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IN THE GRAND COURT OF THE CAYMAN ISLANDS

FINANCIAL SERVICES DIVISION

Cause FSD No. 262 of 2010 (AJJ)

The Hon Mr Justice Andrew J. Jones QC
In Open Court on 31st October and 1st November 2011



BETWEEN:

LEHMAN COMMERCIAL PAPER INC.

Plaintiff

and

ANTHRACITE BALANCED COMPANY (36) LIMITED
(In Voluntary Liquidation)

Defendant

Appearances: Mr John McCaughran QC instructed by Mr Nicholas Dunne of Walkers for the Plaintiff

Mr Richard Millett QC instructed by Mr James Eldridge of Maples and Calder for the Defendant

JUDGMENT

Introduction and the parties

1. This case arises out of the bankruptcy of the Lehman Brothers Holdings Inc and certain of its wholly owned direct or indirect subsidiaries including the Plaintiff, Lehman Commercial Paper Inc. ("LCPI") and Lehman Brothers Finance S.A ("LBF"). LCPI is incorporated in Delaware and had its principal office in New York. LBF is incorporated in Switzerland and had its principal office in Zurich. LCPI and LBF

filed for bankruptcy protection under the United States Bankruptcy Code on 15 September and 3 October 2008 respectively.

2. The Defendant, Anthracite Balanced Company (36) Limited ("ABC"), is one of a number of special purpose vehicles incorporated in the Cayman Islands as part of an investment programme arranged and promoted by the Lehman Brothers banking group, pursuant to which a company called Anthracite Investments (Cayman) Limited ("the Issuer") entered into a programme for offering notes, in different series, up to an aggregate value US\$10 billion. The present case is concerned with the *Series 38 €200,000,000 Principal Protected Notes* offered in September 2006 with a maturity date in November 2019 pursuant to an offering document dated 18 September 2006 (referred to as "the Notes" and "the Offering Circular").¹ The essential commercial features of the Notes can be described as follows –

- (a) The Notes constituted debt obligations of the Issuer, to be redeemed at maturity (on 29 November 2019) or sooner if required in accordance with their terms. At all material times the holder of the Notes was Royal Bank of Scotland Plc ("RBS").
- (b) The proceeds of the issue of the Notes (being €200,000,000) were used by the Issuer to subscribe for 20,000 Class B redeemable preference shares of €0.01 ("the Class B Shares") issued by ABC at a subscription price of €10,000 each.
- (c) ABC invested the proceeds of the issue of its Class B Shares in a structured investment programme, including the shares issued by Anthracite Master Company (6) Limited (referred to as "the Fund" and "the Fund Shares"). ABC leveraged its investment by

¹ The Offering Circular is supplemental to and is to be read in conjunction with the programme offering circular dated 17 March 2004.

borrowing an amount from LCPI pursuant to the Credit Facility, which amount is referred to as "the Loan".

- (d) The Notes bear interest in an amount based upon the performance of the Class B Shares. However, an initial interest amount of €850 per Note (of €10,000 each) was payable on the first interest payment date irrespective of the performance of the Class B Shares and this payment was funded by the Interest Advance made under the Credit Facility. The issue in this case is whether or not ABC has discharged the whole of its repayment obligations in accordance with the terms of Clause 5.4 of the Credit Facility.
- (e) The Notes were secured by, inter alia, a first fixed charge over the Class B Shares and an assignment of the rights of the Issuer under (inter alia) the Principal Protection Agreement made with LBF.

I now turn to analyse in more detail certain of the contractual documents by which the secured note programme was carried into effect, all of which were originally executed on 21 April 2005 and amended and restated on 18 September 2006. I shall refer to the amended and restated versions of the relevant contracts unless stated otherwise. All of the contractual documents are expressed to be governed by English law.

The Credit Facility

3. The Credit Facility is made between LCPI as lender and ABC as borrower. These are the only parties and by Clause 23.4 it is provided that no person shall have any rights under the agreement pursuant to the English Contracts (Rights of Third Parties) Act 1999.² Clause 1.1 provides that the

² The overall effect of this exclusion is to exclude LBF from having any rights under the Credit Facility but also, by doing so, recognized that LCPI would have no rights on behalf of LBF to enforce any interest that LBF might have in being paid by the Issuer.

words and expressions used in Credit Facility shall bear the same meaning as in the Offering Circular unless otherwise defined in the Credit Facility.

4. The Credit Facility provides for two distinct lending facilities, the purpose and terms of which are different. By Clauses 2.1 and 3.1, LCPI agreed to provide ABC with a facility for a principal amount of (potentially) 50 per cent of the principal amount outstanding on the Notes for the purpose of leveraging its investment in the Fund. The principal drawn down under this facility is referred to as an "Advance" and the total sums outstanding, including interest on each Advance under Clause 2.1, are together called "the Loan". By Clause 5.1 ABC covenanted to repay the Loan in full on the third Business Day prior to the Maturity Date (as defined). Clause 14 stipulates usual events of default, upon the occurrence of which LCPI is entitled to accelerate repayment of the Loan. This loan facility is defined in Credit Facility as "the Facility" and I characterise its provisions as a "plain vanilla loan facility agreement".

5. The second facility is quite different. By Clauses 2.2 and 3.2 LCPI made available up to €17 million to finance the special dividend due to be paid by ABC to the Issuer on the first Interest Payment Date in April 2006. The purpose of the special dividend was to enable the Issuer to pay the guaranteed interest payment of €850 on each Note, irrespective of the net asset value attributable to the Class B Shares, the performance of which determined the rate of interest which would otherwise have been payable. This loan facility is referred to in Clause 3.2 of the Credit Facility as the "Initial Interest Facility" and the amount drawn down is the "Interest Advance". The mechanism for satisfying ABC's obligation to repay the Interest Advance is stipulated in Clause 5.4 as follows –

"The Borrower will satisfy its obligation to repay the Interest Advance and pay interest thereon, by paying Recovery Fees to the Lender and/or by the deduction from

Note redemption proceeds and payment to the Principal Protection Provider of the Present Value of the Unpaid Recovery Fees.”

This clause provides for two methods of satisfying the obligation to repay the Interest Advance, each of which includes defined terms, the meaning of which are to be found in the Offering Circular.

6. The first method is the payment of periodic Recovery Fees whilst the Notes remain outstanding. This term is defined in the Offering Circular³ as a percentage of the daily average principal amount outstanding on the Notes, payable quarterly in arrears on specified dates. The obligation of ABC to make payment of Recovery Fees is also set out in a separate letter agreement between LCPI and ABC, as amended and restated on 18 September 2006 (“the Recovery Fees Letter”). It states –

“In consideration of [LCPI] agreeing to grant the Initial Interest Facility to us in relation to [the Notes] issued by the Issuer whose proceeds are invested in our Class B Shares, we agree to pay to you a fee equal to 0.88 per cent per annum of the daily average principal amount outstanding of the Notes ...[on specified quarter days] ... and thereafter a fee equal to 0.79 per cent per annum of the daily average principal amount outstanding of the Notes.”⁴

I note that the amount of the Recovery Fees is not calculated by reference to the Interest Advance. Instead of covenanting to repay the Interest Advance itself in a conventional way (as it does in respect of the Loan under Clause 5.1), ABC agreed to pay a periodic fee by which LCPI would presumably recover the economic equivalent of the Interest Advance, provided that the Notes remained outstanding to the Maturity Date, which might not necessarily happen. In this eventuality, the second method of payment would also come into play.

³ In the Offering Circular the Recovery Fee was stated as being payable to Lehman Brothers International (Europe). However, by the Recovery Fees Letter as amended and restated on 18 September 2006 the amount payable was to be paid to LCPI. Nothing turned on this point.

⁴ As in the case of the other transaction documents, the Recovery Fees Letter contains defined terms, the meaning of which are defined by reference to the Offering Circular.

7. The second method is the payment by the Issuer to the Principal Protection Provider of the Present Value of the Unpaid Recovery Fees as at the date on which the Notes are redeemed. The Present Value of the Unpaid Recovery Fees is defined in the Offering Circular by reference to a calculation which, in substance, is the net present value of the future Recovery Fees which would have been payable had the Notes remained outstanding up to the Maturity Date. Until 14 October 2008 the Principal Protection Provider was LBF. The result of the application of this mechanism is that a different Lehman group company, namely LBF, would recover the economic equivalent of the outstanding balance of the Interest Advance as at the date on which an early redemption of the Notes took place.

The Principal Protection Agreement

8. The Principal Protection Agreement takes the form of a put option. In consideration for the payment of a premium, the Issuer is given the option to sell the Class B Shares to LBF for a specified amount. The Principal Protection Agreement is contained in a Confirmation for Share Option Transaction dated 21 April 2005 as amended and restated on 18 September 2006 and made pursuant to an ISDA Master Agreement dated 19 July 2002 and made between LBF and the Issuer.

9. The purpose of the Principal Protection Agreement is explained in the Offering Circular as follows:⁵

“The Principal Protection Agreement is intended to ensure that the Issuer will have sufficient assets to redeem all the then outstanding Notes upon maturity at an amount at least equal to their principal amount and so provides principal protection only in respect of Notes that are outstanding on the Determination Date.....”

⁵ Offering Circular, page 21 under the heading *Description of Principal Protection Agreement*, fourth paragraph.

Any Note redeemed prior to the Determination Date will not have the benefit of principal protection”.

10. Thus, as one would expect, the Principal Protection Agreement provided protection only in the event of the Notes being held to maturity. The “Determination Date” is a reference to the date that is three Business Days immediately preceding the Maturity Date which was to be 29 November 2019 (or a date thereafter). In the event of an early redemption, the Principal Protection Agreement would provide no protection and would terminate, or would terminate pro rata in the event of a partial early redemption of the Notes.

Procedure for early redemption

11. The terms upon which the Notes were issued contained provisions for their early redemption. These are set out in a Second Supplemental Trust Deed dated 18 September 2006 (“the Second Supplemental Trust Deed”). In substance, the Noteholder could, at any time, give notice to the Issuer requiring redemption of the Notes in whole or in part. In such event, the Issuer was forthwith to request ABC to redeem the Class B Shares (which were redeemable preference shares). ABC would then realise its investments including the redemption of the Fund Shares. Having received the redemption proceeds of the Class B Shares from ABC, the Issuer was then required to redeem the Notes. Any Notes redeemed early did not benefit from principal protection under the Principal Protection Agreement.

12. The amount payable upon early redemption of the Notes was to be an amount equal to the redemption proceeds due from ABC in redemption of the Class B Shares, subject to a number of adjustments reflected in both the Principal Protection Deed and paragraphs 15 and 16 of the Schedule to the Second Supplemental Trust Deed. If the Notes were redeemed before the Maturity Date, this represented a Mandatory Early Termination under

the Principal Protection Agreement and the Issuer became liable to pay to LBF the Early Termination Cash Settlement Amount. This comprised the Premium accrued due to LBF, an amount referred to as the Discount, the net gains or losses realised by LBF upon unwinding certain hedging transactions and the Present Value of the Unpaid Recovery Fees (which must be the economic equivalent of the outstanding balance of the Interest Advance). The same adjustments are made as between the Issuer and the Noteholder, as set out in paragraphs 15 and 16 of the Second Schedule to the Second Supplemental Trust Deed. It thus becomes clear that Clause 5.4 of the Credit Facility is consistent with these provisions in that, upon early redemption of the Notes the Issuer would deduct and pay to LBF a sum which includes the Present Value of the Unpaid Recovery Fees. However, this is not what in fact happened in this case.

Events from September 2008 onwards

13. On 15 September 2008, the ultimate parent company in the Lehman Group, Lehman Brothers Holdings Inc. filed for bankruptcy pursuant to Chapter 11 of the United States Bankruptcy Code. Shortly thereafter, on 3 October 2008, LBF also filed for Chapter 11 relief, thus giving rise to an Event of Default under the Principal Protection Agreement (which incorporates Clause 5(a)(vii) of the ISDA Master Agreement).

14. Pursuant to Clause 6(a) of the ISDA Master Agreement, the non-defaulting party, that is the Issuer, was entitled to serve notice of termination of the Principal Protection Agreement, designating the date of termination. By a letter dated 13 October 2008 from the Issuer, addressed to Lehman Brothers International (Europe)⁶, the Issuer specified that an Event of Default had occurred under the Principal Protection Agreement by

⁶ The Schedule to the ISDA Master Agreement stated that, for the purposes of the notice provision in Section 12(a), any notice required to be given to LBF should be delivered to Lehman Brothers International (Europe) at its office in London.

reason of LBF's Chapter 11 filing and designated 14 October 2008 as the date on which the Principal Protection Agreement would be terminated. It is an agreed fact (as stated in paragraphs 18 and 19 of the parties' Agreed Statement of Facts) that the Principal Protection Agreement terminated on 14 October 2008 by reason of LBF's default.

15. Section 6(e)(i) of the ISDA Master Agreement contains provisions relating to payments due upon termination resulting from an Event of Default. A number of different means of calculating such payments are set out, leaving it to the parties to elect which one is to apply. By paragraph (h) of Part 1 of the Schedule, the parties in this case chose the means of calculation known as *Second Method and Loss* which is defined in Section 6(e)(i)(4) as follows:

"If the Second Method and Loss apply, an amount will be payable equal to the Non-defaulting Party's Loss in respect of this Agreement. If that amount is a positive number, the Defaulting Party will pay it to the Non-defaulting Party; if it is a negative number, the Non-defaulting Party will pay the absolute value of that amount to the Defaulting Party."

It is important to note that selection of the *Second Method and Loss* gives rise to the possibility that the defaulting party, in this case LBF, may be entitled to receive a termination payment notwithstanding that the termination of the Principal Protection Agreement was brought about by its own default.

16. The definition of Loss, for the purposes of the *Second Method and Loss* calculation is contained in Section 14 of the ISDA Master Agreement as follows –

"Loss" means, with respect to this Agreement or one or more Terminated Transactions as the case may be, and a party, the Termination Currency Equivalent of

any amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or trading position (or any gain resulting from any of them. Loss includes loss and costs (or gains) in respect of any payment or delivery required to have been madeon or before the relevant Early Termination Date

17. By a letter dated 20 October 2008 from the Issuer addressed to Lehman Brothers International (Europe), the Issuer provided its statement of the amount payable upon early termination of the Principal Protection Agreement, calculated in accordance with the *Second Method and Loss* methodology. The amount so calculated was "EUR-nil" as set out in Exhibit 1 to the letter.⁷ The Statement of Agreed Facts does not explain how the Issuer arrived at this nil amount.

18. The position as at 14 October 2008 was that the Principal Protection Agreement had terminated by reason of LBF's default, but the Notes remained outstanding and were not, at that stage, redeemed. The result was that LBF never became entitled to receive the Early Termination Cash Settlement Amount. On 20 October 2008 the Issuer entered into a new principal protection agreement whereby it purchased a put option in respect of the Class B Shares from RBS (which was also the Noteholder). Its terms are the same as those of the original Principal Protection Agreement and ABC's case is that RBS became the replacement Principal Protection Provider for the purposes of the Offering Circular and Clause 5.4 of the Credit Facility. By a letter dated 21 October 2008 RBS, as Noteholder, gave notice to the Issuer to redeem all of the Notes, which had the effect of terminating the replacement principal protection agreement in accordance with its terms. In the event, by a Letter Agreement dated 13 January 2009

⁷ The heads of loss (or gain) taken into account are stated to be "Loss of bargain, Cost of Funding, Hedging, Losses and costs in relation to outstanding payments due and/or deliveries to be made." The amount of the loss or gain is stated as "Eur - nil" in respect of each line item.

and made between the Issuer and RBS (as Notcholder), RBS agreed to accept a redemption in specie. Also, by this Letter Agreement, RBS (as Principal Protection Provider) waived its right to receive an Early Termination Cash Settlement Amount under the replacement principal protection agreement. What, if any, consequence flowed from the appointment of RBS as replacement Principal Protection Provider is in issue.

19. Finally, on 15 June 2009 LCPI submitted a proof of debt in the voluntary (solvent) liquidation of ABC by which it claimed the sum of €13,658,945.26⁸ representing “the present value of the future amounts due to [LCPI] but unpaid by [ABC] with respect to the Initial Interest Facility provided by [LCPI] to [ABC] under [the Credit Facility]”. By a letter dated 30 July 2009 the joint voluntary liquidators rejected the proof of debt on the ground that “there is no obligation on [ABC] to repay any outstanding portion of the Initial Interest Facility following redemption of [the Notes]” LCPI responded to the rejection of its proof of debt by commencing this action on 1 October 2009.

The Plaintiff's case

20. Mr McCaughran put LCPI's case on the basis that the Interest Advance was a debt owing by ABC, as borrower, to LCPI as lender. He says the obligation to repay was at all times owed by the debtor to the creditor and that the only person who could waive payment was LCPI, the party to whom the debt was owed. He recognises that Clause 5.4 makes

⁸ ABC had paid €3,076,611.11 by way of Recovery Fees whilst the Notes were still outstanding and a further payment of Recovery Fees of €237,000 was paid subsequently. By its Re-Re-Amended Statement of Claim LCPI claims payment of €13,308,250.33 which is the balance of the Interest Advance allegedly outstanding as at 14 October 2008. Although not specifically pleaded, LCPI also put its case on the basis that, upon the true construction of the Credit Facility, ABC was alternatively liable to pay the Present Value of the Unpaid Recovery Fees to LCPI. This is the basis upon which LCPI's proof of debt was formulated. The amount of the Present Value of the Unpaid Recovery Fees is stated in the proof of debt to be €13,658,945.26. The way in which Mr McCaughran put his case in argument was not entirely consistent with LCPI's pleading but this point was not taken against him.

express provision for two methods of repayment – firstly, by the payment of Recovery Fees to LCPI over the period during which the Notes remain outstanding and, secondly, by the payment of the Present Value of the Unpaid Recovery Fees by the Issuer to LBF, as Principal Protection Provider, in the event that the Notes are redeemed early. Mr McCaughran argues that the obligation to pay the Present Value of the Unpaid Recovery Fees to LBF under Clause 5.4 is an independent obligation, owed to LCPI under the Credit Agreement. He says that this obligation could be discharged by ABC causing the Issuer to make payment to LBF, but it is said that this never happened with the result that ABC remain liable to pay the balance of the Interest Advance directly to LCPI.

21. It follows, according to Mr McCaughran's analysis, that the party to whom the obligation under Clause 5.4 of the Credit Facility was owed has at all times been LCPI, as lender and that it has not waived its right to be repaid the Interest Advance. Furthermore, he submits that upon a true construction of the Offering Circular only LBF (or another Lehman group company)⁹ could be the Principal Protection Provider referred to in Clause 5.4 of the Credit Facility, with the result that the purported appointment of RBS from 20 October 2008 was of no effect.

22. As I understand Mr McCaughran's submission, his conclusion is that ABC still owes the debt to LCPI as lender under the Credit Facility, being the outstanding balance of the Interest Advance. This is the way in which LCPI's case is pleaded in paragraph 30 of the Re-Re-Amended Statement of Claim.

23. The euro amounts of (a) the outstanding balance of the Interest Advance and (b) the Present Value of the Unpaid Recovery Fees, as at 14

⁹ Par: 5. paragraph (j) of the Schedule to the ISDA Master Agreement provided that LBF could transfer its rights and obligations under the Principal Protection Agreement to another entity, provided that such entity's obligations were guaranteed unconditionally and irrevocably by Lehman Brothers Holdings, Inc.

October 2008 or any other given date, must be different because their components are different. However, I assume that the parties must have considered the different amounts resulting from these calculations to be economically equivalent.¹⁰ For this reason, it presumably follows that it was commercially acceptable for the obligation to repay the balance of the Interest Advance to be satisfied by the payment of the Present Value of the Unpaid Recovery Fees. I think that this is the analysis which underpins Mr McCaughran's submission, but he was unable to explain the commercial rationale for structuring this part of the transaction in this way.

The Defendant's case

24. Put simply, Mr Millett's submission on behalf of ABC is that Clause 5.4 of the Credit Facility expressly prescribed a specific payment mechanism for the Interest Advance which has been operated in accordance with its terms and that nothing further is due from ABC to LCPI. He makes the point, rightly in my view, that the Interest Advance was not in any sense a conventional or arms-length loan agreement between a lender and a borrower. It is an integral part of a much larger transaction constituting the *Series 38 €200,000,000 Principal Protected Notes* issue involving a number of other parties. Consistent with its true nature, the Interest Advance was not subject to the same conventional mechanism for repayment as the Loan under the Credit Facility. Instead, Mr Millett submits that the Initial Interest Facility was a self-contained and separate element of the Credit Facility with its own separate stipulated mechanism for repayment contained in Clause 5.4. This mechanism operated in accordance with its terms and ABC is therefore under no further obligation to LCPI in respect of the Interest Advance. It is submitted that this result came about for either of two alternative reasons.

¹⁰ Counsel did not address me about the Euro amounts. As I understand LCPI's case the balance of the Interest Advance (as at 14 October 2008) is said to be €13,308,250.33 and the Present Value of the Unpaid Recovery Fees is said to be €13,658,945.26.

First, as at 14 October 2008, when the Principal Protection Agreement terminated, LBF ceased to be the Principal Protection Provider and the second limb of Clause 5.4 was not engaged because there had been no redemption of the Notes at that point. Alternatively, when the Notes were actually redeemed (on 13 January 2009) and the Present Value of the Unredeemed Recovery Fees became payable to the Principal Protection Provider, LBF had been succeeded in this role by RBS which waived its rights. The resolution of the issue in this case therefore depends upon the true construction of the Credit Facility and whether, in the events which have happened, Clause 5.4 operated in accordance with its terms.

The Proper Construction of the Credit Facility

25. The transaction documents, including the Credit Facility, are all expressed to be governed by English law. The principles of English law relating to construction of commercial contracts are the same as the principles of Cayman Islands law and were not the subject of argument between counsel. I can best summarise these principles by referring to the decision of the Privy Council in *Attorney-General of Belize –v- Belize Telecom Ltd* [2009] 2 All E.R. 1127, in which Lord Hoffman said –

“16. Before discussing in greater detail the reasoning of the Court of Appeal, the Board will make some general observations about the process of implication. The court has no power to improve upon the instrument which it is called upon to construe, whether it be a contract, a statute or articles of association. It cannot introduce terms to make it fairer or more reasonable. It is concerned only to discover what the instrument means. However, that meaning is not necessarily or always what the authors or parties to the document would have intended. It is the meaning which the instrument would convey to a reasonable person having all the background knowledge which would reasonably be available to the audience to whom the instrument is addressed: see *Investors' Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 All ER 98 at 114-115, [1998] 1 WLR 896 at 912-913. It is this objective meaning which is conventionally called the intention of the parties, or the intention of Parliament, or the intention of whatever person or body was or is deemed to have been the author of the instrument.

17. The question of implication arises when the instrument does not expressly provide for what is to happen when some event occurs. The most usual inference in such a case is that nothing is to happen. If the parties had intended something to happen, the instrument would have said so. Otherwise, the express provisions of the instrument are to continue to operate undisturbed. If the event has loss to one or other of the parties, the loss lies where it falls.

21. It follows that in every case in which it is said that some provision ought to be implied in an instrument, the question for the court is whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean. It will be noticed for Lord Pearson's speech that this question can be reformulated in various ways which a court may find helpful in providing an answer – the implied term must “go without saying”, it must be “necessary to give business efficacy to the contract” and so on – but these are not in the Board's opinion to be treated as different or additional tests. There is only one question: is that what the instrument, read as whole against the relevant background, would reasonably be understood to mean?”

26. I emphasise three particular points arising out of Lord Hoffman's statement of principle. First, I should construe the Credit Facility so as to give it the meaning which it would convey to a reasonable person having all the background knowledge which would be available to the audience to whom it is addressed. In this case the “audience” comprises experienced investment bankers who are promoting a very substantial euro denominated medium term note programme and highly sophisticated institutional investors. The contractual terms and conditions are contained in a series of relatively complex contractual documents, all of which have been drafted by well known law firms whose identity is disclosed in the offering circulars. Second, the courts should not rewrite bargains just because they perceive them to be bad for one side, or just because the contracting parties failed to predict an event which they might have considered was unlikely.¹¹ Thirdly, the court will not imply a term which contradicts an express term of the contract.

¹¹ See the decision of the English Court of Appeal in *Cv-Operative Wholesale Society Ltd – v- National Westminster Bank Plc* [1995] 1 EGLR 97, per Hoffman I.J (as he then was) at page 99f-63.

27. Clause 5.4 expressly states that ABC's obligation to repay the Interest Advance will be satisfied by the payment of fees. In my judgment, an analysis of the Credit Facility as a whole leads to the conclusion that this was intended to be the *only* method of repayment. The parties could have treated the Loan and the Interest Advance in exactly the same way, but they chose not to do so. They could have stipulated that the Interest Advance be repaid by the borrower to the lender by quarterly instalments.¹² They could have stipulated that in the event of default of any one instalment, the whole of the outstanding balance of the Interest Advance would become immediately due and payable by the borrower. Instead, the parties chose to distinguish between the Facility/Loan and the Initial Interest Facility/Interest Advance. Clause 5.1 constitutes a perfectly straightforward covenant on the part of the borrower to repay the Loan to the lender on a defined repayment date and Clause 14 is a conventional provision for acceleration in the event of default. However, these clauses do not apply to the Interest Advance. Instead, Clause 5.4 provides for ABC to satisfy its obligation to repay the Interest Advance by an indirect means (producing a different, but economically equivalent result), details of which are contained in other agreements. Instead of having the benefit of a straightforward covenant to repay the Interest Advance (in the form of Clause 5.1), LCPI has the right to recover fees calculated, not by reference to the amount of the Interest Advance, but by reference to the amount outstanding on the Notes. By paying the Recovery Fees each quarter until the Maturity Date, ABC is treated as having discharged its obligation to repay the Interest Advance.

28. Since the Notes were capable of being redeemed at the option of the Noteholder prior to the Maturity date, the parties had to stipulate some mechanism whereby ABC would be treated as having satisfied its

¹² The quarter days specified in the Recovery Fees Letter are 21 January, April, July and October.

obligation to pay the outstanding balance of the Interest Advance in circumstances where its obligation to pay Recovery Fees to LCPI had come to an end as a result of the early redemption of the Notes. They could have stipulated that ABC pay the Present Value of the Unpaid Recovery Fees¹³ to LCPI as lender. They chose not to do so. Instead, they provided for the Issuer to deduct the Present Value of the Unpaid Recovery Fees from the redemption proceeds of the Notes and pay it to LBF. This result was achieved through the Principal Protection Agreement. In the event of an early redemption of the Notes, the Principal Protection Agreement would terminate and the Issuer would be liable to pay the Early Termination Cash Settlement Amount (which included the Present Value of the Unpaid Recovery Fees) to the Principal Protection Provider which was LBF. In this way, ABC is treated as having satisfied its obligation to repay the balance of the Interest Advance in the event of an early redemption of the Notes.

29. It seems reasonably clear to me that the overall commercial purpose and effect of Clause 5.4 is that economic value, equivalent to the Interest Advance, should ultimately pass back from the Noteholder to the Lehman group, though not necessarily to LCPI. The Statement of Agreed Facts does not disclose why the parties chose to structure the Credit Facility in the way that they did, but I think that I am bound to infer that there was some good commercial purpose this structure. As a matter of English law, there can be no doubt that it was open to the parties to stipulate that ABC's obligation to repay the Interest Advance should be treated as having been discharged by another party pursuant to a separate, but related contract.

30. It is trite law that the making of a loan by a lender to a borrower creates a debt and that the lender may sue for it in the event that the borrower fails to repay in accordance with its terms. However, it is also trite

¹³ The Present Value of the Unpaid Recovery Fees is a net present value calculation done in the manner described at page 18 of the Offer Document.

law that the parties to a loan agreement may stipulate that the borrower is under no personal liability to pay and that repayment may be satisfied in some other way. In *Mathew –v- Blackmore* (1857) 1 H&N 762 Pollock CB said, at pages 770-771 : –

“It was argued before us on behalf of the plaintiff, that the fact of a loan involved in it a liability to pay and subjected the borrower to an action of debt On the other hand it was argued on behalf of the defendant, that the lending and borrowing of money is like any other contract, and that the right of the lender and the liability of the borrower depends upon the contract between them; and there was no reason why the ordinary rule should not apply, viz, that where the contract is reduced into in order to define and give evidence of the transaction between the parties, that the writing and the writing alone should regulate their respective rights and liabilities; and that the absence of the ordinary absolute covenant to pay in the indenture and the presence of another covenant whereby the defendant covenanted to pay not absolutely but only out of such moneys as should come into his hands ... showed that it was never intended to create, as between him and the plaintiff, the relation of creditor and debtor as upon simple loan of money.”

This case is relied upon in modern 30th Edition of *Chitty on Contracts* for the proposition that it is perfectly possible for a contract of loan to provide that the borrower’s personal liability shall be limited or that he shall have no personal liability at all. The parties to the Credit Facility were perfectly entitled to limit ABC’s personal liability to the payment of Recovery Fees under the first limb of Clause 5.4.

Conclusions

In my judgment the Plaintiff’s case is hopeless. The structure worked in the sense that the express terms of the various contractual documents were capable of producing the flow of economic value which the parties must be taken to have intended, even in the events which actually happened. It is not necessary to imply any terms into the Credit Facility in order to produce what, objectively, must have been the commercial result intended by the parties. Even though the Principal Protection Agreement terminated prior to the early redemption of the Notes, with the result that the Early

Termination Cash Settlement Amount never became payable by the Issuer to LBF, the flow of economic value was still capable of ending up in the right place. The parties chose the *Second Method and Loss* for determining the amount payable/receivable as between LBF and the Issuer upon termination of the Principal Protection Agreement.¹⁴ There is no doubt that, as a matter of English law, LBF was entitled to claim for its loss of bargain in spite of the fact that termination was brought about by its own default.¹⁵ In determining the close out payment amount, LBF was entitled to have the economic equivalent of the Present Value of the Unpaid Recovery Fees brought into account. Similarly, the Issuer was entitled to have the cost of purchasing a principal protection agreement on the same terms from some other provider brought into account, whether or not it actually did so at that time or at all. The agreed fact is that the Issuer assessed the amount for loss of bargain at nil and that LBF accepted this conclusion. There is no evidence before the court about the way in which the parties actually arrived at this net result. What matters for present purposes is that the operation of the *Second Method and Loss* was capable of producing the intended flow of economic value. It cannot be said that the contractual structure was bound to produce a commercially unacceptable result in the events which actually happened. LBF was entitled to have the damage resulting from its loss of bargain brought into account. Whether or not the nil amount actually reflected an amount equivalent to Present Value of the Unpaid Recovery Fees is beside the point.

31. It follows that there is no basis upon which I can properly construe the Credit Facility in a way which involves implying an obligation on the part of ABC to pay to LCPI the balance of the Interest Advance or the amount of the Present Value of the Unpaid Recovery Fees. To do so would

¹⁴ Had they chosen the *First Method*, then in the event of default by LBF, payment would only have been one way – from LBF to the Issuer.

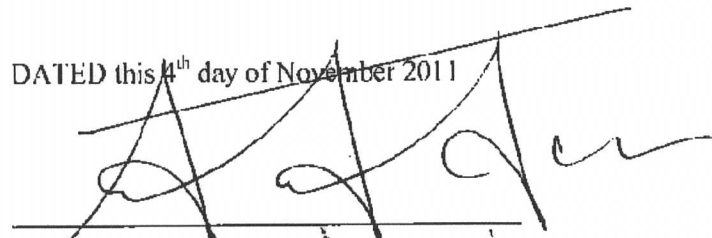
¹⁵ Support for this conclusion may be found in the decision of Briggs J. in *Lonus –v- JBF Fifth Rixson Inc* [2011] 2 B.C.L.C. 120, at page 128h.

be contrary to the express terms of Clause 5.4 and would amount to re-writing the parties' commercial bargain as reflected in the express terms of the overall contractual structure.

32. It also follows that the appointment of RBS as substitute Principal Protection Provider for the purposes of Clause 5.4 is irrelevant. Whether or not RBS was ever in a position to waive the Issuer's obligation to deduct the Present Value of the Recovery Fees from the proceeds of redemption of the Class B Shares did not have any bearing upon the flow of economic value in accordance with the express terms of the contracts. Mr McCaughran submitted that the purported appointment of RBS as substitute Principal Protection Provider for the purposes of Clause 5.4 served no commercial purpose. I think that he is right, but not for the reason which he gave. The point is that the parties' adoption of the *Second Method and Loss* entitled LBF to claim for its loss of bargain in any event.

33. The overall result is that ABC discharged its obligations in accordance with the terms of the Credit Facility and both LCPI and LBF got what they bargained for. I therefore dismiss the Plaintiff's claim and give judgment for the Defendant.

DATED this 4th day of November 2011


The Hon Mr Justice Andrew J. Jones QC
JUDGE OF THE GRAND COURT

