Appeal No. A3/2020/1810(Y)

18 January 2021

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

IN THE MATTER OF LEHMAN BROTHERS HOLDINGS PLC (in administration)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN

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

and

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS HOLDINGS PLC (in administration)
(2) LEHMAN BROTHERS HOLDINGS INC.

SKELETON ARGUMENT FOR THE SECOND APPELLANT (DEUTSCHE BANK)

On 19 December 2020 Newey LJ gave directions: (i) permitting the Second Appellant to file and serve a skeleton argument up to 35 pages in length; and (ii) for a final appeal bundle index to be agreed by the parties and for the appellants to file and serve a replacement skeleton argument incorporating bundle references within seven days of agreeing the bundle index. Accordingly, bundle references in this version of the skeleton argument are incomplete.

INTRODUCTION

1. Deutsche Bank appeals parts of the Order of Mr Justice Marcus Smith dated 24 July 2020 (the "**Trial Order**")[1], made on an application for directions by the Joint Administrators of Lehman Brothers Holdings PLC ("**PLC**" and the "**PLC Application**"). The PLC Application was tried at the same time as a related application

[1] [## REF]

in the administration by the Joint Administrators Of LB Holdings Intermediate 2 Limited ("**LBHI2**" and the "**LBHI2 Application**"). The Judge's conclusions on the LBHI2 Application are the subject of the joined appeal with reference A3/2020/1787(Y), to which Deutsche Bank is a respondent.

2. Deutsche Bank has permission to appeal the declarations at paragraph 6 and 7 of the Trial Order. The Judge granted Deutsche Bank permission to appeal paragraph 7, which concerns the relative priority of PLC's outstanding subordinated liabilities.[2] Newey LJ granted Deutsche Bank permission to appeal paragraph 6, which concerns the quantum of LBHI's subordinated claim against PLC.

3. PLC's outstanding subordinated liabilities can be categorised into two competing groups.

4. The first group comprises PLC's liabilities under two long-term subordinated loan facility agreements dated 30 July 2004 and one short-term subordinated facility

[2] See paragraph 17 of the Trial Order [## REF]. The Judge ordered that "*permission to appeal is refused in relation to Deutsche Bank's "Dividend Stopper argument" (as defined at paragraph 32(2) of the Judgment and as further explained at paragraph 366 of the Judgment), including any contention that the Court erred: (a) in the making of the factual findings made and recorded in paragraphs 365 to 377 of the Judgment; and/or (b) in rejecting the arguments made or recorded as having been made by Deutsche Bank, as described and dealt with in paragraphs 365 to 377 of the Judgment*". Deutsche Bank does not seek (and has never sought) to advance any argument along the lines defined in paragraphs 32(2) and 366 of the Judgment, nor does it seek to challenge the factual findings made by the Judge. As explained below, the Judge misunderstood the nature of the "*Dividend Stopper argument*" which, properly understood, is purely a matter of contractual interpretation and, as such, an argument that the Judge expressly intended that Deutsche Bank should be entitled to advance on appeal (see the transcript of the hearing on 24 July 2020, at ## [## REF]). The Judge having given Deutsche Bank permission to appeal against paragraph 7 of his order, Deutsche Bank does not accept that there is any proper basis to prevent it from pursing the arguments of construction set out in this skeleton argument.

agreement dated 31 October 2005, which are in materially identical terms. These facility agreements were referred to at trial together as the "**PLC Sub-Debt**".

5. The original lender under the PLC Sub-Debt was PLC's immediate parent company in the Lehman group, referred to as "**LB Holdings**". The claims under the PLC Sub-Debt were assigned by LB Holdings in April 2017, ultimately to LBHI. Thus it is LBHI which now asserts the claims against PLC in its administration. The Judge referred to LBHI's claims under the PLC Sub-Debt together as "**Claim C**" in the Judgment, and to the claims under each of the three facility agreements as "**Claim C(i)**, **C(ii)** and **C(iii)**" respectively.

6. The second group comprises PLC's liabilities under fixed rate subordinated notes issued in several series by PLC pursuant to offering circulars dated between March 2005 and February 2006, again on materially identical terms. These notes were referred to at trial together as the "**PLC Sub-Notes**". The PLC Sub-Notes were issued to and are still held by the "**Partnerships**". The claims against PLC under the PLC Sub-Notes are asserted by the first appellant, "**GP1**", as general partner of the Partnerships, and the Judge referred these claims together as "**Claim D**" in the Judgment.

7. The relevant claims, and relationship between the parties, can be represented in diagrammatical form as shown in the Appendix hereto.

8. PLC will not have sufficient assets to pay both Claim C and Claim D in full, and there is therefore an issue as to the priority for payment in PLC's administration between Claim C and Claim D. That is the subject of Deutsche Bank's Ground 3 and alternative Ground 3A, which are referred to below as the "**PLC Ranking Issues**".

9. Deutsche Bank's and GP1's position is that the Judge was wrong to conclude that the claims of LBHI under the PLC Sub-Debt (Claim C) rank for distribution *pari passu* with the claims of GP1 under the PLC Sub-Notes (Claim D) and, instead, that Claim D should be paid in priority to Claim C (i.e., that no distributions should be paid in respect of Claim C unless and until Claim D is paid for (or reserved for) in full). LBHI, on the other hand, argues that distributions should be paid *pari passu* as between Claim C and Claim D; given the much greater quantum of Claim C this would mean that most of the available assets would be paid to LBHI.

10. Deutsche Bank's Ground 2 concerns the quantum of Claim C. Deutsche Bank's position is that the Judge was wrong to conclude that Claim C was not released, discharged or diminished in part as a consequence of the partial payments made by LBHI as guarantor of PLC's liabilities of the PLC Sub-Debt (addressed in the Judgment at [288] to [304]). This is referred to below as the "**Partial Release Issue**".

THE PLC RANKING ISSUES (GROUND 3)

Introduction

11. Deutsche Bank, in agreement with GP1, submits that Claim D ranks for distribution before Claim C, and that the Judge erred in concluding that these competing claims rank *pari passu*, not least because the express terms of the PLC Sub-Debt preclude Claim C from ranking *pari passu* with any other debt.

12. GP1's case relies on a textual construction and iterative comparison of the competing subordination provisions in the PLC Sub-Debt and the PLC Sub-Notes. That is the only purely textual route to determining the relative ranking of Claim C and Claim D.

13. By contrast, Deutsche Bank's analysis, in common with the approach adopted by the Judge, proceeds on the basis that a literal application of the express terms of the PLC Sub-Debt and the PLC Sub-Notes leads to a logically impossible and thus commercially absurd result, which cannot be correct. Unless GP1's proposed construction is accepted, the only possible conclusion is that the terms of the contracts do not contemplate the possibility that PLC would issue subordinated debt on similar FSA standard terms to more than one subordinated creditor, resulting in an absurd circularity between such competing debts. In that event, the only difference between Deutsche Bank and the Judge is as to the correct solution to the circularity problem.

14. Deutsche Bank contends that the answer is to be found in existing principles of contract law that apply where an event or circumstances arises that was not contemplated in the parties' agreement. In that event, the Court should give effect to what the parties would (objectively) be taken to have intended, but did not provide for in their contract, where this can be determined from the terms of the contract and the admissible commercial and factual context. This does not involve any investigation of the parties' actual subjective intentions, but instead looks to the objective meaning of the contractual terms in their

factual and commercial contexts. On that approach the answer is obvious and 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.

15. LBHI's proposed solution at trial was that the Court should imply a term to give effect to a *pari passu* ranking because, in short, this is said to be the legal "*default*". That solution was both unprincipled and unsatisfactory and the Judge rejected it.

16. However the Judge then adopted a different and entirely novel approach, holding that the Court was entitled selectively to disapply the offending terms of the relevant contracts, and that, having disapplied the offending terms, PLC's subordinated debts would be paid *pari passu* under the Insolvency Rules. This approach finds no support in established principles of contract law; it overrides the terms of the parties' agreement, rather than seeking to give effect to the parties' (objective) intentions, in so far as they can be ascertained from their contract. For these reasons Deutsche Bank submits that its approach is to be preferred.

The key terms

17. The relevant terms of the PLC Sub-Debt and the PLC Sub-Notes were in, or derived from, the standard form required by the FSA for regulatory capital for investment firms.[3]

PLC Sub-Debt

18. The subordination provisions under each of the three facility agreements comprising the PLC Sub-Debt are in identical terms: see Clause 5 of the Standard Terms of each agreement ([## REF]). In particular:

(1) Clause 5(1) provides:

> *"the rights of the Lender in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities and accordingly payment of any amount (whether principal, interest or otherwise) of the Subordinated Liabilities is conditional upon [...] (b) the Borrower being "solvent" at the time of, and immediately after, the payment by the*

[3] Paragraphs 61(3)(b) and 68 of the Judgment

Borrower and accordingly no such amount which would otherwise fall due for payment shall be payable except to the extent that the Borrower could make such a payment and still be "solvent"".

(2) Clause 5(2) provides:

"…the Borrower shall be 'solvent' if it is able to pay its Liabilities (other than the Subordinated Liabilities) in full disregarding –

(a) obligations which are not payable or capable of being established or determined in the Insolvency of the Borrower, and

(b) the Excluded Liabilities."

(3) The following definitions used in the Standard Terms are relevant:

"Liabilities" means all present and future sums, liabilities and obligations payable or owing by the Borrower (whether actual or contingent, jointly or severally or otherwise howsoever);

"Senior Liabilities" means all Liabilities except the Subordinated Liabilities and Excluded 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;

"Excluded Liabilities" means Liabilities which are expressed to be and, in the opinion of the Insolvency Officer of the Borrower, do, rank junior to the Subordinated Liabilities in any Insolvency of the Borrower.

19. These terms are materially identical to the subordination provisions contained in three facility agreements comprising the subordinated debts owed by LBHI2 to PLC, which were the subject of the LBHI2 Application. The Judge referred to the claims of PLC under the LBHI2 Sub-Debt as Claim A in the Judgment, and the claims under each of the three facility agreements as Claim A(i), A(ii) and A(iii) respectively. This is relevant to the PLC Application because the Judgment considers the effect of the subordination provisions in the LBHI2 Sub-Debt before applying the analysis of those terms to the identical subordination terms of the PLC Sub-Debt in the context of the PLC Ranking Issues.

PLC Sub-Notes

20. The subordination provisions in Condition 3 of the PLC Sub-Notes are in similar form to the provisions of the PLC Sub-Debt set out above, save that:

(1) The definition of Subordinated Liabilities in the PLC Sub-Notes is different, and provides: "*"Subordinated Liabilities" means 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 Notes."*** (emphasis added).

(2) Condition 3(a) of the PLC Sub-Notes opens with the following words not found in the PLC Sub-Debt: "*The Notes constitute direct, unsecured and subordinated obligations of the Issuer and the rights and claims of the Noteholders against the Issuer rank pari passu without any preference among themselves*".

21. The Judge held that clause 5(1) of the PLC Sub-Debt incorporates two distinct forms of consensual subordination:

(1) The phrase "*the rights of the Lender in respect of the Subordinated Liabilities are subordinated to the Senior Liabilities*" (labelled in paragraph 137 as "Phrase [1]") is identified as a form of "*simple contractual subordination*", being an agreement not to prove until certain identified other liabilities – in this case, the defined "*Senior Liabilities*" – have been paid or reserved for in full (see paragraphs 140 and 142); and

(2) The phrase "*payment of any amount (whether principal, interest or otherwise) of the Subordinated Liabilities is conditional upon*" (labelled in paragraph 137 as "Phrase [3]") is identified as a form of "*contingent debt subordination*", in which the payment of the debt is conditional on the satisfaction of a contingency – in this case, satisfaction of the solvency test in clause 5(2) (see paragraphs 144 and 146).

The circularity between Claim C and Claim D

22. The Judge accepted Deutsche Bank's central contention at trial that, unless GP1's textual analysis is adopted, the effect of the express terms of the PLC Sub-Debt and the PLC Sub-Notes results in an absurd circularity where each purports to subordinate itself to the other. The Judge explained the circularity at paragraphs 150 to 152 in the context of LBHI2's subordinated debts owed to PLC, which were the subject of the LBHI2 Application. The conclusion was applied to the terms of the PLC Sub-Debt and the PLC Sub-Notes at paragraphs 363 to 364.

23. The circularity arises because:

(1) Under the terms of both the PLC Sub-Debt and the PLC Sub-Notes, the claims of the creditor are subordinated to the "*Senior Liabilities*";

(2) Under both sets of instruments, *"Senior Liabilities"* are all *"Liabilities"* other than *"Subordinated Liabilities"* and *"Excluded Liabilities"*;

(3) *"Liabilities"* is broadly defined in both instruments and would include liabilities under both the PLC Sub-Debt and the PLC Sub-Notes;

(4) "*Excluded Liabilities"* under both the PLC Sub-Debt and the PLC Sub-Notes must be expressed to rank junior to the Liabilities of PLC under the instrument in question; 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;

(5) "*Subordinated Liabilities*" under the PLC Sub-Debt are only Liabilities of PLC under "*this Agreement*", and so cannot include Liabilities under the PLC Sub-Notes (i.e. Claim D). Thus Claim D must be a Senior Liability from the perspective of the PLC Sub-Debt (because it is a Liability that is neither a Subordinated Liability nor an Excluded Liability); and

(6) "*Subordinated Liabilities*" under the PLC Sub-Notes are Liabilities of PLC under the PLC Sub-Notes, and also other Liabilities ranking *pari-passu* with the PLC Sub-Notes. However, the PLC Sub-Notes are Senior Liabilities for the purpose of the PLC Sub-Debt, and therefore the two cannot rank or be treated as ranking *pari passu*. Thus the PLC Sub-Debt (i.e. Claim C) cannot therefore be a Subordinated Liability from the perspective of the PLC Sub-Notes either. The result is that, for the purpose of the PLC Sub-Notes, Claim C must be a Senior Liability (because it is a Liability that is neither a Subordinated Liability nor an Excluded Liability).

24. The effect is that the terms of both the PLC Sub-Debt and the PLC Sub-Notes purport to make the other a Senior Liability. As the Judge explained at paragraph 152: "*there is an infinite (never-ending) race to the bottom, with each Claim asserting that (according*

to the express wording governing it) it ranks below the other […] claims: a circle that cannot, at least on the express words of the agreements, be broken."

25. That is a nonsensical conclusion - the two competing debts cannot simultaneously rank behind the other. Even if it were capable of being accepted as a rational interpretation of the terms of the relevant instruments, that conclusion would lead to an absurd commercial result because neither debt could ever be proved for (as a matter of simple contractual subordination) or become payable (as a matter of contingent debt subordination) unless both could be paid in full. This result plainly cannot have been intended, and all parties, in common with the Judge, agree that it would not be correct..

26. The key question on the PLC Ranking Issues is therefore how the circularity on the face of the express terms of the PLC Sub-Debt is to be broken, and with what effect.

Breaking the circularity

Legal principles

27. As noted above, the circularity problem does not arise directly from the terms of any of the relevant instruments comprising the PLC Sub-Debt and the PLC Sub-Notes, but rather from the interaction between the different instruments. In short, the difficulty is that none of the instruments contemplate the possibility that PLC would issue or had issued other subordinated debt on FSA standard subordination terms to different creditors, which would compete in an insolvency of PLC.

28. In Bromarin AB v IMD Investments Ltd [1999] STC 301, Chadwick LJ explained at 310 how a contract is to be applied where an event or circumstances was not contemplated in the parties' agreement:

> *"It is not, to my mind, an appropriate approach to construction to hold that, where the parties contemplated event 'A', and they did not contemplate event 'B', their agreement must be taken as applying only in event 'A' and cannot apply in event 'B'.* ***The task of the court is to decide, in the light of the agreement that the parties made, what they must have been taken to have intended in relation to the event****, event 'B', which they did not contemplate. That is, of course, an artificial exercise, because* ***it requires there to be attributed to the parties an intention which they did not have (as a matter of fact) because they did not appreciate the problem which needed to be addressed****. But it is an exercise which the courts have been willing to undertake for as long as commercial contracts have come before them for construction.* ***It is an exercise which requires the court to look at the whole agreement which the parties made, the words***

which they used and the circumstances in which they used them; and to ask what should reasonable parties be taken to have intended by the use of those words in that agreement, made in those circumstances, in relation to this event which they did not in fact foresee*." (emphasis added).*

29. Chadwick LJ's dictum in the Bromarin case has been applied in numerous subsequent decisions (see, for example, Arnold v Britton [2015] AC 1619 at [22]). In Pluczenik Diamond Co NV v W Nagel (A Firm) [2018] EWCA Civ 2640 and [2019] 2 All E.R. 194, the Court of Appeal (Henderson, Newey and Leggatt LJJ) stated, citing Bromarin, that:

It is, however, commonplace for circumstances to arise which the parties to a contract did not foresee when the contract was made. When this happens, it does not follow that the contract ceases to be binding or ceases to apply. On the contrary, unless the change of circumstances is so radical or fundamental as to frustrate the contract by making it impossible to perform, the parties are held to their bargain. What the contract requires in the changed circumstances depends on its proper construction.

30. The Court will imply a term in similar circumstances, namely where the term to be implied is obvious, or necessary in order to make the contract work and give it commercial and practical coherence: Marks and Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2016] AC 742, per Lord Neuberger at [21].

31. There is a fine line between the Bromarin principle of construction and the test for an implied term. For example, in Aberdeen City Council v Stewart Milne Group Ltd [2011] UKSC 56, Lord Hope preferred to rely on construction to give effect to what the "*unspoken intention*" of the parties "*must be taken to have been*". Lord Clarke preferred to imply a term where a contract failed to specify whether an uplift payment should be calculated by reference to the open market value of or the gross proceeds of the sale of a property. The remaining Judges agreed with both Lord Hope and Lord Clarke.

32. A Court will also imply a term where, without that term, the contract would be incomplete. In Liverpool City Council v Irwin [1977] A.C. 239, the House of Lords held that where the landlord and tenant had not specified who was to be responsible for common areas, a term had to be implied to render the contract complete: "*the court here is simply concerned to establish what the contract is, the parties not having themselves fully stated the terms. In this sense the court is searching for what must be implied*.", per Lord Wilberforce, at 254A.

The authorities thus establish that where a contract fails to contemplate or provide for a circumstance, the Court should nevertheless seek to give effect to the parties (objectively ascertainable) intentions rather than render to contract meaningless or unworkable in the uncontemplated circumstance. The Court has two tools available to achieve this aim: purposive construction as set out in Bromarin or the implication of term. The decision in Aberdeen City Council shows that it may often not matter.

The Judge's approach

33. The Judge explained his approach to breaking the circularity (again, in the context of Claims A(i), A(ii) and A(iii) of the LBHI2 Sub-Debt) at paragraphs 248 to 251. This passage of the judgment begins with a statement that "*… there is no authority on this point. None of the parties pointed me to any*". Whilst there may not have been any authority dealing with the particular question of reconciling subordination provisions in different agreements which on their face lead to an impasse, Deutsche Bank cited extensive authority in both written and oral submissions as to the correct approach as a matter of general principle (being those authorities referred to above).[4]

34. At paragraph 249, the Judge next reasoned that he could not solve the problem through an "*interpretative approach*" because the problem arose from "*an ineffective interaction between two contracts*" and in those circumstances an interpretative approach "*is not defensible, since there is no way the judge can know what the intention of the parties to the instruments in question actually was*". This was, however, asking the wrong question. The relevant question was not what the parties "*actually*" or subjectively intended in respect of the interaction between the two instruments. If the Judge had applied the Bromarin approach cited by Deutsche Bank, he would have asked instead what (if any) intentions could be determined from the express terms of each of the relevant contracts, and the admissible factual and commercial background, and what the parties to those separate contracts would have intended (objectively ascertained) where an impasse along the lines identified arose.

35. Having derived no assistance from authority or principles of contractual interpretation, the Judge went on to adopt a novel solution to the circularity problem, for which no

[4] [## REF]

party had argued. In short, the Judge held at paragraph 250 that "*where the interaction between two subordination clauses results in a meaningless outcome, the provisions should be treated as just that: meaningless in that particular instance*".

36. The novelty of this approach lies in its selective nature. The Judge did not hold that the subordination provisions were void or ineffective for uncertainty, or that the contracts were frustrated. No doubt this was because if the subordination provisions were ineffective for uncertainty they would be ineffective for all purposes and, absent effective contractual subordination, the PLC Sub-Debt and PLC Sub-Notes would cease to be subordinated debts at all, and would compete with and prejudice PLC's unsubordinated creditors. Moreover, there is nothing uncertain in the terms of each instrument viewed in isolation – as the Judge identified, it is the uncontemplated existence of the competing subordinated liabilities of PLC on similar subordination provisions that leads to circularity (where those liabilities are owed to different creditors). Viewed in isolation the terms of each agreement comprising the PLC Sub-Debt and the PLC Sub-Notes make perfect sense.

37. The Judge in effect held that the contractual subordination provisions in each instrument could be given effect in relation to some debts and in some contexts, but would not be given effect in relation to other debts in other contexts. The only guide as to when the parties' agreement would or would not be given effect appears to turn on the Court's evaluation of when their agreement results in an outcome that the Court considers "*meaningless*". This is unsatisfactory as it is liable to lead to uncertainty and confusion, and because the approach fails properly to take into account the objective intentions of the parties, manifested in their written agreements, where these can be determined. It is also unnecessary in circumstances where existing authority provides the answer.

38. The Judge should have concluded that the interaction between the terms of the PLC Sub-Debt and the terms of the PLC Sub-Notes, and the resulting circularity, arose from a situation that the parties to these agreements did not contemplate: namely that PLC had issued or would issue (as the case may be) to different creditors other subordinated debt containing (for these purposes) materially identical and thus circular subordination provisions.

39. In those circumstances, rather than selectively disapplying the effect of the express terms agreed by the parties to the PLC Sub-Debt and the PLC Sub-Notes, the Court should have given effect to what the parties objectively would have intended (but did not turn their minds to), in accordance with the Bromarin approach as a matter of construction, or by implying a term.

40. Deutsche Bank relied on the above approach and authorities at trial, but the Judge either did not take them into account or did not give them sufficient weight, and did not refer to them at all in the Judgment. The principled approach advanced by Deutsche Bank would have provided a clear answer to the priority dispute (as explained below).

What the parties objectively would have intended

41. In the present case, it is clear 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. This is because that is the relative ranking that would have minimised the risk that PLC would be unable to make payments due under the PLC Sub-Notes, which would necessarily result in the triggering of the so-called "***Dividend Stopper***" under the terms of the ECAPS issued by the Partnerships, and there was no other commercial, regulatory or tax reason for any different ranking.

42. The Dividend Stopper is an undertaking given by LBHI in the Limited Partnership Agreements of the Partnerships (the "**LPAs**") [## REF]. The key terms of the LPAs were as follows:

(1) LBHI was a party to the LPAs and, by clause 18(1) undertook as follows:

"18.1 Dividend stopper

LBHI undertakes that, in the event that any Distribution is not paid in full, it

will not:

(a) declare or pay any dividend on its shares of common stock; or

(b) repurchase or redeem any of its non-cumulative preferred stock or common stock at its option,

until such time as Distributions on the Preferred Securities have been paid in full for one year."

(2) Distributions were payable by the Partnerships on the ECAPS annually, but payment of Distributions was contractually conditional on the Partnerships receiving sufficient funds from PLC under the "Subordinated Notes" (being the PLC Sub-Notes) to make the payment: see condition 2.3 at [## REF].

43. PLC's ability to make payments under the PLC Sub-Notes was in turn contractually restricted by the subordination provisions contained in those Notes and, in particular, depended upon PLC's ability to satisfy the contractual solvency test set out in condition 3 of the PLC Sub-Notes. In order to make payments under the PLC Sub-Notes, PLC had to be able to pay its Senior Liabilities in full.

44. LBHI, as the parent company of the Lehman Group, and entity which controlled GP1, PLC and LB Holdings (being all the original parties to the PLC Sub-Debt and the PLC Sub-Notes), was strongly incentivised to ensure that PLC could make regular payments under the PLC Sub-Notes to the Partnerships so that the Partnerships could pay Distributions under the ECAPS, and thereby avoid triggering the Dividend Stopper.

45. Thus, no matter how much liquidity was available elsewhere in the Lehman Group, if PLC could not satisfy the contractual solvency test under the PLC Sub-Notes, no payments could lawfully be made by (or treated as being made on behalf of) PLC under the PLC Sub-Notes to the Partnerships, and the Partnerships would necessarily be unable to pay Distributions under the ECAPS.

46. Given this, it is obvious why the PLC Sub-Debt is (or would have been objectively intended by the Lehman Group) to be an Excluded Liability under the PLC Sub-Notes: otherwise, PLC's ability to pay the PLC Sub-Notes would be competing with its very substantial intra-group Liabilities to LB Holdings under the PLC Sub-Debt (the total amount that could be drawn under the three PLC Sub-Debt facilities was €3bn and $12.5bn, with a floating interest rate that could vary significantly). That would make no sense - the PLC Sub-Debt was merely an intra-group liability settled by book entry, and it would be commercially absurd to risk a suspension of distributions on the ECAPS, which were publicly listed securities issued to third parties, and the triggering of the Dividend Stopper by setting up the PLC Sub-Debt as a competing debt.

47. The commercial position set out above was not seriously disputed at trial and was ultimately accepted by the Judge. Specifically, the Judge concluded that the commercial

purpose of the Dividend Stopper was "*to create a commercial incentive on LBHI to ensure that PLC could pay*" ([366(6)]). It follows that (in the absence of any reason for any other ranking) the parties objectively would be taken to have intended that Claim D was senior because that was the only way to give effect to such a commercial incentive by maximising the chance that PLC could pay.

Confusion of subjective and objective intention

48. Deutsche Bank's argument on the priority dispute is thus one that has always been grounded in the undisputed terms of the contracts before the Court, including the Dividend Stopper in the LPAs. The question is what objective commercial inferences should be drawn from those terms (in circumstances where the express terms do not themselves deal with the question at hand). This was reiterated in Deutsche Bank's written closing submissions in the clearest terms:

> *"Deutsche Bank has never suggested that the parties actually discussed, or addressed in the express terms of the instruments, the relative ranking of the PLC Sub- Notes and the PLC Sub-Debts. Indeed, the legal premise of Deutsche Bank's case is that the Court has to address the absence of such an express term, because the express terms of the PLC Sub-Debt and the PLC Sub-Notes do not provide the answer."*[5]

49. For the avoidance of doubt, Deutsche Bank need not rely on Mr Katz's evidence to, and it certainly does not seek to (or need to) challenge the Judge's factual findings. The argument is, as explained above, one of contractual construction based on the terms of the agreements and obvious commercial consequences.

50. It is therefore surprising that the Judge concluded that Deutsche Bank's argument "*failed on the facts*" because he did not accept the evidence of Mr Katz, who suggested in cross-examination that he had in fact been party to pre-contractual discussions about the relative ranking of the PLC Sub-Debt and the PLC Sub-Notes ([376]). It is similarly surprising that the Judge concluded that Deutsche Bank's argument impermissibly relied on pre-contractual drafting history ([376(3)]) and that Deutsche Bank's argument bears no reference to the terms of the instruments themselves ([378]).

[5] [## REF] Deutsche Bank Closing Note on PLC Ranking, ¶35.

51. As set out above, Deutsche Bank's argument did not (and does not) depend on what actually happened or what the parties actually considered as a matter of fact; nor did it (or does it) depend on whether actual discussions as to the relative priority between Claim C and Claim D took place (as Mr Katz contended but the Court did not accept). It does not therefore matter that Mr Katz's evidence was criticised by the Court. The only point for which Deutsche Bank relied on Mr Katz's evidence was to support the commercial incentive created by the Dividend Stopper, which was in any event accepted by the Judge ([366(6)]).

52. Thus the Judge fell into error by conflating his conclusions as to the existence and relevance of the parties' subjective intentions with the argument advanced by Deutsche Bank based on the objective inferences to be drawn from the contracts themselves. It appears that the Judge permitted his conclusions as to the quality of Mr Katz's evidence to affect the approach to Deutsche Bank's arguments that did not rely on that evidence.

LBHI's flawed approach

53. In its first Respondent's Notice (dated 23 November 2020) LBHI contends that paragraph 7 of the Judge's Order should be upheld for an alternative reason, namely that the Judge "*ought to have held that the PLC Sub-Debt and the PLC-Sub-Notes rank after the same senior liabilities, such that they are entitled to prove at the same time and rank pari passu pursuant to rule 14.12 of IR16*".

54. This is not an additional reason for upholding the Judge's Order, but rather a conclusory statement which begs the question of whether the PLC Sub-Debt and the PLC-Sub-Notes do in fact rank after the same senior liabilities.

55. LBHI's approach is also wrong. As set out above, unless GP1's approach is adopted, a circularity arises precisely because, on the express terms of the PLC Sub-Debt and the PLC Sub-Notes, Clam C and Claim D each fall within the definition of "*Senior Liabilities*" in relation to the other. In other words, the PLC Sub-Debt and the PLC-Sub-Notes cannot "*rank after the same senior liabilities*" because each states that the other should be paid in priority (rank ahead of) the other. LBHI cannot escape the circularity created by the language by pure assertion. The suggestion that the Court should simply default to the *pari passu* rule in the absence of any proper explanation why is manifestly insufficient.

56. Notably LBHI is unable to articulate any commercial reason why the parties would have intended a *pari passu* ranking. As a result, LBHI cannot rely on the Bromarin principle or an implied term.

57. Moreover, and fatally for LBHI's arguments , a *pari passu* ranking is in fact the only ranking that is clearly precluded by the express terms of the PLC Sub-Debt. This is because under the terms of the PLC Sub-Debt the only "*Liabilities*" that rank *pari passu* are the "*Subordinated Liabilities*", which are limited to the Liabilities under the PLC Sub-Debt. In other words, the terms of the PLC Sub-Debt make clear that every other Liability of PLC not arising under the PLC Sub-Debt can only rank junior (as an Excluded Liability) or senior (as a Senior Liability). This stands in contrast to the position under the PLC Sub-Notes, where, as noted above, Subordinated Liabilities is defined to include not only the Liabilities of PLC under the PLC Sub-Notes, but also "*all other Liabilities of the Issuer which rank or are expressed to rank pari passu with the Notes*". Thus the terms of the PLC Sub-Debt simply do not admit the possibility of other *pari passu* ranking debt.

58. At trial and to counter Deutsche Bank's argument that its case was contrary to the express terms of the PLC Sub-Debt, LBHI relied heavily on an apparent "*concession*" by Deutsche Bank that the various tranches of the PLC Sub-Debt rank *pari passu* among themselves, the implication being that this shows that the terms of each of the three facility agreements comprising PLC Sub-Debt do permit a *pari passu* ranking with other debt.[6]

59. However, this is not a "*concession*" and the point does not assist LBHI:

    (1) There was no dispute at trial that it would be commercially absurd for the different tranches of the PLC Sub-Debt not to rank *pari passu* – since they are debts between the same parties, on similar terms, issued for the same funding purpose;

    (2) In that context, the definition of Subordinated Liabilities in each PLC Sub-Debt agreement is to be interpreted as referring not only to the Liabilities

[6] [## REF].

under that agreement but also to the Liabilities arising under the other two PLC Sub-Debt agreements:

(i) As set out above, Subordinated Liabilities are defined as "*all Liabilities to the Lender in respect of the Loan or each Advance made under this Agreement and all interest payable thereon*";

(ii) "*Lender*" causes no difficulty as between the tranches of the PLC Sub-Debt, because the lender is the same across all three tranches, and would also include any permitted future lender (i.e., LB Holdings' permitted successors and assigns);

(iii) The word "*Agreement*" is not a separately defined term in the PLC Sub-Debt. Deutsche Bank accepts that the ordinary meaning of the words "*this Agreement*", looking at one PLC Sub-Debt agreement in a vacuum, might mean the specific contract in issue. However, a permissible construction, and one that makes commercial common sense, is that it includes other tranches of debt between the same parties, on materially identical terms, issued for the same purpose.

(3) However, these same reasons do not apply in relation to the PLC Sub-Notes.

(4) First, Liabilities under the PLC Sub-Notes cannot be "*Subordinated Liabilities*" because Subordinated Liabilities are defined as "*all Liabilities to the Lender in respect of the Loan or each Advance made under this Agreement and all interest payable thereon"*.

i. "*Lender*" is defined to mean "*the person identified as such in the Variable Terms and includes its permitted successors and assigns*" [## REF];

ii. The Variable Terms identify the Lender as LB Holdings [## REF];

iii. The liabilities under the PLC Sub-Notes are liabilities to an entirely different person (namely the ECAPS Issuers), and thus cannot be Liabilities "*to the Lender*"; and

iv. Similarly, there is simply no way to read the word "*Agreement*" as encompassing the PLC Sub-Notes, which are listed and tradeable bonds rather than loans, with different commercial terms and in materially different form.

(5) Second, there is no equivalent commercial reason to interpret the definition of Subordinated Liabilities as encompassing the PLC Sub-Notes (it would not be commercially bizarre for the PLC Sub-Debt and the PLC Sub-Notes to rank in a different way); and

(6) It is on that basis that Deutsche Bank says the reference to one tranche of the PLC Sub-Debt should be read as a reference to all three tranches – all are Subordinated Liabilities. But this is not a concession, and it does not undermine Deutsche Bank's position that the PLC Sub-Debt and the PLC Sub-Notes cannot rank *pari passu*.

Conclusions on Ground 3

60. Deutsche Bank has advanced the only principled approach to resolve the circularity problem identified by the Judge. That approach is based on well-established principles of contract law, and the unchallenged findings of the Judge that there was a commercial incentive to ensure that PLC could pay under the PLC Sub-Notes in a resource constrained scenario in order to fund the Lehman Group's external securities (the ECAPS) in preference to intra-group subordinated debts.

61. In the circumstances, unless the Court is prepared to adopt GP1's textual approach, the Court should either construe the definition of Excluded Liabilities in the PLC Sub-Notes as encompassing Claim C, or imply a term into the definition of like effect.[7]

PLC RANKING ISSUES (Ground 3A)

62. Deutsche Bank pursues "*Ground 3A*" in the alternative to its third ground of appeal referred to above, in the event that the Judge was correct to conclude that:

(1) Each of the agreements comprising the PLC Sub-Debt and the PLC Sub-Notes contain two distinct forms of contractual subordination: (i) simple contractual subordination; and (ii) contingent debt subordination (see [147] to [149]);

(2) For the purposes of the simple contractual subordination Claims C and D are to each other a Senior Liability and therefore purport to subordinated themselves to each other, giving rise to an "*endless loop*" or "*meaningless outcome*": see [150]-[152], [246], [250] and [349]-[360]; and

(3) "[*W*]*here the interaction between two subordination clauses results in a meaningless outcome, the provision should be treated as just that: meaningless in that particular instance*" ([250]), with the result that all such debts become eligible for proof at the same time and so can be said to rank *pari passu* for the purposes of simple contractual subordination.

63. Even if the above conclusions are correct (contrary to Deutsche Bank's position in relation to Ground 3), the Court erred in reading across the ranking for the purposes of

[7] If the Court were to imply a term, Deutsche Bank contends that the following underlined words be implied into the definition of "*Excluded Liabilities*" in Condition 1 of the PLC Sub-Notes, such that it reads: "*means Liabilities of the Issuer in respect of the PLC Sub-Debt and any other Liabilities which are expressed to be and, in the opinion of the Insolvency Officer of the Issuer, do, rank junior to the Subordinated Liabilities in any Insolvency of the Issuer*". It would also be necessary to imply a definition identifying the three tranches of the PLC Sub-Debt. Alternatively, the same result could be achieved by implying a term into the PLC Sub-Debt to the effect that the PLC Sub-Notes qualify as Senior Liabilities.

simple contractual subordination to the operation of the contingent debt subordination provisions. Thus the Court was wrong to conclude:

> *"[I]f (for purposes of simple contractual subordination) two claims are treated as ranking pari passu despite the strict wording of the instrument then, where the same issue arises in … the context of contingent debt subordination, the same treatment must pertain, and the claims must continue to be treated as ranking pari passu" ([253(4)]).*

64. Different debts which rank *pari passu* in an insolvency may (and commonly do) become payable at different points in time (both within and outside of an insolvency) if they contain different conditions to payment. There is no reason that a conclusion that two debts that can be proved for at the same time should mean that the debts also become payable at the same time. To take a simple example: a future debt and a current debt may be provable at the same time but be payable at different times.

65. In any event, "*the same issue*" (namely the circularity between the terms of the PLC Sub-Debt and the PLC Sub-Notes for the purposes of simple contractual subordination) does not on the Judge's approach arise in the context of contingent debt subordination as it applies to Claim C and Claim D:

(1) Claim D falls to be taken into account when testing the solvency condition to payment contained in the PLC Sub-Debt for the purposes of paying Claim C because Claim D is, under the terms of the PLC Sub-Debt, a Liability that is not an Excluded Liability or a Subordinated Liability;

(2) This follows from the definition of Subordinated Liabilities in the PLC Sub-Debt, which is limited to Liabilities under "*the Agreement*". The fact that (on this analysis) Claim C and Claim D are entitled to prove in PLC's insolvency at the same time ([378(3)(e)]), such that they "*rank*" *pari passu* in an Insolvency of PLC, does not affect this conclusion: Claim D cannot be a Subordinated Liability and therefore Claim C cannot be paid because the solvency condition is not met;

(3) However, Claim C does not fall to be taken into account when testing the solvency condition to payment contained in the PLC Sub-Notes for the purposes of paying Claim D. This is because of the different definition of Subordinated Liability in the PLC Sub-Notes. For the purposes of the solvency condition to payment in the PLC Sub-Notes, Claim C is a Subordinated Liability, namely a Liability of PLC

which ranks or is expressed to rank *pari passu* with the Notes. It does not therefore have to be taken into account in assessing whether the solvency condition to payment of Claim D is met because the Judge concluded that Claim C and Claim D are entitled to be proved for in PLC's insolvency at the same time such that they "*rank*" *pari passu* in an Insolvency of PLC;

(4) The consequence of this analysis is that there will never be a situation in which the solvency condition to payment of Claim D cannot be satisfied on account of PLC's liabilities under Claim C and, on that basis, there is not for the purposes of contingent debt subordination the same "*endless loop*" or "*meaningless outcome*" as in relation to simple contractual subordination. The Judge's method of breaking the impasse in relation to the ranking of Claims C and D is therefore, on its own terms, inapplicable because there is no meaningless outcome or impasse as regards the operation of the solvency conditions. Claim D will have to be paid before Claim C if the solvency condition in Claim C is to be satisfied.

66. In short, if the Judge's approach to simple contractual subordination is correct, his conclusions ought to have led to the result that the solvency condition in respect of Claim D is satisfied and there is no reason why payment cannot be made in respect of that claim. The same reasoning does not, however, apply in the case of Claim C.

PARTIAL RELEASE ISSUES (Ground 2)

Introduction

67. Deutsche Bank's second ground of appeal is that the Judge was wrong to conclude that LBHI's Claim C was not released, discharged or diminished in part as a consequence of the partial payments made by LBHI as guarantor of PLC's liabilities under the PLC Sub-Debt.

68. The above conclusion follows from the application of established principles of law applicable to guarantees in circumstances where the surety has released any indemnity claim that it would otherwise have. It is this point that is crucial and leads to the unsurprising conclusion that the amount of any proof by LBHI as creditor should be limited to the amount that it is actually owed.

69. In short:

(1) As a matter of general principle, a payment by a surety (S) will discharge *pro tanto* the debt due by the principal debtor (PD) to the creditor (C);

(2) Normally, S will, as a consequence of making payment in discharge of the guaranteed obligation, have an indemnity claim against PD;

(3) Where S makes payment in discharge of the guaranteed obligation prior to the insolvency of PD, both S and C can prove against PD in a subsequent insolvency for the amounts owed to them (C's claim being limited to the amount due from C after the payment from S has been taken into account);

(4) Where S makes payment to C after the commencement of insolvency proceedings against PD, a different rule applies and displaces the general principle i.e. C's claim may be maintained for the full guaranteed amount notwithstanding post-insolvency payments by S;

(5) However, that approach is predicated on the assumption that PD's estate remains liable for the full guaranteed amount (whether directly to C, or as a consequence of the indemnity obligation owed to S). Permitting C to maintain a claim for the full guaranteed amount, and preventing S from proving, is justified by (i) C's senior creditor status preventing S from competing with it in PD's insolvency (ii) the need to avoid a double proof in PD's estate; and (iii) the need to ensure that PD's estate is not unjustly enriched by being required only to pay a dividend on the reduced principal debt (notwithstanding the existence of an indemnity obligation owed to S);

(6) However, where S's indemnity claim against PD has been released, PD's estate is no longer liable for the full guaranteed amount. There is no longer any risk of double proof or unjust enrichment of the estate, and no justification for permitting C's claim to be maintained for any amount other than that which is actually due to it. In such a scenario, the analysis should revert to application of the general principle such that C's claim is limited to what (with hindsight[8]) it can now be seen

[8] See Re MF Global (UK) Ltd [2013] EWHC 92 (Ch) at [48]-[51].

was owed to it. Any other result would lead to overpayment of C at the expense of other creditors, contrary to the *pari passu* principle.

70. The Judge addressed the Partial Release Issues at paragraphs 388 to 304 of the Judgment, but did not (or did not adequately) take into account the arguments advanced by Deutsche Bank.

Factual background

71. The relevant facts are not in dispute and are summarised in paragraphs 289 to 290 of the Judgment. In summary:

(1) As described above, Claim C arises under the agreements comprising the PLC Sub-Debt, originally between PLC (as borrower) and LB Holdings (as lender). LB Holdings was an indirect subsidiary of LBHI;

(2) PLC's obligations to LB Holdings under the PLC Sub-Debt were guaranteed by LBHI pursuant to a guarantee (the "LBHI Guarantee");

(3) In September 2008, LBHI, PLC and LB Holdings entered into insolvency proceedings in their respective jurisdictions. LB Holdings asserted a claim against LBHI under the LBHI Guarantee in LBHI's US Chapter 11 proceedings;

(4) Pursuant to a settlement agreement dated 24 October 2011, LBHI allowed the claim by LB Holdings under the LBHI Guarantee, and has made distributions of approximately 36% on this class of claim;

(5) LBHI now asserts Claim C against PLC as assignee of LB Holdings' claim under the PLC Sub-Debt; and

(6) Importantly, any secondary liability to indemnify LBHI that was owed by PLC as a consequence of the payments under the LBHI Guarantee was released in accordance with the terms of the Settlement Agreement: see the LBHI Reply PP para 64(2) [## REF]. Thus LBHI's only claim against PLC is as assignee of LB Holdings' claim, that is as principal creditor and not as surety.

The general rule

72. It is a fundamental principle of the law of guarantees that a part payment by S to C operates to reduce the principal debt *pro tanto*: see Milverton Group Ltd v Warner World Ltd (1994) 68 P. & C.R. D9 [1995] 2 EGLR 28, per Glidewell LJ and Hoffmann LJ. This is explained in Andrews and Millett, '*The Law of Guarantees*' (7th Ed.) at [9-003]:

"The surety sometimes makes a part-payment of the guaranteed debt to the creditor in consideration of his being granted an absolute release.[9] *Where this occurs, the part-payment constitutes part-payment of the principal obligation and reduces it pro tanto as between the principal and the creditor."*

73. The making of such a payment will generally give rise to a right to an indemnity in favour of S: Re a Debtor [1937] Ch 156 at 163-164.

74. Milverton concerned the question of whether a lessor who receives payment from a guarantor in consideration of releasing the latter from his obligations is obliged to give credit for that payment when seeking to enforce the rental and other covenants against the lessee. Glidewell LJ stated at page 6 ([1995] 2 EGLR 28 at 30):

"If a lessor is entitled to be a paid a sum by way of rent for a particular period, and the original lessee, an assignee and a surety have all covenanted to pay that rent, the lessor may recover it from any one of them (in the case of the surety, if the assignee has defaulted). If the lessor does however recover that sum from any one of the three, the rent has then been paid. The other two persons who were liable cease to be liable to pay that rent though of course they are still liable for any future rent under their respective covenants."

75. Milverton is only one example of the application of this general principle. The principle was also stated in clear and express terms by a unanimous Court of Appeal in MS Fashions v BCCI [1993] 1 Ch 425 at 448E, where Dillon LJ (with whom Nolan and Steyn LLJ agreed) said:

"*A creditor cannot sue the principal debtor for an amount of the debt which the creditor has already received from the guarantor.*"

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9 As noted at paragraph 78 below, the general rule is not dependent on the payment being made in return for an absolute release.

76. The position was further considered in detail in the New Zealand case of Stotter v Equiticorp Australia Ltd (in liquidation) [2002] 2 NZLR 686[10] at [31], where Fisher J (applying MS Fashions and Milverton) said that it was clear that, "*insolvency aside*", a creditor could not recover from the principal debtor the full amount of the debt if he had already recovered part of the debt from the surety[11]. The Judge went on to consider all relevant authorities in this area, including Ulster Bank v Lambe [1966] NI 161 . At [68]-[70], when noting that Lambe was one of only two authorities which commentators had relied upon as indicating doubt as to the correct approach, he observed at [69] that:

> *"In my respectful view several considerations diminish the authority of Ulster Bank and Westpac Banking. In Ulster Bank only the bank was represented at the hearing. Lowry J declined to following Mackinnon's Trustees and saw the bills of exchange cases as a discrete category. In arriving at this decision he relied upon Harvie's Trustees and Re Sass. But neither of those cases involved pre-liquidation payments."*

77. In the subsequent Australian case of The Public Trustee of Queensland v Octaviar Ltd (subject to a deed of company arrangement) [2009] QSC 202, McMurdo J (as he then was) considered all of these authorities in the context of a challenge to a deed of arrangement, as well as a suggestion in an academic text that Milverton was in fact a case concerning a common principal obligation, and therefore different. In rejecting that distinction (see [84], he concluded that a creditor and guarantor's liability should be co-extensive and part payments by a guarantor would therefore reduce the debtor's liability (see generally the analysis [75]-[91]).

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[10] A case concerning pre-liquidation receipts, and whether a "whole of money" clause was effective such that the creditor could ignore payments made and prove for the full amount: see [1]-[5]

[11] See also at [44]-[46], analysing the decision in Re Blakeley (1892) 9 Morr 173 as supporting the proposition that payments by the principal debtor prior to the commencement of an insolvency against the surety have to be taken as reducing the amount of any claim against the surety. As the Court of Appeal commented, the amount cannot change (and increase) by virtue of the debtor (or surety) becoming bankrupt.

78. In this case, the Judge expressed some doubt that the above principles apply "*where LBHI was granted an absolute release as a result of making the payments*" (see Judgment at [295]). This is a point that LBHI now makes in its second Respondent's Notice at section 6, paragraph 1 [## REF]. However, Milverton makes clear that an absolute release of the surety makes no difference to the application of the general rule – see Hoffmann LJ at page 9 ([1995] 2 EGLR 28 at 31):

> *"Payment for release and payment to discharge obligations under the lease are not mutually exclusive. In return for granting a release, the landlord accepted performance in part. And to avoid any problems over whether payment of a debt already due was good consideration, the release was given by deed. This was, in my judgment, the effect of the deeds of release in this case. But I would go further. For the purpose of deciding whether money owed by more than one person has been paid, I do not think that it is possible for the creditor and one of the debtors to characterise a payment in return for a release as anything other than a part performance of the obligation. If this were possible, a creditor could pick off his debtors one by one and recover in total more than the whole debt. For the payment to count as part discharge of the common obligation, it is sufficient for the payment to be referable to the guarantee."*

79. Leaving aside the possible impact of insolvency, it is therefore clear that partial payments by LBHI on the LBHI Guarantee will have reduced or discharged in part the quantum of LB Holdings' claim against PLC in the amount of those payments. When LB Holdings then assigned that claim ultimately to LBHI it could not assign more than it had, such that LBHI's claim as assignee of LB Holdings would be for an amount reduced by the partial payments. LBHI would, ordinarily, also have a separate claim against PLC as surety by way of indemnity in the amount of the payments in the LBHI Guarantee, such that LBHI would not be out of pocket. However, as set out above, that separate surety claim was released by the Settlement Agreement and cannot now be pursued.

80. It follows that Deutsche Bank's position on the Partial Release Issues is correct, unless the intervention of insolvency before the making of the payments by LBHI displaces the general rule considered above. The Judge concluded that insolvency did make a difference (paragraph 299 of the Judgment), but the principles of law that the Judge relied upon do not apply in the present circumstances where the surety has now released its indemnity claim.

The impact of insolvency

81. It has long been the rule that, where the principal debtor, PD, becomes insolvent, and part payments are subsequently made by a surety, S, the primary creditor, C, is entitled to maintain a proof in respect of the whole of the guaranteed indebtedness, and S is treated as a contingent creditor whose indemnity claim against PD is debarred from proof by the rule against double proof. Therefore, within the insolvency process, C is not usually required to reduce its proof against the principal debtor by reason of post insolvency payments made by S.

82. This approach is explained in Andrews & Millet, *The Law of Guarantees (7th Edition)*, at [13-007]:

> "*Where the principal is insolvent and the surety makes a part payment to the creditor before the creditor has been paid a dividend, the rule is that the surety has no right to prove, and the creditor does not have to give credit by reducing his proof by the amount received from the surety, so long as the creditor does not receive more than 100 pence in the pound. The creditor can prove for the full amount and the surety is barred from proving at all.*"

See also Rowlatt on Principal and Surety at 11-01; Re Fitness Centre (South East) Limited [1986] BCLC 99, 535 at 538, and Re Sass [1896] 2 QB 12[12].

83. As observed in Andrews & Millet at 13-002, fn 5, "*this may be seen as somewhat hard on the surety, who is entitled, where the principal is solvent, to recover a pro tanto indemnity from him to the extent of the amount of the principal debt discharged by the surety*". But it has long been the rule in insolvency proceedings, recognising that: (i) C is the senior creditor for the purposes of proof, and (ii) that only one claim in respect of what is in substance the same debt can be permitted in the insolvency.

84. As regards the senior position of C, and as was explained by Robert Walker J in Re Polly Peck plc (in administration) (no. 4) [1996] 2 All ER 433 at 442:

[12] There is some debate as to whether this same rule should apply even where the payments are made pre-insolvency (see the discussion in Stotter, above). However, that issue does not arise for determination on this appeal as all payments were made post commencement of the relevant insolvency proceedings.

"*the surety's contingent claim is not regarded as an independent free-standing debt, but only as a reflection of the real debt – that in respect of money which the principal creditor had loans to the principal debtor.*"

85. The basis upon which C is permitted to prove for the full amount of the guaranteed claim without deduction is therefore (see Andrews and Millet at 13-007):

"*…that the surety has undertaken to be responsible for the full sum guaranteed, including whatever may remain due to the creditor after receipt of dividends in the principal's insolvency, and cannot prove (or more correctly, receive a dividend) in competition with the creditors for a right of indemnity.*"

See also Goode on Problems of Credit and Security, 6th Edition, at paragraph 8-18: S has "*no equity to prove for his right of reimbursement in competition with the creditor.*"

86. Permitting proof by C for the full amount of the guaranteed claim necessitates that S is prevented from making any simultaneous claim against D in respect of what is in substance the same debt. That is achieved by the operation of the rule against double proof, which was described in Cattles Plc v Welcome Financial Services Ltd [2010] EWCA Civ 599; [2010] 2 Lloyd's Rep. 514 per Lloyd LJ at [25] in these terms:

"*This is the rule under which, where a debtor is subject to insolvency proceedings, if a creditor proves in those proceedings for the debt, a guarantor of the debt, though in principle entitled to a right of contribution against the debtor to the extent that he has paid the creditor, is not allowed to prove against the debtor unless and until he has paid the creditor in full. He cannot do so either in respect of the right of contribution for sums that he has paid to the creditor in part satisfaction of his own liability, nor in respect of his contingent claim for contribution.*"[13]

87. Permitting C to claim for the full amount of the guaranteed sum, and applying the rule against double proof, ensures that the principal debtor does not escape liability for any part of the amount due, whilst protecting the primacy of C's rights against PD. As observed in '*Goode on Legal Problems of Credit and Security*' (6th Ed.) at [8-18], it therefore prevents the estate from being unjustly enriched.

88. Whilst in many respects technical (and some might say artificial), the operation of the rule against double proof in this manner is ultimately what the Courts have regarded as

[13] Cited in Andrews and Millett, '*The Law of Guarantees*' (7th ed.) at 13-002. See also Re KSF [2012] 1 AC 804, per Lord Walker at [11] and [12]; and Bundeszentralamt v Heis [2019] EWHC 705 (Ch).

achieving justice as between all creditors (see, for example, Kerr LJ in Barclays Bank v TOSG Fund Ltd [1984] AC 626 at 649).

89. There are therefore two underlying policies being achieved by permitting C to maintain the claim in full notwithstanding any post-insolvency part payment by S, and preventing S from proving:

(1) C's senior creditor status as compared to S is given effect. S's rights against D are secondary to C's, and therefore S cannot as a matter of equity compete with C (see the passages cited above)[14]; and

(2) PD's estate is required to pay a dividend on the full amount of its debt, and is not therefore unjustly enriched[15]. No unfairness is caused to other creditors of D, because PD is required to pay a dividend by reference to what it owes (whether treated as owed to C or S).

The impact of release

90. The rule against double proof operates only for so long as there is the possibility of a double proof. See Re KSF, at [11]-[12]:

> "*[11] … The rule prevents a double proof of what is in substance the same debt being made against the same estate, leading to the payment of a double dividend out of one estate. It is for that reason sometimes called the rule against double dividend … [12]. The primary purpose of the rule has been described as the protection of other creditors of PD against unfair treatment by an arrangement under which there are multiple creditors in respect of the same debt.*".

[14] See also In Re Fenton [1931] 1 Ch 85; and KSF (above) at [12].

[15] This could equally be achieved by allowing S to prove for its indemnity claim and C for the reduced proof, but would be contrary to equitable rule that prevents S competing with C in a manner that reduces what C receives.

91. Thus, even where a surety has made a part payment to a creditor after the insolvency of the principal debtor, the rule applies only for so long as the creditor and the surety might both be able to prove in the insolvency, see *The Law of Guarantees* at [13-007][16]:

> "*where the surety … has made a part-payment, and the creditor has been paid the balance of the indebtedness by the principal or by a co-surety, then the surety may prove in the principal's insolvency for the amount which he has paid to the creditor. The same consequence should follow if the creditor has been paid in full by a co-surety and the surety has made a payment to the co-surety in contribution. In either case there is no possibility of a double proof, because the creditor has been satisfied in full and would recover in excess of 100 pence in the pound.*

92. The unusual feature of the present case is that the indemnity claim of the surety, S, has been released. There is now no possibility of S's indemnity claim competing with the principal debtor's claim. In this scenario, the rule against double-proof becomes irrelevant. There is only one person entitled to prove for the PLC Sub-Debt, namely LBHI as assignee of the principal debtor i.e. C.

93. However, and of crucial importance, there is now no basis on which maintaining C's claim for the full amount of the guaranteed indebtedness, and ignoring any part payments by S, can be justified. With hindsight, and taking into account the partial payments made by S, the only liability owed by PD is for the remaining outstanding sum due to C (i.e. the guarantee sum, minus the part payments made by S). PD has no liability to indemnify S which can justify maintaining C's claim for the full amount of the guaranteed sum. It would therefore be unfair, and contrary to the *pari passu* principle, for C to receive dividends by reference to a proof that does not give credit for the partial payments made by S.

94. The Judgment does not address at all the relevance of the release of the surety's claim, despite this being emphasised repeatedly to the Judge as being the key point that Deutsche Bank was making[17]. The Judge applies the Re Sass approach – that is the insolvency exception to the general rule – without any analysis as to whether that exception should apply once S's claim has been released.

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[16] See also Bundeszentralamt v Heis [2019] EWHC 705 (Ch), per Hildyard J at [170]-[180].

[17] See Deutsche Bank's Closing Note on Partial Release at [## REF].

95. In the current scenario, DB maintains that the general principle should apply: prior part payments by the surety must be taken into account for the purpose of assessing any residual claim by the creditor against the principal debtor. It does not matter that such payments occurred after the commencement of the insolvency, because the indemnity claim has been released. There is no risk of competition between the surety and the creditor, and no risk that the estate will be unjustly enriched if the creditor is not permitted to maintain a claim for the full amount of the debt prior to receipt of the part payments.

96. As noted above, any other approach would lead to over-compensation of the creditor, contrary to the *pari passu* principle. If the creditor has already received part payment of a debt from another source (the surety), it should only be entitled to receive dividends from the principal debtor in respect of the outstanding part of the debt. It follows that LBHI's claims under the PLC Sub-Debt were diminished by the part-payments made to LB Holdings.

97. There is, in this regard, a clear parallel with the result which occurs where C releases its claim against PD. In such a case, S can now prove. But S is only able to do so in respect of the indemnity claim that it has (which will be referable to the amount due to it as a consequence of actually having made payment): see Andrews and Millet at para 13-013, and In Re Fenton [1931] 1 Ch 85.

The relevance of Clause 7(f)

98. The conclusion for which Deutsche Bank advocates as set out above is, in fact, supported by the terms of the documents in issue. The documents suggest that the same commercial result that Deutsche Bank contends for as a consequence of partial discharge by S of the guaranteed debt would prevail in this case, even if the payment by LBHI had not been used by LB Holdings to discharge the guaranteed debt.

99. The guarantor's right of indemnity only arises if and to the extent that the payment received by C is applied in discharge of the guaranteed obligation (see Andrews and Millet at par 13-011). Clause 7(f) of the PLC Sub-Debt in fact required the "*Lender*" to hold any sums received in respect of a guarantee of PLC's liabilities under the PLC Sub-Debt on trust for PLC [## REF]. The purpose of this clause appears to have been to ensure the effectiveness of the contractual subordination provisions considered above

by preventing creditors of PLC from recovering on their debts other than through payments by PLC, which are subject to the subordination conditions.

100. All parties to date have proceeded on the basis that the monies received from LBHI were in fact applied in satisfaction of the debt due from PLC to LB Holdings, such as to give rise to a right of indemnity in favour of LBHI against PLC. However, if LB Holdings, as original Lender of the PLC Sub-Debt, did not apply those payments for PLC's benefit to discharge PLC's liabilities, it would have held those payments on trust for PLC, and PLC would have been entitled to set off those sums held on trust for it against any claim by LB Holdings under the PLC Sub-Debt. In those circumstances, PLC would be entitled to assert the same set off claim against LBHI as assignee of the PLC Sub-Debt: per Templeman J in Business Computers Ltd v Anglo-African Leasing Ltd [1977] 1 W.L.R. 578, at 585. The effect would be (as Deutsche Bank has contended) to reduce the amount of LBHI's claim against PLC by the amount of the guarantee payments.

101. In its second Respondent's Notice at section 6, paragraph 4 [## REF], LBHI contends that Deutsche Bank's reliance on Clause 7(f) of the PLC Sub-Debt is a new argument that cannot be advanced in this appeal. That is not (or at least not entirely) correct. Deutsche Bank's alternative reliance on Clause 7(f) was clearly set out in its Position Paper at paragraph 33(6) [## REF]. It is true that the effect of clause 7(f) was not the subject of submissions at trial, and was not addressed in the Judgment. However, it is an argument plainly open to be considered on appeal (whether in support of Deutsche Bank's principal argument on partial release, or as a free-standing point). It raises a simple and short point of law based on clear and express contractual provision of the documents in issue. It is a point on which no party chose to adduce evidence following the Position Papers, and which the Court of Appeal is therefore well-placed to determine. Deutsche Bank maintains, for all of the reasons given above, that the LBHI claim has to be reduced by the amount paid under the guarantee. That result either arises as a matter of law (which is its primary position) or as a consequence of set-off if, for

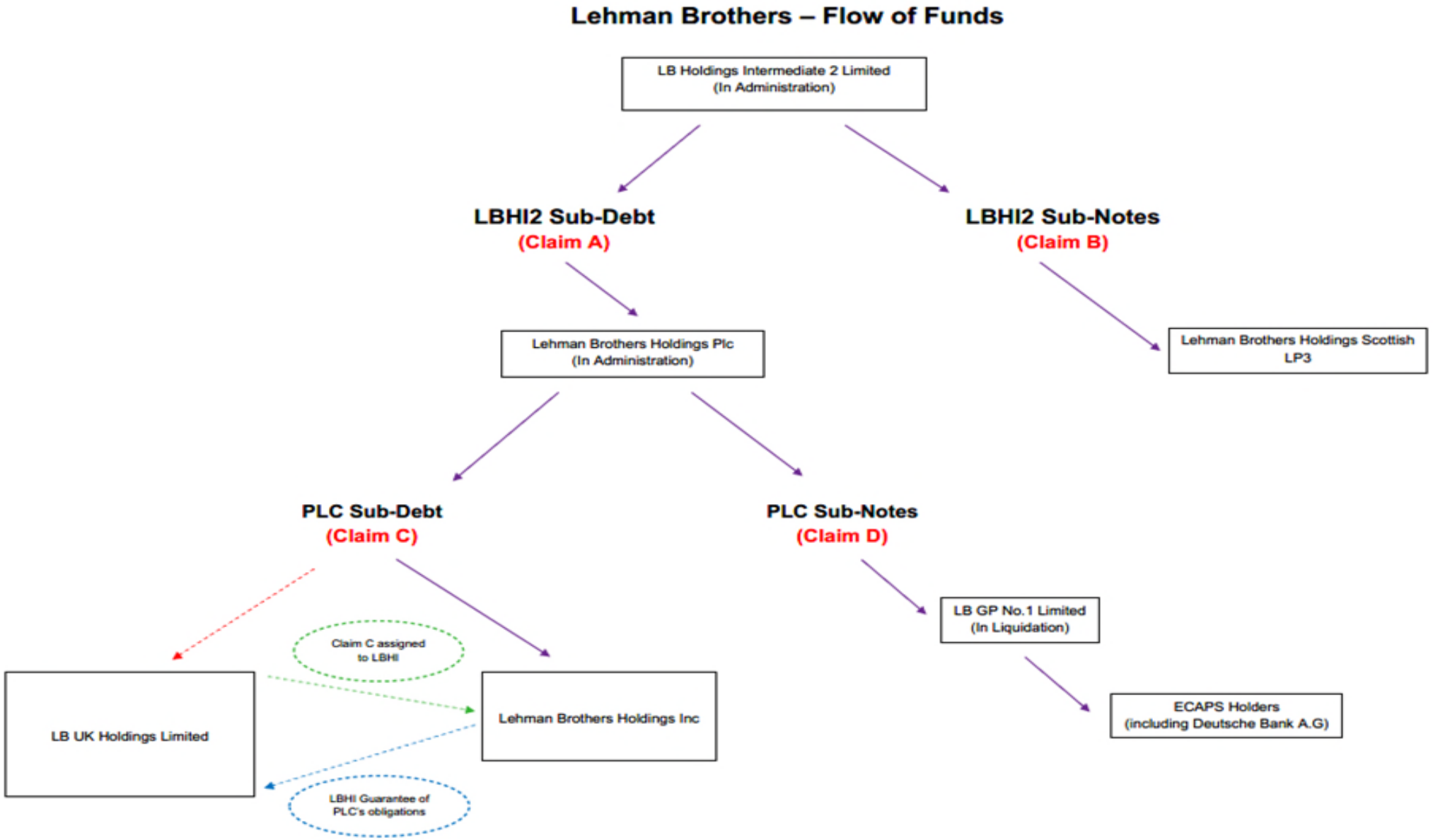
any reason, LB Holdings did not in fact apply the monies received in satisfaction of the guaranteed debt but held them in accordance with Clause 7(f)[18].

Sonia Tolaney QC
Richard Fisher QC
Tim Goldfarb

18 January 2021

[18] In so far as Deutsche Bank's argument is to be treated as a "*new*" argument on appeal (notwithstanding that it was pleaded in the Position Papers), it satisfies the test for the Court to exercise its discretion to consider it. The argument can be dealt with based on the factual findings made by the Judge, and LBHI has not suffered any prejudice that cannot be compensated for in costs in circumstances where it chose not to adduce any evidence on an issue squarely raised in the Position Papers: see Notting Hill Finance Limited v Sheikh [2019] EWCA Civ 1337, at [21]-[28].

APPENDIX


Lehman Brothers – Flow of Funds
LB Holdings Intermediate 2 Limited
(In Administration)
LBHI2 Sub-Debt
(Claim A)
LBHI2 Sub-Notes
(Claim B)
Lehman Brothers Holdings Plc
(In Administration)
Lehman Brothers Holdings Scottish
LP3
PLC Sub-Debt
(Claim C)
PLC Sub-Notes
(Claim D)
LB GP No.1 Limited
(In Liquidation)
Claim C assigned
to LBHI
LB UK Holdings Limited
Lehman Brothers Holdings Inc
ECAPS Holders
(including Deutsche Bank A.G)
LBHI Guarantee of
PLC's obligations