[C5/57/1315]**, LBHI allowed a claim by LB Holdings (as original lender) under a guarantee it had issued, or allegedly issued, in relation to all liabilities of PLC in respect of the PLC Sub-Debt (the "**LBHI Guarantee**") (the "**LBHI Guarantee Claim**").

(2) Under Section 8.02(iii) of the Settlement Agreement **[C5/57/1338]**, LBHI's right to an indemnity from PLC as a consequence of the payments made under the LBHI Guarantee was released.

(3) LBHI subsequently made distributions of approximately $216 million in respect of the LBHI Guarantee Claim, which accounts for 36% of the allowed claim.

(4) The PLC Sub-Debt was initially assigned from LB Holdings to LBLIS; and then from LBLIS to LBDI (Geraghty 2, [53]-[58] **[S1/7/107]**; Judgment, [17], [273]). In April 2017, the PLC Sub-Debt was assigned by LBDI to LBHI.

The General Rule

89. There is no fundamental principle of the law of guarantees that a part payment by the surety to the creditor operates to reduce the principal debt *pro tanto* in the manner suggested by Deutsche Bank. In fact, the general rule outside insolvency is that a part payment by the surety does not prevent the creditor suing the solvent principal debtor for the whole amount of the debt: Goode on Legal Problems of Credit and Security, 6th edition, 8-18 ("**Goode**").

90. Deutsche Bank's general rule (see DBSkel, at [72]) is identified in a single passage in The Law of Guarantees (Andrews/Millett, 7th edition, 9-003). This refers to Milverton Group Ltd v Warner World Ltd [1995] 2 EGLR 28. The issue in that case was whether a

lessor, who had received a payment in consideration for his releasing the guarantor from his obligations under a contract of guarantee, was obliged to give credit for that payment when seeking to enforce against the lessee. The guarantor had accepted liability as principal and was, therefore, a primary obligor.

91. In Milverton, the Court of Appeal decided that payment of rent by the surety discharged the lessee's obligations to pay the same rent. The case is not of more general application (Goode, 8.18), and it turns on its particular facts, three of which warrant attention:

(1) First, the surety was under the same express obligations as the original lessee, such that there was a single set of obligations[22] owed by the tenant and guarantor. The fact that the surety was a primary obligor who had covenanted directly to pay the rent was dispositive of the case. In this regard, payment as a primary obligor discharges the debt to the extent of the payment: however, payment as a surety only does so on payment of the principal debt in full.

(2) Second, the surety paid the rent for a particular period and discharged the rent for that specific period, so that the landlord was paid in full for that period and the tenant (and assignee) were no longer required to pay for that period[23] (at page 30). This appropriation of payments was material to the Court's conclusions.

(3) Third, the release granted was absolute. Deutsche Bank contends (DBSkel, at [78]) that an absolute release makes no difference to the application of the general rule. That is neither the meaning nor the effect of the passage quoted from the judgment of Hoffmann LJ (at page 31): on the facts of the case, he held that an absolute release "*as part discharge of the common obligation*" was the necessary consideration for the landlord accepting part performance.

92. Unsurprisingly, in this context, there is limited reference to Milverton in the leading textbooks on suretyship/guarantees, and it has not been cited in England on this "*fundamental*" point of principle.

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[22] "*In other words, there is a single set of obligations, to pay the rent, and perform the covenants, owed by both tenant and guarantor*" (page 31).

[23] The instalment of rent due for the Michaelmas Day 1991 rental quarter date was not paid. The guarantors entered a release with the landlord where the landlord agreed that, upon receipt of £50,348 from the guarantors, they would be released from all their obligations (on which basis the guarantors duly paid the sum of £50,348).

93. Instead, the general principle is that where (as here) the entire debt is guaranteed the creditor can sue the principal debtor for the full amount of the debt despite any payments having been made under the guarantee, provided that the payments fall short of the full amount of the debt (Ulster v Lambe [1966] NI 161, per Lowry J). The decision has been described as "*correct because…..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 and there remains an outstanding obligation on [the guarantor] to see that the whole debt is paid*" (O'Donovan/Phillips, The Modern Contract of Guarantee, 4th edition, 10-051).

94. This statement of law finds support in Re Sass (at 14, per Vaughan Williams J): "*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 sums paid by the surety, unless the sum amounted to 20 s. in the pound*"; as well as Westpac Banking Corp v Gollin & Co Ltd [1988] VR 397. Crucially, if the creditor recovers the full amount from the debtor, they are obliged to reimburse the surety (and hold any surplus on trust for them). It is this safeguard which prevents any unjust enrichment/excess recovery by the creditor.

95. Against this, Deutsche Bank cite passages in Stotter v Equiticorp Australia (in liquidation) 2 NZLR 686 (Fisher J); MS Fashions v BCCI [1993] 1 Ch 425, 448 (Dillon LJ); and The Public Trustee of Queensland v Octaviar Ltd [2009] QSC 2020 (McMurdo J). This body of case-law has been doubted by the leading textbooks: see Goode, at 8-18; and The Law of Guarantees, at 13.10. LBHI agrees with and adopts the position of the authors of those works. In summary:

(1) In MS Fashions v BCCI, Dillon LJ said at 448E that "*a creditor cannot sue the principal debtor for an amount of the debt which the creditor has already received from the guarantee*". However, the very specific context is important: (a) it is because the directors/guarantors were principal debtors that insolvency set-off was available and (b) it was the insolvency set-off that was held to reduce the primary obligor's liability. It would be wrong to take this passage out of context and restate it as a general principle of the law of suretyship (in which respect, like Milverton, it is not an authority which appears in the leading textbooks on the law of guarantees). Further, as pointed out by Goode, neither Re Sass nor Ulster Bank v Lambe were cited to the Court of Appeal in argument.

(2) The reasoning in Stotter v Equiticorp is doubtful (for the reasons cited in both Goode and by Andrews/Millett above, and see O'Donovan/Phillips at 10-81). Its starting point, that the creditor must give credit for the surety's part payment, is derived from Milverton and MS Fashions, which are not cases of general application. The proper corrective mechanism where the "*creditor receives more than the net amount as a result of his proof for the gross amount*" is that they hold the surplus on trust for the surety; and Fisher J's approach ignores the windfall arising for other creditors in such circumstances.

(3) Finally, the reasoning in The Public Trustee of Queensland should not be followed for the same reasons set out by Goode at 8.18.

Impact of Insolvency

96. It is common ground that, under the rule in Re Sass, where the principal debtor becomes insolvent, and part payments are subsequently made by a surety, the creditor is entitled to submit a proof of debt in respect of the full amount of the guaranteed indebtedness.

97. In that case, Sass owed his bank c£755. Sass became bankrupt and subsequently the guarantor paid the bank £303 on demand. The bank then submitted a proof against Sass' estate for the full £755. The trustee rejected the proof on the basis that it should be reduced by the £303 the bank received from the guarantor.

98. The Court (Vaughan Williams J) considered whether, as a matter of construction, either (a) the guarantee was for the whole debt (even if the guarantor's liability to pay was capped) and therefore the creditor was free to prove against the debtor for the full debt until paid in full or (b) the guarantee was for part of the debt only and therefore the guarantor was entitled to step in and prove for the part paid by the guarantor instead of the creditor, with the creditor proving for the remainder.

99. The judge concluded that the first alternative applied and so the creditor was entitled to prove for the full amount of the debt (see page 15): "*his suretyship was in respect of the whole debt, and he, having paid only a part of that debt, has in my judgment no proof in preference or priority to the bank to whom he became a guarantor*."

100. The *ratio* in Re Sass is that, where the guarantor has agreed to guarantee the whole of the debt, their obligations are not fulfilled until the creditor has been paid in full – and that,

to prioritise the recoveries of the creditor, the surety should not be allowed to compete with them. The purpose of the rule is to prioritise and maximise the recovery of the creditor and to prevent the unjust enrichment of the general body of creditors.

101. Accordingly, where a creditor has submitted a proof of debt, and a payment is received from a surety, the creditor is not obliged to amend their proof of debt (The Modern Contract of Guarantee, 10-087). In this regard, the creditor is in no different position to that where a payment is made by or on behalf of the principal debtor (ibid, at 10-076).

102. By contrast, the rule against double proof prevents an aggregate proof in excess of 100 pence in the pound. Accordingly, the rule against double proof would prevent LBHI from submitting a proof for the full amount of the PLC Sub-Debt and in respect of the amount paid to LB Holdings under the LBHI Guarantee.

Impact of Release

103. Deutsche Bank criticise the Judge for not addressing the release of LBHI's claim in its capacity as guarantor (DBSkel, [90]-[94]).

104. The Judge did not refer expressly to this argument, but it would not have assisted Deutsche Bank or otherwise affect the analysis. It is correct that the rule against double proof would not be engaged where the surety's claim for an indemnity is released. However, the rule in Re Sass continues to apply.

105. Deutsche Bank contends (DBSkel, at [96]) that any other approach would lead to over-compensation of the creditor, and that this would be contrary to the *pari passu* principle. This is obviously wrong. The correct position is follows:

(1) It has always been part of the rule in Re Sass that it is not possible for the creditor to receive more than 100 pence in the pound. The rule expressly safeguards against this through requiring the creditor to hold any surplus on trust for the surety. There is therefore no risk of over-compensation to speak of (and on the facts of this case the dividend will not be 100 pence in any event).

(2) In fact, it is the approach proposed by Deutsche Bank which would lead to the unjust enrichment of the general body of creditors (in this case the PLC Sub-Notes, in which it has a substantial economic interest). If LBHI as creditor cannot prove

for the full amount because of the part payments under the LBHI Guarantee, and LBHI cannot prove as guarantor for the part payment made, that would result in an obvious windfall to the other creditors of PLC.

106. Accordingly, there is no reason why the rule in Re Sass should be disapplied – and, even if it were, the general principle outside of insolvency is that the payment by the surety does not prevent the creditor suing for the full amount.

Relevance of Clause 7(f)

107. Finally, Deutsche Bank advance a further argument that its "Partial Release Argument" (which is a point of law) is supported by "*the terms of the documents in issue*" such that the same commercial result would prevail "*even if*" (DBSkel, at [98]) the payment by LBHI under the LBHI Guarantee had not been used by LB Holdings to discharge the guaranteed debt.

108. This is a new argument of, at best, mixed fact/law, and, at worse pure fact, which was not advanced in written or oral submissions at trial, and in relation to which there was no evidence filed. For these reasons it is, with respect, not one that the Court of Appeal should entertain. In this regard:

(1) Whilst Deutsche Bank referred to Clause 7(f) of the PLC Sub-Debt in two lines of its Position Paper, no statement of its case was pleaded (which is, under the procedure adopted in the Lehman proceedings, the purpose of position papers[24]).

(2) On this basis, it is unsurprising that no party adduced evidence. However, that does not make it a "*short point of law*". Further, the suggestion (at footnote 18) that it "*can be dealt with based on the factual findings made by the Judge*" is obviously wrong: the argument (in as much as it is understood) appears to proceed on a counter-factual that was not explored in the evidence or even considered by the Judge at trial. It was certainly not a point raised by Deutsche Bank. It would not be possible to conduct such an enquiry without further disclosure and factual evidence.

[24] See LBHI's Reply Position Paper, at [64(3)] **[C2/37/664]**: "*This argument is not particularised, is unsupported by any authority and cannot be realistically pursued*".

(3) This argument is a "*new*" argument, and one which the Court of Appeal, in exercising its discretion (applying the principles in Notting Hill Finance Limited v Sheikh [2019] EWCA Civ 1337, at [21]-[28]), should not consider on appeal.

109. Clause 7(f) of the PLC Sub-Debt requires the "*Lender*" (which is LB Holdings) to hold any sums received in respect of a guarantee of PLC's liabilities under the PLC Sub-Debt on trust for PLC.

110. As to the substance of Deutsche Bank's belated attempt to rely on this provision, the argument appears to be based on PLC's right to set off any claim by LB Holdings under the PLC Sub-Debt against the sums held on trust under Clause 7(f) (DBSkel, at [100]-[101]). This argument is obviously flawed. In this regard:

(1) For there to be an insolvency set-off, the claim *into* the insolvent estate must be a provable claim (Rule 14.25), although the claim going the other way can be non-provable (Waterfall I *(SC)* at [167]-[169]). A trust claim is a proprietary claim and, as a result, is not capable of being set off, just as it is not capable of being schemed (Re Lehman [2009] EWCA Civ 1161; Re Lehman [2010] 2 BCLC 301).

(2) A trust claim would clearly not have been a provable claim in the LB Holdings estate, so there could have been no insolvency set-off.

(3) Further, once all the senior claims have been paid, the PLC Sub-Debt will be provable in the PLC estate: again, because a trust claim is a proprietary claim (and not a debt claim), it is not capable of being set off, and therefore no set-off arises.

K. CONCLUSIONS

111. The GP1 appeal and the DB appeal should both be dismissed, and the Court of Appeal should uphold the Judge's finding that Claim C and Claim D rank *pari passu*.

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