A3/2020/1787

CR-2009-000052

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 LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N:

LEHMAN BROTHERS HOLDINGS SCOTTISH LP 3

Appellant

-AND-

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

Respondents

REPLACEMENT SKELETON ARGUMENT OF SLP3 IN SUPPORT OF ITS APPEAL AGAINST PARAGRAPH 1 OF THE ORDER OF MR JUSTICE MARCUS SMITH

18 JANUARY 2021

A. INTRODUCTION

1. At trial, SLP3's primary position was that, both prior to and following certain amendments made to the LBHI2 Sub-Notes in September 2008, the LBHI2 Sub-Notes and the LBHI2 Sub-Debt ranked *pari passu*. In the alternative, SLP3 contended that, if the effect of the amendments to the subordination provision in the LBHI2 Sub-Notes Circular was to alter the existing relative ranking between the LBHI2 Sub-Notes and the LBHI2 Sub-Debt, then the amendments should be rectified on the grounds of common mistake. Against this, PLC argued that the LBHI2 Sub-Debt ranked *senior* to the LBHI2 Sub-Notes both pre- and post-amendment, and that amendments to the LBHI2 Sub-Notes Circular should not be rectified.

2. Mr Justice Marcus Smith (the "**Judge**") found[1] that: (a) the Unamended LBHI2 Sub-Notes ranked *senior* to the LBHI2 Sub-Debt; but (b) following the amendments in September 2008, the Amended LBHI2 Sub-Notes ranked *junior* to the LBHI2 Sub-Debt. In other words, the Judge concluded[2] that the legal effect of the amendments was to *reverse* the existing relative ranking between the LBHI2 Sub-Debt ("**Claim A**") and the LBHI2 Sub-Notes ("**Claim B**") (the "**Ranking Alteration**"). As the Judge twice acknowledged (at [231], [262]), this was a "*surprising*" outcome (and not one advanced by any party). The Judge granted permission to appeal his findings on construction.[3]

3. For the reasons set out below, the Judge's conclusion at LBHI2 was wrong, and he ought to have found that the LBHI2 Sub-Debt and LBHI2 Sub-Notes rank *pari passu* both pre- and post-amendment.

B. EXECUTIVE SUMMARY

4. The priority issues in this case involve the interaction of subordination provisions in regulatory subordinated debt. The provisions are structured and drafted in materially similar terms, which prohibit the subordinated creditors from proving until defined senior creditors or senior liabilities have been paid in full. None of the subordinated instruments in question expressly cross-refer to each other.

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[1] The Judge's judgment is reported at [2020] EWHC 1681 (Ch) ("**the Judgment**") **[C2/22]**. Save where expressly stated otherwise, the same defined terms as used in the Judgment are adopted herein.
[2] Separately, in relation to the PLC Priority Dispute, the Judge concluded at [378(3)(e)] that the PLC Sub-Debt and the PLC Sub-Notes rank *pari passu*.
[3] The Judge also granted permission in relation to the PLC Priority Dispute.

5. In considering both the relative ranking of Claims A(i), A(ii) and A(iii)[4] in the context of the LBHI2 Priority Dispute, and the PLC Priority Dispute between Claim C and Claim D, the Judge found that the similarity[5] in wording and structure of the subordination provisions resulted in a "*circuity*" whereby each instrument is a senior creditor vis-a-vis the other. The Judge 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**").

6. SLP3's case at trial was based on the fundamental similarity between the subordination provisions in question.[6] It contended that this same similarity in wording and structure inevitably led to the conclusion that these subordinated creditors had agreed to prove behind the same senior liabilities and, therefore, to prove at the same time, ranking *pari passu* pursuant to Rule 14.12.[7]

7. In short, both approaches concluded (correctly) that the inevitable legal consequence of the similarity in the wording and structure of the subordination provisions is a *pari passu* outcome.

8. However, when the Judge turned to the LBHI2 Priority Dispute, he erred by approaching this issue in a materially different way to the other priority disputes before him. He should have concluded that pre-amendment Claim A and Claim B were entitled to prove at the same time and rank *pari passu*. In this regard:

   (1) The Judge ought to have applied the same independent construction to the instruments that he adopted elsewhere[8] instead of construing Claim A and Claim B conjunctively. If he had applied his own stated approach (using the Three-Step Approach described at para 31 below) and construed the instruments independently, the Judge would have found that the interaction between Claim A and Claim B leads to exactly the same circuity that he observed in relation to the other priority disputes. Accordingly, Claim A and Claim B's subordination

[4] There are three LBHI2 Sub-Debt Agreements, which the Judge labelled Claims A(i), A(ii) and A(iii).
[5] Judgment at [150] and [358].
[6] See SLP3's Trial Submissions at [14(4)-(5)] **[S1/8/115]**; [265(1)] **[S1/8/176]**.
[7] SLP3's Trial Submissions at [8] **[S1/8/112]**; [14]-[15] **[S1/8/115]**; [265(4)] **[S1/8/177]**; [321] **[S1/8/190]**; and [331] **[S1/8/195]**.
[8] In relation to (a) the circuity of Claim A(i), Claim A(ii) and Claim A(iii) (at [151], [250]) and (b) the PLC Priority Dispute (at [350]-[357]).

provisions are ineffective as between each other, they prove at the same time and they rank *pari passu*: see **Pari Passu Outcome: Ineffectiveness of Subordination Provisions Inter Se** at paras 37 to 44 below.

(2) Alternatively, the Judge ought to have adopted the approach advanced by SLP3 at trial. The critical contractual question arising against the backdrop of the statutory insolvency scheme[9] is to ascertain which senior creditors or senior liabilities these subordinated instruments have agreed to prove behind.[10] The reasonable reader would identify a complete symmetry between the categories of debt to which Claim A and Claim B are subordinated, such that they prove after the same senior creditors or senior liabilities, at the same time, and rank *pari passu*: see **Pari Passu Outcome: Same Senior Creditors or Senior Liabilities** at paras 45 to 49 below.

9. Accordingly, both on (a) the Judge's stated approach (properly applied to the LBHI2 Priority Dispute) and (b) SLP3's trial case, Claim A and Claim B prove at the same time and rank *pari passu*. The former approach leads to this conclusion as a result of Claim A and Claim B being senior creditors for each other's purposes, such that their subordination provisions are ineffective as between each other. The latter approach leads to this conclusion as a result of Claim A and Claim B being subordinated to the same senior liabilities, such that they prove at the same time, and not after one another. The Judge erred by failing to apply either of these two approaches to the LBHI2 Priority Dispute.

10. The position is the same post-amendment of the LBHI2 Sub-Notes Circular. The Judge was wrong to conclude that the legal effect of the amendments to Condition 3(a) of the LBHI2 Sub-Notes resulted in the Ranking Alteration. The key subordination language (including the critical definition of "Senior Creditors") remained unchanged, such that Claim A and Claim B continued, by either one of the two approaches described above, to prove at the same time and rank *pari passu* by operation of Rule 14.12. The amendments did not in any way alter the identity of the Senior Creditors after which the LBHI2 Sub-Notes agreed to prove, such that they continued to prove at the same time as the LBHI2 Sub-Debt post-amendment, and thereby rank *pari passu*.

[9] See paras 19 to 21 below.
[10] See Counsel for SLP3 at Day 1, page 28/11-15: "*The contractual question which arises against the backdrop of the statutory scheme is to ask when subordinated creditors are entitled to be admitted for proof, which in turn requires identification of the senior creditors to which they are to be subordinated*" **[S2/49/533]**.

11. Alternatively, if the amendments to the LBHI2 Sub-Notes Circular did alter the relative priority between Claim A and Claim B as a matter of construction, the Judge erred by declining to order that the LBHI2 Sub-Notes Circular be rectified on the basis of common mistake: see **Rectification of the Amended LBHI2 Sub-Notes** at paras 69 ff. below.

C. BACKGROUND

12. The LBHI2 Sub-Debt[11] arises under three materially identical subordinated loan agreements[12] dated 1 November 2006, whose purpose was to provide LBHI2 with regulatory capital (at [10]-[11]).

13. The LBHI2 Sub-Debt Agreements were all subject to Chapter 10 of IPRU(INV).[13] This required that subordinated debt agreements for securities and investments firms were drawn up on FSA Standard Form 10.[14] The purpose of this and other FSA templates was to provide a "*uniform system of subordination*" to ensure that subordinated creditors ranked behind all other creditors.[15] Chapter 5 of IPRU(INV) also required that subordinated debt agreements for investment management firms were drawn up on FSA Standard Form 5 to ensure ranking after the claims of "*all other creditors*".[16] The different templates were used to achieve the same subordination outcome.[17]

14. The LBHI2 Sub-Notes[18] are floating rate subordinated notes issued under the LBHI2 Sub-Notes Circular dated 26 April 2007. Their purpose was to provide LBHI2 with regulatory capital and were structured as notes (not loans) for tax purposes (at [12]-[13]). The LBHI2 Sub-Notes refinanced an equivalent sum of LBHI2 Sub-Debt.[19]

15. The LBHI2 Sub-Notes were subject to the GENPRU regime (IPRU(INV)'s successor),[20] which envisaged three tiers of capital (Tier 3, Tier 2, Tier 1). Tier 2 was sub-divided into Lower Tier 2 ("**LT2**") and Upper Tier 2 ("**UT2**"). Tier 3 and LT2 eligible instruments

[11] The form and content of the LBHI2 Sub-Debt is accurately set out at [126]-[137].
[12] These three agreements were mirrored by three materially identical back-to-back loan agreements between LBHI2 and LBIE, which were the subject matter of Waterfall I: SLP3 Trial Submissions, [273] **[S1/8/178]**.
[13] IPRU(INV) was introduced by the FSA to implement the European legislation introduced in the wake of Basel I (SLP3 Trial Submissions, [55]-[72] **[S1/8/126]**) and was in force until 31 December 2006.
[14] In Waterfall I, at [49], David Richards J emphasised the importance of the regulatory context to construction.
[15] See Waterfall I, David Richards at [75]; and Moore-Bick LJ at [246].
[16] See SLP3 Trial Submissions, [73]-[83] **[S1/8/131]**.
[17] See below at paras 48(3) and 53(2) in relation to FSA Standard Form 5 and FSA Standard Form 10.
[18] Their form and contents (as unamended) are set out at [159].
[19] Dolby 1, [47]-[49] **[S1/5/76]**.
[20] GENPRU was introduced by the FSA to address European legislative changes in the wake of Basel II: SLP3 Trial Submissions, [84]-[97] **[S1/8/134]**.

included dated subordinated debt (respectively short-term and longer-term),[21] while UT2 instruments included perpetual subordinated debt and perpetual cumulative preference shares.[22] Tier 1 capital eligible instruments included share capital.[23]

16. The LBHI2 Sub-Notes were dated subordinated debts which complied with the GENPRU requirements for LT2 (Dolby 1, [50] **[S1/5/77]**), while the LBHI2 Sub-Debt was LT2, or alternatively Tier 3.[24] The "*default setting*" and market expectation was that LT2/Tier 3 would rank *pari passu*, which reflected the "*custom in the market as to how these instruments are regarded relative to each other*".[25] In turn, the market expectation was for (a) LT2/Tier 3 to rank senior to UT2 securities, and (b) for UT2 securities to rank senior to Tier 1 capital.[26]

17. The LBHI2 Sub-Notes were amended[27] pursuant to the LBHI2 Sub-Notes Resolution dated 3 September 2008 (at [14]). The genesis of the modifications was to allow the deferral of interest payments to achieve a tax advantage.[28] It did not lie in a decision to alter the subordination of (or the subordination provisions in) the LBHI2 Sub-Notes (at [204]). The Amended LBHI2 Sub-Notes remained LT2 capital.

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

18. The Judge addressed the nature of subordination at [71]-[124].[29]

<u>The Statutory Scheme</u>

19. In Section E(2) the Judge described the statutory context in which subordination takes effect.[30] The Judge considered that "*legal subordination*" is the default rule pursuant to which the ranking of claims is determined by the operation of law and not by party

[21] GENPRU 2.2.12 and 2.2.245.
[22] GENPRU 2.2.157 and 2.2.176.
[23] GENPRU 2.2.10.
[24] It was common ground at trial that the LBHI2 Sub-Debt was either LT2 or Tier 3 (see PLC PP, at [51.4] **[C2/33/563]).**
[25] 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]**).
[26] See the evidence of Mr Grant (Day 2, page 138/5-page 139/1**[S2/52/552]**).
[27] The form and content of the modifications are set out in the Judgment at [203].
[28] See the Judgment at footnote 230, referring to the draft minutes stating the purpose of the amendments to be "*to allow the Company to defer payments of interest on the Notes at its discretion"* (at [212]).
[29] In this regard, the Judge derived assistance from the "Legal Framework" section in SLP3's Trial Submissions at [29]-[48] **[S1/8/118]**.
[30] In this regard, the Judge derived assistance from the "Statutory Scheme" section in SLP3's Trial Submissions at [31]-[37] **[S1/8/118]**.

consent[31] (at [72]). In this regard, the Judge referred to the relevant statutory provisions relating to the definition of "*debt*"[32] and "*provable debt*"[33] in IR16 (at [74]-[78]); Lord Neuberger's description of the "Waterfall" (in Waterfall I, at [17]); and the order of distribution in the "Waterfall" provided for in the Insolvency Act 1986 ("**IA86**") and IR16 (at [86]-[87]).

20. The Judge considered the question[34] of whether subordinated creditors have *provable* claims or *non-provable* claims and correctly concluded (at [122]) that the subordinated debt obligations before him were *provable*. The Judge's decision on this point is not being appealed.[35]

21. The starting point is that provable claims rank *pari passu* pursuant to Rule 14.12(2) of IR16:[36] "*Debts other than preferential debts rank equally between themselves and, after the preferential debts, must be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves*" (the "**Pari Passu Principle**").[37] Furthermore:

    (1) First,[38] for two subordinated debts to rank *pari passu* by operation of law, it is not necessary for them to cross-refer to each other and/or expressly provide that they rank *pari passu* with each other. It is sufficient that they are subordinated to the same senior liabilities: if A subordinates its debt to C, and B subordinates its debt to C, A and B will prove at the same time, and will rank *pari passu*.

    (2) Second, there is no rule of law prescribing the order in which provable debts are entitled to prove. Accordingly, save for certain specified statutory exceptions which are not engaged here,[39] creditors are entitled to prove at the same time unless

[31] In this regard, it can be ""*displaced*" (at [250]), by other arrangements, including "*consensual subordination*". However, where "*consensual subordination*" does not work, the rules provide that provable debts rank *pari passu* (ibid.).
[32] Rule 14.1(3) of IR16.
[33] Rule 14.2(1) of IR16.
[34] This was to address an argument that subordinated debt obligations are non-provable liabilities in light of Lord Neuberger's *obiter dictum* that "*it may be that the proper analysis is that the subordinated debt is a non-provable debt which ranks after all non-provable liabilities. It is unnecessary to decide that point, and, as it was not argued, I say no more about it*" (Waterfall I, at [71]).
[35] See Deutsche Bank's Appellant's Notice **[C1/13/182]**.
[36] See in this regard, footnote 63 of the Judgment, addressing unsecured provable claims, and also footnote 67, which states the applicability of the *pari passu* principle in relation to non-provable claims.
[37] As regards creditors' voluntary liquidation and members' voluntary liquidation, the Pari Passu Principle is put on a statutory footing by Section 107 of the Insolvency Act 1986.
[38] SLP3's Trial Submissions, [13(1)] **[S1/8/114]**.
[39] For example, in relation to deferred debts pursuant to Rule 14.2(4) IR16.

they agree otherwise. A creditor must prove its debt (Rule 14.3 of IR16) in order to claim in an insolvency, but may prove late after other creditors have proved, following the distribution of a dividend. If it does so, it cannot disturb the payment of any prior distribution, but is entitled to be paid a dividend out of any funds remaining for distribution: Rules 14.40(1)(b) and 14.40(2) of IR16.

(3) Third, if two creditors prove late and at the same time, and there are sufficient assets, they will both receive 100 pence in the pound. But if there are insufficient assets in the insolvent estate to pay the admitted debts in full then, by virtue of Rule 14.12, these claims will abate in equal proportion between themselves.

Simple Contractual Subordination

22. Having addressed the statutory context in which subordination takes place, the Judge described[40] consensual subordination and its subset, "*simple contractual subordination*"[41] (at [97]-[105]; [115]-[122]). The Judge correctly held (at [117]) that contractual subordination enables the creditor to select at what point in the "Waterfall" of creditor claims their interests will be considered. He thereby acknowledged that the operation of simple contractual subordination needs be considered in the context of the statutory scheme for proof described above.[42]

23. The Judge considered the critical issue of when subordinated creditors can prove in the administration (at [122]). The Judge concluded correctly (and consistent with SLP3's case at trial) (at [122], and [142]) that:

(1) The effect of the contractual subordination provisions in Waterfall I was to prevent the lodging of proof until all prior obligations (i.e. the relevant Senior Liabilities or Senior Creditors) have been satisfied.[43] Notably, the same subordination provision as that contained in the LBHI2 Sub-Debt (i.e. FSA Standard Form 10) was under consideration in Waterfall I.

(2) The subordinated creditor has a provable claim which they can prove late, using

[40] In this regard, the Judge derived assistance from the "Operation of contractual subordination" section in SLP3's trial submissions: SLP3 Trial Submissions, [38]-[48] **[S1/8/120**].
[41] The Judge used the label "*simple contractual subordination*", which is the label used by Fuller.
[42] See SLP3's Trial Submissions, [48] **[S1/8/123]**.
[43] See SLP3's Trial Submissions, [36]-[38] **[S1/8/119]**. Lord Neuberger disagreed with Lewison LJ in this regard, and restored the order of David Richards J.

the statutory mechanisms set out in Rule 14.40 of IR16, described above.

24. It follows from the Judge's findings on the statutory scheme and "*simple contractual subordination*" that where subordinated debts prove as a matter of contract at the same time and behind the same senior liabilities, they can and do rank *pari passu* as a result of Rule 14.12.

Contingent Debt Subordination

25. Finally, the Judge considered "*contingent debt subordination*". In treating this as a free-standing species of "*consensual subordination*", which is separate and distinct[44] from "*simple contractual subordination*", he erred in two key respects.

26. First, the Judge concluded (incorrectly) that in each of the LBHI2 Sub-Debt and the LBHI2 Sub-Notes the "*contingent debt subordination*" and "*simple contractual subordination*" provisions "*operate very differently and by reference to different factors*" (at [146]). There was no basis for this in view of the clear guidance from the Supreme Court in Waterfall I that both parts of the subordination provision should be read as achieving the same outcome, i.e. specifying at what point the subordinated creditor can prove (and without enabling it to prove at any time as a contingent creditor). Further:

    (1) As the Judge acknowledged, in Waterfall I Lord Neuberger identified a "*logical problem*" (at [69]) which means that subordinated creditors cannot prove as contingent creditors *at all* given the risk of this defeating the subordination to senior liabilities.[45]

    (2) The Judge acknowledged that Lord Neuberger (like David Richards J, but unlike Lewison LJ) regarded the subordination provisions in Waterfall I "*as a form of simple contractual subordination*" (as opposed to "*contingent debt subordination*") at [107]. However, he went on to state that "*neither decision states this unequivocally in these terms*" (ibid.) and that "*if I am right that the Court of Appeal viewed these provisions as amounting to contingent debt subordination – that disagreement was less to do with the right to prove and more to do with the*

[44] See e.g. [94]-[96]; [111]-[114].
[45] Lord Neuberger explained that "*if the proof is ascribed a valuation greater than nil, it would have to be paid out on any distribution made prior to the satisfaction in full of other proved claims…further any dividend would be paid out before any statutory interest or non-provable liabilities, which would be inconsistent with the conclusions I have just expressed*".

difference of view between the various instances as to the nature of the clause between them" (footnote 103). There was no basis for this further qualification. It is clear from the passages cited by the Judge that Lord Neuberger expressly rejected the "*contingent debt subordination*" analysis in favour of a simple contractual subordination analysis, pursuant to which the subordination provision as a whole must be construed in a unified manner to determine at which point the subordinated creditor is entitled to prove.

27. Second, in reaching his conclusions on contingent debt subordination, the Judge relied on The Law and Practice of International Capital Markets, 3rd edition (2012) ("**Fuller**").[46] However, this text pre-dates the "Waterfall" litigation[47] and, most importantly, Waterfall I. As a result, the Judge was wrong to rely on certain passages taken from Fuller,[48] particularly its descriptions of so-called "*contingent debt subordination*" as a free-standing mechanism. Fuller's analysis on this issue did not survive the Supreme Court's ruling in Waterfall I.[49]

28. The Judge's approach to "*contingent debt subordination*" in materially identical subordination agreements was therefore erroneous and, for the reasons set out further below, it is not one that should be adopted on appeal. The subordination provisions in Claim A and Claim B read as a whole have the effect described above, namely, to prohibit proof in LBHI2's administration until after the senior claims have been satisfied in full.

E. THE INTERPRETATION OF CONTRACTS – RELEVANT PRINCIPLES

29. The Judge correctly summarised the general principles[50] of contractual construction at [60] to [61]. However, he gave insufficient regard to the following principles relating to the scope of the factual matrix:

    (1) The identification of the relevant audience is important because it serves to identify

[46] SLP3 (like the other parties) did not cite Fuller at trial for the reasons explained at footnote 50 of the Judgment.
[47] See footnote 50.
[48] For example, he referred to and relied upon Fuller at [11.67]-[11.68] on several occasions (at [96]; [111]) in support of the proposition that "*a liquidator is required to estimate the value of the debt having regard to the likelihood of the contingency occurring…The liquidator may revise the estimate during the course of the winding up as circumstances change*".
[49] There is a difference between a liability that does not arise until occurrence of a contingency and a liability that cannot be proved or paid until certain conditions are met. A contingent debt is proved and a value put on the debt based upon the likelihood of the contingency occurring: Rule 14.14 IR16. In contrast, a provision prohibiting proof until after senior creditors have been paid and subject to a payability condition can only prove at the relevant time and will receive a pro rata share of the assets then available.
[50] In this regard, SLP3's trial submissions on the law are at SLP3 Trial Submissions, [112]-[139] **[S1/8/140]**.

the range of background facts relevant to interpretation (In LB Re Financing No 3 Ltd v Excalibur Funding No 1 Plc [2011] EWHC 2111 (Ch), per Briggs J). In determining the relevant audience the Court is entitled to have regard to the evidence concerning the *purpose* of the instrument.

(2) The sort of background knowledge that can be used as an aid to construction is background knowledge that is accessible to all the people who it is reasonably foreseeable might, in the future, need to construe the document (Cherry Tree Investments Ltd v Landmain [2012] EWCA Civ 736, at [128]).

F. LBHI2 PRIORITY DISPUTE – THE JUDGE'S APPROACH

30. As the Judge acknowledged, his approach to and conclusion on the construction of the LBHI2 Sub-Debt and the Unamended LBHI2 Sub-Notes were markedly different to the cases advanced by both SLP3 and PLC at trial.[51]

31. The Judge set out a three-step approach to construing the competing subordination provisions (the "**Three-Step Approach**") (at [176]). As described by the Judge, it involves:

(1) First, considering ranking from the perspective of the subordination provisions in Claim A. The Judge held that it was permissible to have limited regard to the terms of Claim B as part of this exercise,[52] but that it would be impermissible to read the subordination provisions in the two instruments "*conjunctively*" (i.e. "*in conjunction with one another*)".[53] The latter was a correct and important qualification.

(2) Second, carrying out exactly the same exercise from the perspective of Claim B's subordination provisions.

(3) Third, concluding that if the result of the two independent exercises above is a common (but not agreed) order of priority, that resolves the priority question. If,

[51] Deutsche Bank did not advance any construction arguments orally at trial. It was only joined to the LBHI2 Application for the purposes of its "Dividend Stopper" argument, in relation to which permission to appeal has been refused.
[52] [175(2)] and [176(1)].
[53] [175(1)].

on the other hand, the result is a form of circuity, a further step is required.[54]

32. The Judge purported to apply the Three-Step Approach to "*simple contractual subordination*" in relation to Claim A and Claim B at [177]-[185], [190]-[191] and [196]-[198]. However, despite earlier emphasising that it is generally impermissible to read the subordination provisions conjunctively, the Judge proceeded to do exactly that. Thus, when construing whether, for instance, Claim B is an Excluded Liability from the standpoint of Claim A, the Judge proceeded to construe Claim A's status within Claim B (the "**Conjunctive Construction**").[55] The Conjunctive Construction analysis involved an erroneous application of the Judge's Three-Step Approach, as described further below at paras 37 to 39.

33. For present purposes, the Judge's key conclusions on simple contractual subordination can be summarised as follows:

(1) At Step 1, starting with the subordination provision in Claim A, when considering whether Claim B was an Excluded Liability, he construed Claim A from the standpoint of Claim B ("*Turning, then to the provisions in Claim B…*" [182]). As part of this Conjunctive Construction, the Judge concluded that Claim A is not a "Senior Creditor" in Claim B. Therefore, he reasoned that Claim B is not an Excluded Liability in Claim A and, accordingly, it is a Senior Liability in Claim A.

(2) At Step 2, turning to the subordination provision in Claim B, the Judge concluded that Claim A is not a Senior Creditor in Claim B (at [191]). The Judge reached this conclusion by applying his Step 1 Conjunctive Construction analysis (at [191(3)]). He reasoned that Claim B says nothing about ranking between Claim B and creditors who are not a Senior Creditor. The default rules apply. Claim A and Claim B rank *pari passu*.

(3) At Step 3, in circumstances where the outcome is not common to the provisions, the operative provision is in Claim A (the provision in Claim B being ineffective) (at [198]). The priority dispute is "*as between a subordinated creditor and an*

[54] Where different subordination provisions result in an infinite race to the bottom, those provisions generate a meaningless interaction in that particular instance (at [250]).
[55] That is to say, actually construing the status of the first instrument within the second instrument, when one is nominally considering matters from the standpoint of the first instrument's contractual subordination provisions.

unsubordinated creditor" (at [198(2)]). The Judge concluded that Claim B is senior to Claim A.

34. The Judge then applied the Three-Step Approach to "*contingent debt subordination*" at [186]-[189], [192]-[195] and [196]-[198]. Treating the solvency condition as entailing a separate exercise to the identification of the point at which Claim A and Claim B can prove was an error. It flowed from the Judge's conclusion (at [147] and [172]) that the words "*and accordingly*" in both instruments meant that there were two potentially conflicting subordination mechanisms ("*simple contractual subordination*" and "*contingent debt subordination*"). The Judge bifurcated his subordination analysis accordingly. He was wrong to do so:

    (1) As described above, the Judge overlooked the binding guidance of the Supreme Court that provisions drafted in this form operate as simple contractual (and not contingent debt) subordination, and should be construed in a unified manner, not with the result that "*a payment permissible under one provision will nevertheless be precluded by the other*" (at [147]).

    (2) He rejected the (correct) construction that the words "*and accordingly*" are intended to give effect to the simple contractual subordination provision, which describes the Senior Liabilities/Senior Creditors that the rights of the subordinated creditors are subordinated to, and defines when they are entitled to prove. The different parts of the subordination provision should be read together.

35. Finally, the Judge performed the same exercise in relation to the Amended LBHI2 Sub-Notes and the LBHI2 Sub-Debt: see in relation to "*simple contractual subordination*" at [235]-[240], [243]; and in respect of "*contingent subordination*", at [241]-[242]. He was wrong to do so.

G. LBHI2 PRIORITY DISPUTE: PRE-AMENDMENT

36. The Judge was wrong to conclude that the LBHI2 Sub-Debt is *junior* to the Unamended LBHI2 Sub-Notes. He should have concluded that they are entitled to prove at the same time and rank *pari passu*. The Judge should have reached that conclusion by means of either: (a) the proper application of his own Three-Step Approach (such that the relevant subordination provisions are ineffective as between each other); or (b) SLP3's case at

trial (i.e. construing Claim A and Claim B as proving behind the same senior creditors or senior liabilities).

Pari Passu Outcome: Ineffectiveness of Subordination Provisions Inter Se

37. If the Judge had correctly applied his own Three-Step Approach as set out at [176], without resorting to a Conjunctive Construction of the instruments, he would have held that a circuity arises by which Claim B ranks senior to Claim A, and Claim A ranks senior to Claim B. That meaningless outcome would have resulted in the subordination provisions in question being *ineffective* as between each other (at [248] to [250]), such that Claim A and Claim B prove at the same time and rank *pari passu* pursuant to Rule 14.12 of IR16.

38. The Judge was wrong to perform a Conjunctive Construction of Claim A and Claim B, having held that it was impermissible to do so. His approach failed to consider matters at Step 1 "*always from the standpoint*" of Claim A (at [182]) and, at Step 2, always from the standpoint of Claim B. Instead:

    (1) At Step 1, in answering whether Claim B was an Excluded Liability in Claim A, he incorrectly construed Claim A's position from the standpoint of Claim B; and,

    (2) At Step 2, instead of construing Claim A's status within Claim B afresh, he incorrectly applied the conclusion derived from the Conjunctive Construction analysis at Step 1 to construe Claim B.[56]

39. Both analytical steps were wrong. The ranking (as a matter of construction) of Claim B in Claim A should not depend on the prior question of Claim A's status within Claim B, and vice-versa (not least given that the two claims do not expressly refer to each other). The Conjunctive Construction leads to an unprincipled circularity, involving cross-reference back-and-forth between the two instruments, as demonstrated most clearly by Row 4(d) of Table 2 at [185]. The instruments should be construed independently.

40. The Judge did *not* perform a Conjunctive Construction in respect of (a) Claim A(i), Claim A(ii) and Claim A(iii) (at [151], [250]) and (b) Claim C and Claim D (at [351]-[358]). In relation to those priority disputes, the Judge correctly adopted an *independent*

[56] At [191(3)], the Judge said: "*The process articulated in Table 2 above applies, with the result there stated*."

construction. This was the correct approach and yielded the correct outcome.

41. For example, in respect of Claim A(i), the Judge considered (a) whether, according to its own terms, Claim A(ii) was a Subordinated Liability in A(i) (to which the answer was "No"); (b) whether Claim A(ii) was, on its face, an Excluded Liability (to which the answer was "No");[57] and (c) whether Claim A(ii) was a Senior Liability in Claim A(i) (to which the answer was "Yes").[58] Since Claim A(i), Claim A(ii) and Claim A(iii) have matching subordination clauses, he found that they were all Senior Liabilities for each other's purposes. The Judge thus held that they were involved in an "*infinite (never-ending) race to the bottom*", which was "meaningless" such that the subordination provisions were ineffective as between each other and they ranked *pari passu*.

42. If the Judge had applied this same approach to the LBHI2 Priority Dispute (and without undertaking a Conjunctive Construction):

    (1) Starting with Claim A, he would have found that Claim B is: (a) not a Subordinated Liability (because it is not LBHI2 Sub-Debt), (b) not an Excluded Liability (because the terms of Claim B do not expressly rank it junior to Claim A, having regard to those terms but without construing Claim A within Claim B), such that (c) Claim B is a Senior Liability within Claim A.

    (2) Moving on to Claim B, the Judge would have found that Claim A is: (a) not expressed to rank *pari passu* with Claim B, (b) not expressed, on its own terms, to rank junior to Claim B, such that (c) Claim A is a Senior Creditor within Claim B.[59]

43. Accordingly, the Judge would have reached the same conclusion in relation to the relative priority of Claim A and Claim B as he did in relation to Claim A(i), Claim A(ii) and Claim A(iii) (at [151], [250]) and (b) Claim C and Claim D – the subordination provisions in Claim A and Claim B produce a meaningless outcome as between each other, such

[57] That is because the wording of Claim A(ii) (and A(iii)) "*makes clear their subordination of what they term "Senior Liabilities" but does not bring them within the class of "Excluded Liabilities" as that term is defined in Claim A(i)*" ([151(1)(b)]);

[58] This is because it was not a Subordinated Liability or an Excluded Liability.

[59] In this regard, the Judge appears to have made a clear error in Row 4(d) Table 2. The Judge found that Claim A is not "expressed to rank junior" and is not "expressed to rank pari passu" for the purposes of the exclusions from the definition of Senior Creditors. However, having done so he ought to have concluded that Claim A is a "Senior Creditor" in Claim B. That is because (according to the Judge's reasoning) as PLC's rights under Claim A are subordinated and are not expressed to rank *pari passu* or junior, then logically they are not excluded from the definition of "Senior Creditors". Instead, he concluded that Claim A is not a "Senior Creditor" in Claim B.

that the "*non-functioning set of subordination provisions gives way to the default imposed by legal subordination, namely that the claims rank pari passu*" (at [253]).

44. Given that all the instruments before the Court have materially the same subordination provisions, if the Judge had adopted a unified (and correct) approach, he should have reached the same subordination outcome in relation to all of them i.e. that the claims rank senior vis-à-vis each other and, to avert the race to the bottom, they rank *pari passu*.

Pari Passu Outcome: Same Senior Creditors or Senior Liabilities

45. Alternatively, the Judge should have reached the conclusion that the Unamended LBHI2 Sub-Notes and the LBHI2 Sub-Debt rank *pari passu* without needing to find that the subordination provisions produce a meaningless outcome.[60] The similarity between the wording and structure of Claim A and Claim B's subordination provisions should have led the Judge to conclude that they are, on a proper construction, subordinated to the same senior creditors or liabilities, such that they are not subordinated to each other.

(1) Pari Passu: Construction of Senior Creditors/Senior Liabilities

46. The Judge ought to have addressed himself to the core legal question in relation to the ranking of subordinated debt: after which senior liabilities has the subordinated debt agreed to prove?[61] Had the Judge framed the interpretative question arising on the LBHI2 Priority Dispute in this way, he would again have reached the conclusion that these subordinated instruments rank *pari passu*.

47. In the absence of clear and unequivocal language to the contrary, the Judge should have concluded that the default legal position pertains (to use the Judge's words at [250]), and the subordinated creditors are entitled to prove their claims at the same time and rank *pari passu*. He erred in the following further key respects.

[60] In this regard, the Judge ought to have had regard to the following ancillary propositions of contract law: (1) Where contracts incorporate standard terms or are standard forms, the Court should seek to respect the parties' choice and to understand the commercial context, providing certainty and consistency in matters of business (GSO v Barclays Bank [2016] EWHC 146 (Comm) at [27]); and (2) Where there are two alternative interpretations of an instrument each of which is realistic, the Court should lean towards that interpretation which validates a provision if possible, particularly where it is part of a standard form commercial agreement used widely in the market (The Interpretation of Contracts, at [7.16]).

[61] As Lord Neuberger said in Waterfall I: "…*it would not be open to LBHI2 to lodge a proof in respect of the subordinated debt until the non-provable liabilities have been paid in full, or at least until it is clear that, after meeting that proof in full and paying any statutory interest due on it, the non-provable liabilities could be met in full*" (at [70]).

48. First, the Judge erred by apparently construing the terms of Claim A and Claim B respectively as precluding them from proving at the same time as any other subordinated creditors (including each other), absent the subordination provisions being ineffective as between themselves in that particular instance. [62] He should have held that both Claim A and Claim B can prove at the same time as other subordinated debts either as a matter of construction[63] (including by construing the agreements (a) commercially/purposively in the context of their regulatory backdrop and (b) with a view to validating the operation of their subordination provisions)[64] or by necessary implication[65]. In support of 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 the scheme was not to prevent dated subordinated debts from proving alongside other dated subordinated debts where (as is the case in relation to LBHI2) all other creditors have been paid.

(2) As demonstrated by the facts of this case, the FSA Standard Forms were used at every point of the 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[66] 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*.

(3) In this regard, FSA Standard Form 5 (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

[62] See Judgment at [166(2)(e)] in relation to the LBHI2 Sub-Notes (and in particular the Judge's restrictive reading of Phrase **[17])**; and [151(1)] in relation to the LBHI2 Sub-Debt (and the Judge's conclusion, by reference to Claim A(i), A(ii) and A(iii), that the LBHI2 Sub-Debt cannot rank *pari passu* with other subordinated debt).
[63] In this regard, Phrase **[17]** expressly provides an exclusion from the category of Senior Creditors of any subordinated liabilities that either do rank or are expressed to rank *pari passu* with the LBHI2 Sub-Notes.
[64] See in regard to (a) SLP3's Trial Submissions at [208] **[S1/8/155]**, [213]-[214] **[S1/8/156]** in relation to the proper construction of FSA Standard Form 10; and in regard to (b) the authorities cited at footnote 60 above.
[65] On the grounds of obviousness and business efficacy: see Marks and Spencer Plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2016] AC 742. SLP3 submitted at trial that the category of Subordinated Liabilities extends by implication to other subordinated debts which either do rank or are expressed to rank *pari passu* with the LBHI2 Sub-Debt: see (a) SLP3's Trial Submissions at [219]-[223] **[S1/8/159]** and [322]-[332] **[S1/8/191]**; (b) Transcript: Day 6, pages 9-48 **[S2/56/580]**; Day 9, pages 178-183 **[S2/57/598]**. For example, it cannot be the case that a subordinated debt that expresses itself to rank *pari passu* with the LBHI2 Sub-Debt is a Senior Liability for the purposes of the LBHI2 Sub-Debt.
[66] In relation to which, see the presumption against absurdity (Chitty on Contracts, 3-083).

Standard Form, but was *impossible* in relation to another FSA Standard Form (i.e. FSA Standard Form 10), which was in use at the same time and was intended to achieve the same result.

(4) Both Claim A and Claim B were LT2/Tier 3 debt, which the market generally expected to rank *pari passu*.[67]

49. Second (and having concluded that Claim A and Claim B *can* prove behind the same subordinated debts) the Judge should have held that Claim A and Claim B *are* subordinated behind the same Senior Liabilities or Senior Creditors, and not to each other. He should have held similarly in relation to Claim A(i), Claim A(ii) and Claim A(iii). More specifically:

(1) The LBHI2 Sub-Debt and the LBHI2 Sub-Notes do not expressly cross-refer to each other.

(2) The operative provisions under the LBHI2 Sub-Debt and the LBHI2 Sub-Notes are structured in materially the same way. The subordination categories which the instruments envisage are entirely symmetrical.[68] Both Claim A and Claim B (a) can prove alongside other subordinated debts for the reasons above, and (b) as PLC conceded at trial,[69] both admit the possibility of subordinated senior debt.

(3) This gives rise to the material similarity between the instruments' subordination categories which, in SLP3's submission, should have led the Judge to conclude that these instruments are not subordinated to each other. When this material similarity is viewed against (a) the admissible factual matrix, which strongly supports a *pari passu* conclusion (see below at paras 50 to 54) 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 SLP3 is entitled to prove for the full nominal amount of the LBHI2 Sub-Notes at the same time as PLC is entitled to prove in respect of the LBHI2 Sub-Debt.

(4) Accordingly, by operation of the IR16, SLP3's claims in respect of the LBHI2

[67] 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]**.
[68] SLP3's Trial Submissions, [330] **[S1/8/195]**.
[69] Day 1, page 120/3-8: "*I accept, and I have to deal with this in closing, that the contrary argument to this is if you actually look at the sub-debt agreements it includes subordinated debts potentially*" **[S2/49/537]**.

Sub-Notes and PLC's claims in respect of the LBHI2 Sub-Debt rank *pari passu* and abate in equal proportions.

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

50. The Judge erred in law by not identifying the relevant audience for the instruments he was construing. In the present case, the instruments were only addressed to internal entities within the Lehman Group, and it was never intended to transfer the LBHI2 Sub-Notes outside of the Lehman Group.[70] Accordingly, the factual matrix in this case is made up of the knowledge reasonably available to the centralised decision-makers within the Lehman Group. Alternatively, if this is incorrect, the factual matrix is the knowledge available to participants in the banking/financial services sector.[71]

51. In this regard, the Judge failed to give any weight to the following: (a) as a matter of fact, there was never any intention[72] to transfer or assign the LBHI2 Sub-Notes outside of the Lehman Group (which is unsurprising in view of the LBHI2 Sub-Notes' status as regulatory capital); and (b) the terms of the LBHI2 Sub-Notes were not in fact public but were stored in the internal records of the Channel Islands Stock Exchange.

52. The Judge was wrong not to conclude that the relevant audience was the centralised decision-makers within the Lehman Group.[73] If he had done so, he would have had regard to at least the following: (a) the purpose[74] of the transaction, namely that the LBHI2 Sub-Notes should partially refinance the existing LBHI2 Sub-Debt on materially the same commercial terms (see In LB Re Financing No 3 Ltd v Excalibur Funding No 1 Plc); and (b) the existing *pari passu* ranking of the debt being refinanced (i.e. $6.139 billion of the LBHI2 Sub-Debt drawn on Claim A(i), A(ii) and A(iii)). This factual matrix overwhelmingly supported a *pari passu* construction between the unrefinanced balance

[70] See SLP3's Trial Submissions, [313]-[316] **[S1/8/189]** and Ms Dolby's confirmation that there was no intention to transfer the LBHI2 Sub-Notes out of the Lehman Group (Dolby Interview, page 13, lines 1-2 **[S1/4/48]**).
[71] See Chitty on Contracts, 33rd edition, 13-051: "*the court is more likely to focus its attention on the background generally known to participants in the industry or the market*".
[72] Ms Dolby confirmed in her interview that "*there was never an intention to transfer it [the LBHI2 Sub-Notes] out of the Lehman Group*" (page 13, line 1 **[S1/4/48]**).
[73] The unchallenged evidence of Ms Hutcherson was that these transactions were intra-group, with the same cross-departmental group negotiating and advising on both sides of the transaction (with a view to the benefit of the Lehman Group as a whole) (Hutcherson 1, [68] **[S1/6/98]**).
[74] The LBHI2 Sub-Notes partially refinanced the LBHI2 Sub-Debt on materially the same terms, including the same interest rate/coupon (LIBOR plus 32 basis points). The refinancing purpose is clearly stated on the face of the LBHI2 Sub-Notes: see Offering Circular, page 14 **[C3/41/731]** stating the purpose as including "*to pay off existing loans*". See SLP3 Trial Submissions, [288]-[291] **[S1/8/182]**.

of the LBHI2 Sub-Debt and the LBHI2 Sub-Notes.

53. Alternatively, if SLP3 is wrong about the relevant audience, the Judge agreed[75] (at [61]) that the relevant audience was made up of participants in the banking/financial services sector. However, having identified this "*relevant audience*", the Judge failed to give any weight to the following significant facts and matters that would have been "*generally*" known to it:

    (1) The LBHI2 Sub-Debt and the LBHI2 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).[76]

    (2) The relevant subordination provisions were based either on the standard form itself (in the case of the LBHI2 Sub-Debt, FSA Standard Form 10) or language very similar to standard form language (in the case of the LBHI2 Sub-Notes, FSA Standard Form 5). The standard forms were intended to achieve the same subordination outcome.

54. This was all relevant background that would have been reasonably available to "*participants in the banking/financial services sector*" (at [61]). The factual matrix supported a *pari passu* construction and gainsaid a conclusion that the instruments were subordinated to each other.

H. LBHI2 PRIORITY DISPUTE: POST-AMENDMENT

55. The Judge was wrong to conclude that the LBHI2 Sub-Debt ranks *senior* to the Amended LBHI2 Sub-Notes.

Pari Passu Outcome: Ineffectiveness of Subordination Provisions Inter Se

56. As he did pre-amendment, the Judge adopted an internally inconsistent approach to construing the two separate subordination provisions *inter se* (at [236]). Had the Judge used the same approach (without undertaking the Conjunctive Construction) as he did in relation to, on the one hand, Claim A(i), Claim A(ii) and Claim A(iii) and, on the other

[75] See SLP3 Trial Submissions, [133].
[76] 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]**.

hand, Claim C and Claim D, he would have concluded that the LBHI2 Sub-Debt and the Amended LBHI2 Sub-Notes rank *pari passu*.

57. In this regard, the Judge would have reached the same conclusions as set out above at paras 37 to 44 in respect of the pre-amendment position: Claim A and Claim B continued to rank senior vis-à-vis the other and, to avert the race to the bottom, they rank *pari passu* post-amendment. This analysis is unaffected by the amendments to the wording in Condition 3(a) of the LBHI2 Sub-Notes because the key subordination wording and the definition of "Senior Creditors" remained the same, as set out more fully below at paras 60 to 64.

Pari Passu Outcome: Same Senior Creditors or Senior Liabilities

(1) Pari Passu: Incorrect Construction of the Amended LBHI2 Sub-Notes

58. Alternatively, as SLP3 contended at trial, the Judge should have reached the conclusion that the Amended LBHI2 Sub-Notes and the LBHI2 Sub-Debt rank *pari passu*, without needing to find that their subordination provisions produce a meaningless outcome. The Amended LBHI2 Sub-Notes remained subordinated to the same Senior Creditors and, therefore, the relative ranking in respect of the LBHI2 Sub-Debt was unchanged: Claim A and Claim B continued to rank behind the same Senior Creditors/Senior Liabilities, were therefore entitled to prove at the same time, and ranked *pari passu* pursuant to Rule 14.12.

59. The Judge failed to reach this conclusion because, on his analysis, the starting point was that the amendments to Condition 3(a) ranked them "*below all debt – including subordinated debt – except for debt that has a subordination provision similar to the deeming provisions used by the Noteholders themselves for the purposes of subordination*" (original emphasis).[77] That finding was unsustainable and undermined the Judge's conclusions in relation to post-amendment ranking. The Judge erred in four respects in this regard.

60. First, the Judge erred in construing Condition 3(a) as being constituted by two distinct parts. He treated the insertions to that Condition as creating a new mechanism which did not require consideration of the old regime. By so doing, the Judge did not have

[77] [231]; and see similar conclusions at [238], Row 4C of the table at [240], and at [243].

sufficient regard to the purpose and effect of Condition 3(a), which was to subordinate the LBHI2 Sub-Notes to the "Senior Creditors", who continued to be defined in the same way. The Judge should have construed the amended Condition 3(a) as a whole, treating the new payability condition (Phrases **[8]** to **[17] [C3/42/741]**) as implementing the critical subordination language that remained unchanged under Phrase **[2] [C3/42/741]**. In particular:

(1) By not reading Condition 3(a) as a whole, the Judge gave insufficient effect to Phrase **[2]** of the Amended LBHI2 Sub-Notes in a winding-up and indeed did not appear to recognise its continued application at all. If he had done so, the Judge would have concluded that the Amended LBHI2 Sub-Notes continued to be subordinated to the same pre-amendment Senior Creditors, who were defined in the same terms under Phrases **[25]** to **[30] [C3/42/741]**, such that there was no alteration of ranking post-amendment.

(2) The Judge should have held that, on a natural reading, the term "*accordingly*" in Phrase **[3] [C3/42/741]** connects subordination to the Senior Creditors under phrase **[2]** to both of the conditionalities that follow, implementing the subordination by a solvency condition outside of a winding up, and by the new payability condition in a winding up.

(3) The Judge should not have concluded (at [231]) that '[t]*he subordination provision thus altogether fails to qualify its relative priority in relation to claims that are subordinated by methods other than by reference to a "notional share" or the "holder of a notional share"*'. He should instead have concluded that the qualification is provided by Phrase **[2]**, which qualifies the Amended LBHI2 Sub-Notes' priority by reference to its Senior Creditors, who continued to be defined in exactly the same terms under Phrases **[25]** to **[30]**.

(4) If the Judge had treated the new payability condition in the Amended LBHI2 Sub-Notes consistently with his approach to the solvency condition in Claim C and Claim D, he should have concluded that the new payability condition cannot alter the *pari passu* ranking which subsisted as a result of the LBHI2 Sub-Notes' simple contractual subordination provisions under Phrases **[2]** and **[25]**.[78]

[78] Judgment, [253].

(5) The Judge's bifurcation of Condition 3(a) and his conclusion that the LBHI2 Sub-Notes rank behind all subordinated debt gave insufficient regard to Phrases **[25]** to **[30]**, which provide in terms that the LBHI2 Sub-Notes can rank *pari passu* with other subordinated debts.

61. Second, the Judge erred in concluding that the amendments altered the identity of the creditors to which the LBHI2 Sub-Notes are subordinated. He should have concluded that the amendments only described ranking from the "bottom up"[79] and left the ranking from the "top down" the same:

(1) Having correctly found that: (a) the new Phrase **[11] [C3/42/741]** is "*phrased in language alien to subordination ("above", rather than "below")*", (b) that "*all this provision does is make clear that the rights of the Noteholders do not fall below those of any shareholder*"[80] and (c) that the effect of Phrases **[12]** and **[15] [C3/42/741]** were that "*the Noteholders are not subordinated to other deemed preference shares*", the Judge went on incorrectly to conclude that:

> "*the rights of the Noteholders rank above all shareholdings, but **below** <u>all</u> debt – <u>including subordinated debt</u> – <u>except</u> for debt that has a subordination provision similar to the deeming provisions used by the Noteholders themselves for the purposes of subordination*" (Judgment [231] original underlining with emboldening added).

(2) That conclusion does not follow from what the Judge held to be the effect of Phrases **[11]**, **[12]**, and **[15]**, which only concerned the ranking of the LBHI2 Sub-Notes "above" certain defined categories, but in no way altered "below" which categories the LBHI2 Sub-Notes are subordinated. The "*below*" question continued to be addressed by Phrase **[2]**, resulting in the same outcomes as pre-amendment as described in Section G above.

(3) Moreover, the unchanged definition of "*Senior Creditors*" in Phrases **[29]-[30]** continued to exclude the same categories.[81] The Judge's conclusion at [231] is therefore inconsistent with the express language of the LBHI2 Sub-Notes. For instance, on the Judge's analysis, a subordinated debt which expressly stated that it was junior to the LBHI2 Sub-Notes would nevertheless be a "Senior Creditor"

[79] These concepts are described more fully by Mr Grant in his evidence: see Grant 1, [52]-[53] **[S1/1/19]**.
[80] Judgment, [229].
[81] These are in the same terms as Phrases **[15]-[16] [C3/41/723]** in the Unamended LBHI2 Sub-Notes.

unless it contained a similar deeming mechanism to Claim B. That cannot be the case.

62. Third, the Judge erred in his treatment of the Confirmatory Note **[C3/42/741]**, mischaracterising it as a matter of law and/or adopting a construction that was inconsistent with the account of the transaction provided by the Confirmatory Note. The Judge should have construed the Confirmatory Note as stating that the LBHI2 Sub-Notes continued to rank above any securities qualifying as UT2 capital (including any UT2 debt), using the account it provided of the transaction as a starting point, and then proceeding to compare it with his conclusion. If he had done so, he would have revisited and/or altered his conclusion that the LBHI2 Sub-Notes rank *below* all UT2 debts, except those using a preference share "*deeming provision*". In particular:

(1) The Judge erred in treating the Confirmatory Note in the same way as a Recital. Instead, in the regulatory context of the LBHI2 Sub-Notes, he should have started with the assumption that the Confirmatory Note was giving an accurate account of the effect of the amendments to Condition 3(a).[82]

(2) If the Judge had correctly construed the Confirmatory Note he would have noted that his conclusion on ranking was at odds with the Confirmatory Note. It provides in terms that the intention was for the LBHI2 Sub-Notes to continue to rank above "*any securities*" that qualify as Upper Tier 2 capital, which includes any Upper Tier 2 debt. Against this, the Judge's conclusion was to the effect that *all* UT2 securities (including all undated subordinated UT2 debt),[83] except UT2 debt which uses a so-called preference share deeming provision, rank above the LBHI2 Sub-Notes (which are agreed to have been LT2 debt at all times).[84]

(3) Accordingly, the Judge was incorrect when he said '*It does not appear to me that this meaning is gainsaid by the "recital"*'[85] in respect of his conclusions. His conclusions on the effect of the amendments at [231], [238] and [243] directly contradicted the account provided by the Confirmatory Note.

[82] This was the position of SLP3 at trial (Day 9, page193/22 **[S2/57/601]**). See Investors Compensation Scheme [1997] UKHL 28 at pages 913-914.
[83] Consistent with PLC's Closing Note [83].
[84] As confirmed by A&O's confirmatory letter dated 17 June 2008 **[S2/35/501]**.
[85] Judgment, [231].

63. Fourth, the Judge erred in law by failing to check the rival constructions against the provisions of the contract and their commercial consequences.[86] Most significantly, the Judge did not have sufficient regard to the fact that, on his construction, *outside* a winding up the LBHI2 Sub-Notes rank senior to the LBHI2 Sub-Debt but *inside* a winding up, the opposite position pertains.[87] That consequence was highly improbable from a commercial perspective.

64. The correct contractual analysis in relation to the interaction between the key unamended subordination wording in the LBHI2 Sub-Notes and the LBHI2 Sub-Debt is set out above in Section G. That *pari passu* outcome, by either route described, continued to pertain as a matter of contract following the amendments to the LBHI2 Sub-Notes in 2008: there was no introduction of an entirely 'new' substantive subordination regime or a re-ordering of who Claim B's Senior Creditors are. Indeed, that definition remained the same. The Judge therefore ought to have concluded the Amended LBHI2 Sub-Notes rank *pari passu* with the LBHI2 Sub-Debt.

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

65. Further, the Judge erred in law by not addressing the relevant audience for the instruments he was construing. If the Judge had done so, he would have concluded that the instruments were addressed to the Lehman Group for the same reasons as above at paras 50 to 52. In this context, there were at least two aspects of the factual matrix which the Judge overlooked, both of which offered strong support for the *pari passu* construction.

(1) First, he did not take account of the purpose of the transaction (In LB Re Financing No 3 Ltd v Excalibur). In all of the principal documents documenting the decision to approve or assent to the amendments to the LBHI2 Sub-Notes, the purpose of those amendments was unequivocally stated to be to allow LBHI2 to defer cash settlement of the interest on the LBHI2 Sub-Notes at its discretion.[88] That purpose

[86] See Lord Collins in Re Sigma Finance Corp [2009] UKSC: "*In complex documents of the kind in issue there are bound to be ambiguities, infelicities and inconsistencies. An over-literal interpretation of one provision without regard to the whole may distort or frustrate the commercial purpose*".

[87] This is because Phrase **[7] [C3/42/741]** meant that the solvency condition to payment was only disapplied in a "winding-up", and the notional preference share language was only engaged in a "winding-up", which included LBHI2's distributing administration. On the Judge's (incorrect) approach, the "old" mechanism results in Claim B ranking senior to Claim A, whereas the "new" mechanism results in Claim A ranking senior to Claim B.

[88] In his section entitled "*Factual history giving rise to the modifications*" (which the Judge treated, set out at [199], as both factual matrix for construction purposes and relevant background for the question of rectification)

did not involve the Ranking Alteration.

(2) Second, the Judge gave no weight to the *pari passu* ranking of the LBHI2 Sub-Debt and the Unamended LBHI2 Sub-Notes, which he should have found was the pre-existing ranking between Claim A and Claim B.

66. Had the Judge considered this relevant background, he would have concluded that the amendments to Condition 3(a) did not have the effect of altering the relative ranking of Claim A and Claim B, and that they continue to rank *pari passu*.

67. Alternatively, and despite having acknowledged that the relevant audience were "*participants in the banking/financial services*" sector, the Judge failed to take account of relevant background which would have been very familiar to the relevant audience. In particular, he did not consider the following: (a) the LBHI2 Sub-Debt and the Amended LBHI2 Sub-Notes were all either LT2/Tier 3 regulatory capital; (b) the prevailing custom in the market was that LT2/Tier 3 regulatory debt ranked *pari passu* (in the absence of clear wording to the contrary); and (c) the general market expectation was for UT2 regulatory capital to rank *junior* to LT2 regulatory capital.[89]

68. The Judge overlooked these important elements of the factual matrix. He was wrong to do so. Taken together, they are a strong indication *against* the Judge's stated conclusion that (a) the Amended LBHI2 Sub-Notes (which are LT2 debt) rank junior to <u>all</u> subordinated debt, <u>including UT2 debt</u> (with one exception); and (b) that the Amended LBHI2 Sub-Notes rank junior to (as opposed to *pari passu* with) the LBHI2 Sub-Debt. The Judge therefore ought to have concluded that the Amended LBHI2 Sub-Notes rank *pari passu* with the LBHI2 Sub-Debt.

I. RECTIFICATION OF THE AMENDED LBHI2 SUB-NOTES

69. Alternatively, if on a proper construction the amendments to the LBHI2 Sub-Notes resulted in the Ranking Alteration, the Judge ought to have ordered that the amendments to the subordination provision be rectified for common mistake. The materials before the Court demonstrated that the intention behind the 2008 Amendments was no more and no less than to enable LBHI2 to defer payment of interest on the LBHI2 Sub-Notes as part

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the Judge acknowledged that this was the purpose of the amendments (at [204]) and that it was a "*tax-motivated project*" (at [213]).

[89] See the evidence of Mr Grant (Day 2, page 138/5-page 139/1) **[S2/52/552]**.

of a discrete, US tax-driven project. If the amendments altered the relative ranking of the LBHI2 Sub-Notes then, by mistake, this ran contrary to the common intention. The LBHI2 Sub-Notes Circular should be rectified accordingly.[90]

70. SLP3 advances five grounds of appeal in respect of which it respectfully submits that the Judge erred as a matter of law and/or fact.

71. First, the Judge failed to have regard to evidence that was both relevant and admissible for the purposes of rectification. He (incorrectly) addressed[91] the rectification issue by reference to the same factual history he had relied upon when addressing the construction issue. This approach appears to have caused him to overlook much of the relevant evidence that would have otherwise been admissible on SLP3's rectification claim.

72. Second, the Judge did not address the legal issue concerning the proper characterisation of the relevant common intention in cases where amendments to pre-existing contracts have resulted in unintended legal consequences. In this regard:

    (1) A key question before the Judge was whether SLP3 must show: (a) (as PLC contended) actual consideration by the parties of the legal consequence they did not intend (i.e. positive proof of a specific intention/decision not to effect the unintended consequence) or (b) (as SLP3 contended) actual intention for the amendments to do no more and no less than have a specific/limited legal effect, such that it necessarily follows that the decision makers did not actually intend to make the further legal change sought to be rectified. The Judge adopted the former, more stringent test, requiring SLP3 to prove that LBHI2/SLP3 had a positive intention in relation to relative ranking.

    (2) SLP3 contends that this was the wrong approach to the characterisation of the nature/extent of the requisite intention. In this regard, the amendments to Condition 3(a) of the LBHI2 Sub-Notes Circular were made to a pre-existing contractual scheme which resulted (on the Judge's construction) in a fundamental legal change to the ranking of US$6,139,000,000 of subordinated debt where (a) the Ranking Alteration had not been discussed internally within the Lehman Group and (b) the

[90] In the manner set out in SLP3's Position Paper [30(4)] **[C2/32/530**].
[91] See in this regard Judgment, at [262(2)] (in relation to rectification) which refers to [199]-[215] (in relation to construction).

external lawyers, A&O, had not been instructed to put the Ranking Alteration into effect.

73. Third, the Judge incorrectly found[92] that LBHI2 and SLP3 had no discernible intention beyond the words in the LBHI2 Sub-Notes. The evidence showed that the common intention in respect of the amendments was solely to permit the deferral of the payment of interest on the LBHI2 Sub-Notes in order to achieve a discrete US tax benefit.[93] In this respect, the Ranking Alteration was an unintended mistake, running contrary to the (far more limited) intention in respect of the amendments.

74. Fourth, the Judge incorrectly found that the Lehman Group would have been "*indifferent*" to the Ranking Alteration (and that it would have elicited the response "*So what?*"). This was plainly wrong.

75. Fifth (and by way of analogy with the pensions cases), there was no requirement to prove an outward expression of accord at all; alternatively, based on the evidence, the Judge was wrong to find that there was no outward expression of accord.

J. THE JUDGE'S REASONING ON RECTIFICATION

76. As regards the amendments to the LBHI2 Sub-Notes, the Judge found that the LBHI2 Sub-Notes Resolution dated 3 September 2008 properly altered the terms of the LBHI2 Sub-Notes Circular in accordance with Condition 12 of the LBHI2 Sub-Notes Circular **[C3/41/728]**. No party contended otherwise. The LBHI2 Sub-Notes Resolution, which took effect as an Extraordinary Resolution pursuant to Condition 12, provided that SLP3 "*assent[ed]*" to the proposed amendments to the LBHI2 Sub-Notes Circular (in the same way that the consent of the employer needs to be obtained in amendments to pension schemes). This amounted to the requisite noteholder "*sanction*" in respect of a Reserved Matter by Extraordinary Resolution within the meaning of Condition 12.[94]

77. The Judge summarised the three reasons why SLP3's rectification claim failed at [260]:

    (1) First, he found that "*[t]here is no discernible intention on the part of the Issuer [LBHI2] regarding the drafting of the LBHI2 Sub-Notes going beyond the words*

[92] Judgment at [263] and [267].
[93] SLP3's Trial Submissions at [452] **[S1/8/219]**.
[94] Judgment at [201(2)].

contained in the notes themselves" (at [260(1)]).

(2) Second, he concluded that "*[t]here is no discernible intention on the part of the Noteholders [SLP3] beyond the words contained in the instruments themselves"* (at [260(2)]).

(3) Third, he held that "*[t]here is no subjective continuing common intention manifested by an outward expression of accord*" (at [260(3)]).

78. In addition, the Judge made a subsidiary finding in relation to LBHI2's and SLP3's intention regarding the relative ranking of the LBHI2 Sub-Notes, and upon which he placed a great deal of emphasis:

(1) He found that relative subordination was "*a matter that simply was not considered by LBHI2 <u>at all</u>*" (Judgment at [262], original emphasis). By implication, the Judge therefore concluded that it was a legal requirement for SLP3 to show that LBHI2 and SLP3 had given actual and/or positive consideration to relative subordination during the amendments process.

(2) He further considered at [262(4)] the hypothetical question of how LBHI2 would have reacted if they had been informed of the Ranking Alteration. The Judge concluded that the response would have been "*So what?*", and that "*it would have been a matter of indifference to the Lehman Group as a whole, and to LBHI2 in particular, which subordinated creditor ranked above or below which other subordinated creditor*". The implication was that it was a further requirement for SLP3 to show that the Lehman Group would (hypothetically) not have been indifferent had it been informed of the Ranking Alteration.

79. In this context, the Judge concluded that the requisite intention for rectification purposes was not present anywhere within the Lehman Group.[95] SLP3 contends that the relevant individuals in the Lehman Group had the requisite subjective intention necessary to satisfy the requirements for rectification, and that their subjective intention falls to be attributed to SLP3 and LBHI2 in this case.[96]

[95] Judgment at [269].

[96] Ms Dolby and Ms McMorrow were in reality either the relevant decision makers in relation to the transaction on the reality of the facts or, alternatively, their intentions were ultimately adopted by or shared with the technical

K. THE RECTIFICATION MATERIALS BEFORE THE COURT

80. SLP3's rectification claim was set out in its Position Paper at [30] **[C2/32/530]**; its Reply Position Paper at [52]-[58] **[C2/37/655]**; its Trial Submissions at [406]-[471] **[S1/8/204]**; and its Reply Rectification Written Closings. A key document also lodged at trial was SLP3's rectification chronology (the "**Rectification Chronology**") **[S1/12/291]**.[97]

81. In making his factual findings in Section F(5) (at [214]-[215]), the Judge did not refer to the Rectification Chronology or, more importantly, to the bulk of the relevant and admissible documentary evidence which it summarised. Further, the Judge's findings that no one within the Lehman Group had any discernible intention in respect of the amendments to the LBHI2 Sub-Notes overlooked and/or was at odds with the following five evidential matters.

82. First, the written/oral evidence of the key Lehman Group decision-maker, Ms Dolby (who was the European tax lead with overall conduct of the amendments), as to her actual intention in relation to amendments. The Judge did not refer to Ms Dolby's evidence of her intention despite her having (as the Judge accepted) co-ordinated the issue of the LBHI2 Sub-Notes and having been closely involved in the amendments process.[98] Ms Dolby provided a witness statement, was interviewed by the parties ahead of trial,[99] and was cross-examined. Despite finding her to be a straightforward and honest witness,[100] the Judge did not explain how his finding that there was no discernible intention regarding the LBHI2 Sub-Notes was consistent with her clear evidence to the contrary.[101]

83. Second, the history of the draft amendments shared with the Lehman Group and the internal correspondence within the Lehman Group relating to the purpose of the

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decision makers, the board of directors of LBDI and LBHI2: see Murray Holdings Ltd v Oscatello Investments Ltd [2018] EWHC 162 (Ch), at [198] (Mann J).

[97] This summarised in chronological order the documentary materials before the Court going to rectification, as well as the oral evidence given at trial.

[98] Judgment at [213].

[99] This was conducted on 10 April 2019 (the "**Dolby Interview**") **[S1/4/36**].

[100] Judgment at [44].

[101] For example: Ms Dolby accepted that she had no issue with Condition 3 in its original form in the Unamended LBHI2 Sub-Notes (Day3/66/8-11**[S2/54/561]**). When asked in cross-examination "*All you intended was that interest should be deferred or could be deferred?*", Ms Dolby replied "*Yes*" (Day3/110/13-18 **[S2/54/567]**), and see (Day3/131/10-14 **[S2/54/570]**), (Day3/135/4-7 [**S2/54/571]**). Ms Dolby also confirmed that she was not aware of any intention to change the ranking of the LBHI2 Sub-Notes (Dolby Interview, page 20, line 11**[S1/4/55]**) and that if there had been an intention to alter ranking, she would have expected it to be mentioned in the LBHI2 board minutes (Dolby Interview, page 20, line 3 **[S1/4/55]**).

amendments. In particular, the Judge did not refer to the first draft of the amendments that was attached to Mr Grant's email to the Lehman Group dated 5 June 2008 (the "**First Draft**") **[S2/24/419]**.[102] The First Draft did not amend the relevant subordination provision (Condition 3) in any way, and Ms Dolby and Ms McMorrow[103] were satisfied that the amendments achieved the limited purpose intended.[104]

84. Subsequently, when the approval of SLP3's general partner was needed, a draft consent (the "**Delaware Draft Consent**") **[S2/43/521]** was emailed to a director, with a covering email which stated that "*Jackie [Dolby] has been looking at amending the terms of [the LBHI2 Sub-Notes] issued by [LBHI2] to [SLP3]*" and that "*The Change will allow [LBHI2] to defer payment to SLP3 under the [LBHI2 Sub-Notes]*".[105] It recited that "*The purpose of the amendment is to allow the Issuer to defer payment of interest on the [LBHI2 Sub-Notes] at its discretion*". Other important contemporaneous documents describing materially the same limited intention in respect of the amendments included the A&O Corporate Benefit Memorandum **[S2/30/446]**,[106] and the A&O 2008 Confirmation **[S2/35/501]** confirming the LT2 status of the LBHI2 Sub-Notes.

85. Third, the account of the amendments provided to third parties, namely, the FSA[107] and the Channel Islands Stock Exchange,[108] which only referred to the intention to permit the deferral of interest payments on the LBHI2 Sub-Notes.

86. Fourth, the instructions given by the Lehman Group to the draftsman at A&O, Mr Thomas Grant. Ms Dolby agreed that the sole instruction to A&O was to defer interest and that she "*wasn't aware that anyone else was directing A&O to change anything else*".[109] She was clear that A&O were not instructed to provide tax advice and that

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[102] Rectification Chronology, at [8] ff **[S1/12/292]**.
[103] Ms McMorrow was a senior lawyer within the Lehman Group (at [205).
[104] "*We don't have any comments other than the holder on the resolution…*": Ms McMorrow's email of 10 June 2008 to Mr Grant **[S2/25/431]**.
[105] Rectification Chronology, at [73] **[S1/12/312]**.
[106] Rectification Chronology, at [34] **[S1/12/299]**.
[107] Rectification Chronology, at [51] **[S1/12/306]**. The Lehman Group emailed the FSA on 11 July 2008 **[S2/39/516]** to explain that "*It is our intention to amend the terms of the notes to allow deferral of the cash payment for the interest on the notes*". When an associate at the FSA asked the Lehman Group to elaborate on the rationale for the change, Ms Dolby drafted a response which recorded that: "*The change to the terms of the notes is to provide Lehman with flexibility around their US tax planning*".
[108] Rectification Chronology, at [76] **[S1/12/313]**. Mr Grant emailed the Channel Islands Stock Exchange on 3 September 2008 **[S2/48/529]** to explain that "*The Issuer and the sole investor (resolutions attached) agreed to insert provisions to allow the Issuer to defer payments of interest on the Notes at its discretion*".
[109] Dolby Interview, page 18, lines 31-32 **[S1/4/53]**.

there were no concerns about the LBHI2 Sub-Notes' tax deductibility.[110] Further, Ms Dolby specifically did not accept that she would simply agree to any drafting carried out by A&O. On the contrary, she accepted that if the effect of the amendments was the Ranking Alteration, then this would have been to the disadvantage of SLP3 and she said she would have thought SLP3 would have needed to consider it.[111] For his part, Mr Grant confirmed that he was not instructed to alter the ranking of the LBH2 Sub-Notes, that the amendments he drafted were not intended to cause any kind of Ranking Alteration and that they were intended to "*preserve the status quo*" (Grant 1, [53] **[S1/1/19]).**

87. Fifth, the complete absence of any discussion relating to the Ranking Alteration in *any* contemporaneous document. The Judge appears (incorrectly) to have taken this as a point *against* SLP3 (at [262]) rather than as a point militating against an intention to effect the Ranking Alteration.

88. A review of Section F(5) of the Judgment shows that all of the materials referred to above were overlooked by the Judge such that, when he concluded that LBHI2 and SLP3 had "*no discernible intention…beyond the words contained in the instruments themselves*", he gave no weight to contradictory witness evidence or the contemporaneous documents going to actual intention. The materials above show, separately or cumulatively, that there was a clearly "*discernible intention*", which was limited to permitting the deferral of the payment of interest on the LBHI2 Sub-Notes in order to achieve a discrete US tax benefit.[112]

L. RECTIFICATION - THE LAW

FSHC CA

89. As set out in FSHC Group Holdings Ltd v GLAS Trust Corporation Limited [2019] EWCA Civ 1361 ("**FSHC CA**") (see Judgment, at [258]) at [176], it is necessary to show: (a) the existence of a *subjective* continuing common intention; and (b) that this is manifested by an outward expression of accord (except where there is an antecedent

[110] "*A&O weren't my tax advisors*", Dolby Interview, page 22, line 15 **[S1/4/57]**. There was no engagement letter to provide a tax opinion (Dolby Interview, page 35 **[S1/4/70**]), and the Lehman Group had already obtained a tax opinion on the whole structure before implementing it such that any advice on tax deductibility "*probably wasn't A&O's call*" (Dolby Interview, page 22, lines 1-2 **[S1/4/57]**).
[111] (Day3/103/21–104/1) **[S2/54/565]**. See also: (Day3/104/2-7 **[S2/54/565]**); (Day3/92/11 **[S2/54/562]**); (Day3/92/15-16) **[S2/54/562]**.
[112] SLP3's Trial Submissions at [452] **[S1/8/219]**.

contract) in order to rectify a contract for common mistake.

Rectifying Amendments – Preliminary

90. Despite SLP3's written and oral submissions on this topic at trial,[113] the Judge's review of the authorities did not consider the particular issues that arise in the application of the general requirements where the rectification is of amendments to a pre-existing contractual scheme.

91. SLP3 contends that the Judge was wrong not to consider this point in circumstances where:

(1) As the Judge himself specifically acknowledged, the rules of employee pensions schemes are "*an excellent example*" of instruments which "*contain specific provisions regarding their own amendments, as the terms of the [LBHI2 Sub-Notes] do here*."[114] However, and despite accepting that "*[s]uch provisions can affect the rules regarding rectification"*[115] the Judge did not go on to consider *in what way* the rules regarding rectification apply to an amendments case.

(2) In FSHC CA, the Court of Appeal highlighted the particular considerations that arise in the context of rectification of amendments (as opposed to where there is a new contract). For example:

(a) Leggatt LJ accepted that it was a significant aspect of the case before the court that, "*the parties were not negotiating a new contract from scratch. The relevant commercial negotiations had taken place some four years earlier, in 2012, when the terms of the FSHC acquisition had been agreed*" (at [187]).

(b) Further, Leggatt LJ gave specific consideration to a line of pensions cases in connection with the requirement of an outward expression of accord. He noted that in pensions cases "*involving the rectification of amendments*" the scheme trustees have the power to alter the scheme rules provided they obtain the employer's *consent*, without there being a requirement for the parties to *agree* to a change of rules (much like Condition 12 of the LBHI2 Sub-Notes

[113] See SLP3/LBHI's Reply Position Paper at [53(2) **[C2/37/655]**], [57(5) **[C2/37/659]**]; SLP3's Trial Submissions, [416]-[419] **[S1/8/205]**, [448] **[S1/8/218**], [460] **[S1/8/221]**; and Reply Rectification Written Closings **[S1/14/330]**.
[114] Judgment at [257(3)].
[115] Ibid.

in this case). Leggatt LJ accepted that in these cases it is not necessary to show an outward expression of accord (at [78]-[79]).

Rectifying Amendments – the Relevant Intention

92. SLP3 contends that it is generally more likely that parties amending limited or specific aspects of an existing contractual arrangement will have the requisite actual common intention *not* to alter a pre-existing contract save in a specific respect. This is to be contrasted with parties entering new contracts from scratch, who may well have no discernible intention as regards certain clauses of the agreement.[116]

93. If the Judge had considered the specific issues arising in relation to the relevant common intention in the context of amendments, he should have identified the following principles and then applied them to the facts:

    (1) First, where an existing contract is amended, if it can be shown that the relevant decision makers had a subjective intention *only* to make a specific and limited legal change to an existing contractual arrangement ("**X**"), then it necessarily follows that the decision makers did not actually intend to make a further legal change ("**Y**"). If, on an objective construction of the amended contract, the effect of the amendment *is* to result in change Y, then it follows that change Y was a mistake in circumstances where the decision makers only ever actually intended to effect change X; and

    (2) Second, and related to this, where change X has been the subject of significant preparation, discussion and advice, and change Y has never been discussed at all, the absence of any discussion about Y may itself be compelling evidence that the parties did not *subjectively* intend it.

94. Both of these propositions can be derived from case-law (and accord with both principle and common sense).

[116] FSHC CA at [149]: "*In many, if not most, cases in which parties to a contract disagree about how it should be interpreted, it is likely, if not certain, that they had no relevant intention when they entered into the contract that the particular clause should have the particular effect for which they later contend – let alone a common intention in that regard which they had communicated to each other*".

95. The first principle was clearly articulated by Lawrence Collins J in AMP (UK) Plc v Barker [2001] Pens LR 77 at [67] (as well as in the authorities cited at [417] ff. of SLP3's Trial Submissions):[117] Lawrence Collins J held at [67] that:

"…*what AMP has to show convincingly is a continuing common intention by the trustees and the NP1 to affect only incapacity benefits. It is clear from the factual findings that there is overwhelming evidence that their intentions were limited to improving the benefits for those leaving on account of incapacity…If objective manifestation of their intentions is a separate requirement then there can be no doubt that it is fulfilled in abundance*" (emphasis added).

96. Put another way, Lawrence Collins J accepted that the requirement was to show a common continuing intention *only* to effect change X. He did not require AMP to show actual (and positive) consideration of change Y, the unintended consequence in question, in order to obtain rectification. This principle was recently applied by Trower J in Univar UK Ltd v Smith [2020] EWHC 1596 (Ch) at [213] and [239]-[240]. Trower J specifically considered that AMP (UK) v Barker was compatible with a subjective approach to intention (at [210]).

97. The second principle was applied by Henry Carr J in FSHC HC where he said (in relation to the pensions cases) that "*if it can be seen from the evidence that the change in question was never discussed at all, the absence of discussion may itself support the conclusion that the parties did not intend to make that change*" (at [46]). However, he went on to conclude that "*I do not accept that the principle is confined to pension cases*" (at [47]), and concluded that "*the authorities illustrate the proposition that, where an important change is made to an existing arrangement between the parties, the absence of any discussion of that change may itself be evidence that the parties did not intend it*".[118]

98. Significantly, this principle also appears to have been approved by the Court of Appeal in FSHC CA in the context of ascertaining a subjective (rather than merely objective) intention. At [191], Leggatt LJ undertook a review of the evidence as to *objective* intention and identified as a "*compelling factor*", "*the absence of any discussion of such a fundamental change to the structure of the transaction"*. However, he had prefaced this

[117] See also Vos J in Industrial Acoustics Company Ltd v Crowhurst [2012] EWHC 1614 (Ch), at [45]: "…*it seems to me that there will be cases, particularly in the pensions context, where it will be permissible to allow rectification when one can say by implication perfectly clearly that the parties did not intend by the Deed they entered into, to effect a particular change, even though they had not stated outwardly to each other (or indeed at all) that they did not intend to effect that change, simply the change was not in any form discussed*" (emphasis added); and Blatchford Limited v Blatchford & Ors [2019] EWHC 2743 (Ch), at [26].

[118] In Univar v Smith, Trower J specifically accepted the proposition expressed by Henry Carr J at [47] in FSHC HC, which he went on to apply when considering the parties' subjective intentions in that case (at [214]).

objective analysis by saying that the factors considered at [186] to [192] were "*relevant…in making the factual findings that [Carr J] did about what the parties actually understood and intended*".[119]

99. In these cases (which, like the current case, concern amendments), it was no part of the legal test for rectification to show either (a) actual and/or active consideration of the unintended legal consequence in question, or (b) that had the parties hypothetically been made aware of that unintended legal consequence, then they would have insisted that the drafting be amended to rectify the position.

100. Instead, the cases adopt a pragmatic approach to the identification of the relevant common intention which involves, as part of that exercise, establishing the scope of the limited change that the parties intend ("X"), which necessarily means that they do not have a common intention to effect change "Y", particularly where change "Y" is a fundamental legal change to a pre-existing scheme which has not been discussed at all.

M. RECTIFICATION – GROUNDS OF APPEAL

(1) Failure to consider relevant evidence

101. The Judge erred in not having regard to the evidence that was both relevant and admissible for the purposes of rectification.

102. In this regard, he erred by concluding that it was unnecessary to consider the detailed documentary and oral evidence that was before the Court, as summarised at paras 81 to 88 above, which went to the relevant intention concerning the amendments to the LBHI2 Sub-Notes. By so doing, the Judge wrongly failed to have regard to evidence that was both admissible and relevant to the rectification issue when he reached his primary conclusions on common intention at [260]. The Judge instead limited himself to the relatively narrow factual history in Section F(5) of the Judgment (which section addressed construction, not rectification).

103. It is accepted that an appellate court is bound to assume that a trial judge has taken the whole of the evidence into his consideration unless there is compelling reason to the contrary: Henderson v Foxworth Investments Ltd [2014] 1 WLR 2600 at [48]. However,

[119] FSHC CA at [183].

as Lord Sumption said in Volcafe Ltd v Cia Sud Americana de Vapores SA [2018] UKSC 61, [2018] 3 WLR 2087 at [41], that approach gives way in a number of circumstances, which include a failure to take evidence into account.

104. In this context, in Simetra Global Assets Ltd v Ikon Finance Ltd [2019] EWCA Civ 1413 at [48]-[49], the Court of Appeal explained that the trial judge is under a positive obligation to explain why apparently relevant evidence is overlooked and/or not taken into account.

105. In the current case, the Judge considered that it was "*convenient*" to set out the history of the amendments in Section F(5) for the purposes of *both* construction and rectification (Judgment at [125(4)]), because "*there may be something in the factual history that has a bearing on construction…but also because such points are relevant to the question of rectification…It is convenient to set out the modification and their history in one place*" (at [199]). This approach is to be contrasted with the more common approach where the evidence relevant to construction and rectification are addressed *separately* in a judgment to "*guard against illegitimate transgression of evidential boundaries*" (Murray v Oscatello [2018] EWHC 162 (Ch), per Mann J at [14]).

106. Moreover, when the Judge set out the factual history in Section F(5), he said at [211] of the key discussions within both A&O and also within the Lehman Group that: "*I simply do not consider it material to set out these communications and discussions, to the extent they were in evidence*". This was a critical omission in the context of a rectification claim. For, while such discussions may well have been both inadmissible and therefore immaterial for construction purposes, that would not have been the case in relation to rectification. Thus, when the Judge turned to consider common intention and rectification at [262] ff. he simply cross-referred to the "*factual history behind the modifications – set out in paragraph 204ff*" (at [262(2)]). By proceeding in this way, the Judge clearly fell into error, with the approach leading him not to consider relevant and admissible evidence regarding actual intention for the purposes of SLP3's rectification claim.

(2) The Relevant Intention

107. The Judge erred in law and did not address the critical legal issue of the proper characterisation of the relevant common intention in cases where amendments to pre-existing contracts have resulted in unintended legal consequences.

108. The Judge proceeded on the basis that positive proof of a specific intention not to effect an alteration to ranking was necessary and/or that the Lehman Group would hypothetically have insisted on the drafting being amended in the counterfactual where it was informed of the Ranking Alteration at [262(4)]. This required SLP3 to prove a negative.

109. As set out above, the Judge's approach is inconsistent with the principles referred to above, including: (a) the principle to be drawn from the pensions cases (e.g. AMP (UK) Plc v Barker and Industrial Acoustics Company Ltd v Crowhurst) that where there is an amendment the only requirement is to show a common intention *only* to effect change "X"; (b) the finding of Henry Carr J in FSHC HC at [47] that the absence of discussion supports the conclusion that the parties only intended to effect change "X", and not change "Y" (which is not restricted to pensions cases); (c) the finding by the Court of Appeal in FSHC CA at [191] that absence of discussion is a "*compelling factor*" in the identification of the relevant common intention; and (d) the approach taken by Trower J in the recent case of Univar v Smith.

110. The Judge ought to have considered these principles, given both that this is an amendments case and given the close analogy with the pensions cases (noting that the mechanism of the assent provision in Condition 12 of the LBHI2 Sub-Notes operates analogously to the consent mechanism in the pensions context).

111. The Judge misdirected himself as to the necessary relevant intention by focussing on whether it had been shown that LBHI2 and SLP3 had a specific subjective intention regarding relative ranking (see at [262] ff.). However, this was not the relevant intention that SLP3 was required to show: it was sufficient clearly to demonstrate that there was an intention to do no more and no less than permit the deferral of interest payments on the LBHI2 Sub-Notes. In this regard:

    (1) The Judge did not address submissions made by SLP3 on how general rectification principles apply in the context of amendment cases (specifically with reference to the pensions cases cited to him).

    (2) As a result, the Judge misdirected himself on the law, causing him to observe that: "*I can see no evidence of any intention…as to how the Notes, as subordinated debt,*

should rank as against other subordinated debt issued by LBHI2".[120] There was no legal requirement for SLP3 to prove this.

(3) The Judge then addressed the "*hypothetical*"[121] question of how the Lehman Group would have reacted to being informed about the Ranking Alteration. That was plainly not a question concerned with the parties' *actual* intention, arising on what the Judge accepted was necessarily a counterfactual scenario where the Lehman Group had been informed by A&O (whose evidence was that they intended to preserve the ranking status quo) that they were altering the ranking of the LBHI2 Sub-Notes in a winding-up of LBHI2.

(4) By requiring SLP3 to prove that it had given active consideration to the unintended legal consequence in question, the Judge did not have regard to or apply the two propositions set out at para 93 above i.e. (a) where, as here, it can be shown that there is an intention only to achieve change "X", then it necessarily follows that the decision makers did not actually intend to make a further legal change "Y"; and (b) the absence of any discussion about a fundamental change, such as the subordination of the LBHI2 Sub-Notes to all other subordinated debt (with limited exceptions), is evidence of an actual intention not to make the change.

(3) "No discernible intention"

112. The Judge erred in finding[122] that LBHI2 and SLP3 had no discernible intention beyond the words in the LBHI2 Sub-Notes. The Judge should have found that the relevant common intention was – no more and no less – than to permit the deferral of the payment of interest. This intention was clear from all of the materials summarised at paras 81 to 88 above, and which the Judge did not have regard to as a result of his approach to the rectification evidence.

113. These materials contradicted the Judge's finding that the Lehman Group's intention as regards the amendments was at large. On the contrary, the materials before the Court plainly showed that the intention was limited and targeted towards permitting the deferral of interest payments on the LBHI2 Sub-Notes.

[120] Judgment at [252].
[121] Judgment at [262(4)(d)].
[122] Judgment at [260], and [263] and [267].

114. Further, it is not clear that the Judge's primary findings are consistent with his own analysis expressed elsewhere in the Judgment. The Judge said at footnote 230:

"*That is my conclusion even if the draft minutes referred to in paragraph 212*[123] *can be said accurately to state the purpose of the modifications. I am quite prepared to proceed on the basis that this was the intention behind the modifications. But that does not mean to say that that is all the modifications achieved*." (emphasis added).

115. If the Judge was prepared to accept this as the intention behind the modifications, it is not clear how it could be said that neither LBHI2 nor SLP3 had any discernible intentions regarding the amendments (see Judgment [260], [263] and [267]). Moreover, the statement "*But that does not mean to say that that is all the modifications achieved*" is precisely the point SLP3 relies on: the modifications achieved something different to what was actually intended, which is the classic basis for rectification (see FSHC CA [149] and [151]).

(4) "So what?"

116. The Judge erred in finding that the Lehman Group would have been "*indifferent*" to the Ranking Alteration (and that it would have elicited the response "*So what?*"): see Judgment at [262(4)] and [262(4)(d)].

117. As to this point (which was not one that was put to Ms Dolby in cross-examination):

(1) In making these findings, the Judge did not have regard to the totality of Ms Dolby's evidence. She accepted that if the effect of the amendments was to alter ranking then it would have been to the disadvantage of SLP3, and she agreed that SLP3 would have needed to consider it (Day3/103/21–104/1 **[S2/54/565]**); and, further, that if Mr Grant had raised a priority issue, she would have needed to discuss it with the legal and regulatory departments (Day3/91/22-92/8 **[S2/54/562]**). She accepted that such a change would have warranted discussions (Day3/92/11**[S2/54/562]**). Further, Mr Grant's evidence was that he would have raised the matter of a Ranking Alteration with the Lehman Group.

[123] LBHI2's draft minutes, consistent with the rest of the evidence before the Court, described the purpose of the amendments as being "*to allow the Company to defer payments of interest on the Notes at its discretion*".

(2) Indeed, the passage of Ms Dolby's cross-examination relied on by the Judge in the Judgment at [262(4)(b)] does not suggest that such a change is something that the Lehman Group would have simply accepted and been "*indifferent*" to.

(5) Outward Expression of Accord

118. The Judge was wrong to find that there was a requirement to prove an outward expression of accord at all; alternatively, based on the evidence, the Judge was wrong to find that there was no outward expression of accord.

119. First, and by way of analogy with the pensions cases approved in FSHC CA at [78]-[79], there was no separate requirement to show an outward expression of accord in circumstances where modification of the LBHI2 Sub-Notes Circular only required SLP3's assent as noteholder (as opposed to a mutual agreement between the parties). In this regard, a convergence of intention sufficed (see AMP (UK) v Barker at [65]) (and was also consistent with the intra-group nature of the arrangements).

120. Second, and in any event, the outward expression of accord was plainly made out in circumstances where the Lehman Group decision maker's intentions regarding the amendments were not left unexpressed but communicated within the Lehman Group, to external third parties (the FSA and the Channel Islands Stock Exchange) as well as to A&O: see at paras 81 to 88 above.

N. CONCLUSIONS

121. The Court is asked to vary paragraph 1 of the Order to state that the claims of the LBHI2 Sub-Debt and the LBHI2 Sub-Notes rank *pari passu*.

MARK PHILLIPS QC

WILLIAM WILLSON

EDOARDO LUPI

South Square

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