

IN THE UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER
FINANCIAL SERVICES

BETWEEN:

NORTHERN ROCK APPLICANTS

Applicants

- AND -

(1) ANDREW CALDWELL

(As the Independent Valuer of Northern Rock plc)

(2) HM TREASURY

Respondents

NOTE ON EXPERT EVIDENCE
FILED ON BEHALF OF HARBINGER CAPITAL PARTNERS

Introduction

1. This note is filed by Harbinger Capital Partners (“**Harbinger**”) pursuant to paragraph 3 (1)(b) of the order (“**the Order**”) of Andrew Bartlett QC (“**the Judge**”) dated 24 February 2011, which states that:

“Harbinger shall file and serve a document identifying, in relation to the two expert reports of Mr Mckillop and the expert report of Mr Thompson, which parts of the said reports they rely on, in relation to which issues and on what basis”.

The Expert Reports

2. The expert reports referred to at paragraph 3 (1)(b) of the Order (“**the Expert Reports**”) are, respectively:

(a) The first expert report of Murdoch McKillop dated 3 April 2009¹ (“**the First Expert Report**”). This document was served on the First Respondent (“**Mr Caldwell**”) at the beginning of his consultation process. It sets out Mr McKillop’s model of the hypothetical administration of Northern Rock based on the Repayment-in-Kind Interpretation² (“**the First Valuation**”).

(b) The second expert report of Murdoch McKillop dated 27 January 2010 (“**the Second Expert Report**”). This document was served on Mr Caldwell specifically in response to his Consultation Document dated 9 December 2009 (“**the Consultation Document**”). It sets out Mr McKillop’s model of the hypothetical administration of Northern Rock based on the Demand Interpretation³ (“**the Second Valuation**”).

(c) The expert report of Paul Thompson dated 28 October 2010 (“**the Thompson Report**”). This document was served on Mr Caldwell after his Response

¹ This document was served on Mr Caldwell with Harbinger’s written submissions in the period after the appointment of Mr Caldwell.

² The Repayment-in-Kind Interpretation is Harbinger’s primary analysis of the correct construction of the Withdrawn Assumption i.e. the financial assistance should be treated as having been withdrawn from the balance sheet for an equivalent value of Northern Rock’s unencumbered residential mortgage assets immediately before 22 February 2008.

³ The Demand Interpretation is Harbinger’s secondary analysis of the correct construction of the Withdrawn Assumption i.e. that a demand for repayment of financial assistance was made by the Bank of England immediately prior to 22 February 2008, following which Northern Rock was placed into administration pursuant to paragraph 22, Schedule B1 of the Insolvency Act 1986

Document dated 1 October 2010 (“**the Response Document**”)⁴. It sets out Mr Thompson’s expert opinion on (a) how a commercial lender would have approached the hypothetical demand for the repayment of financial assistance provided for by the Withdrawn Assumption and (b) whether the fire-sale of assets posited by the Repayment Interpretation⁵ is a factual scenario that would have occurred in reality.

3. Since the First Expert Report and Second Expert Report both set out detailed narrative and modeling of how the reasonably competent administrator would have conducted the hypothetical administration⁶ of Northern Rock, the documents need to be read as a whole for the reader to understand the conclusions reached.
4. The issues that arise for determination are inter-related. Accordingly, many sections of the Expert Reports will have an impact on more than one issue. In the exercise below, Harbinger has attributed sections to the issue to which they predominantly relate, but it reserves the right to refer to them in relation to other issues.

The Issues

5. Mr Caldwell largely ignores the Expert Reports in the Consultation Document/Final Document/Response Document and, more recently, in his Statement of Case. However, by comparing each of these documents against the Expert Reports, it can be seen that the following matters are in issue between the parties (“**the Issues**”):

⁴ The Response Document contained responses to requests for reconsideration of the Final Document (“**the Final Document**”) and the assessment notice dated 29 March 2010.

⁵ Mr Caldwell’s analysis that the only way of giving proper effect to the Withdrawn Assumption is to deduct from Northern Rock’s balance sheet, immediately before 22 February 2008, assets which, if realised at that time, would yield £25.38 billion.

⁶ This is assumed by virtue of section 6 of the Compensation Scheme Order, which sets out the Going Concern Assumption and the Administration Assumption.

- (a) The correct interpretation of the Withdrawn Assumption (“**the Interpretation Issue**”). In particular:
- (i) The consequences of that interpretation for the opening balance sheet of Northern Rock at the beginning of the hypothetical administration.
 - (ii) In relation to an informed assessment of the competing constructions of the Demand Interpretation and the Repayment Interpretation, the realistic course of action that (i) the directors of Northern Rock (“**the Board**”) would have taken in response to a demand for repayment of the financial assistance from the Bank of England (“**the Bank**”), (ii) the Bank would have taken after the making of the demand, and (iii) the Administrator would have taken in the hypothetical administration.
- (b) The treatment of interest on debts by the Administrator in the hypothetical administration (“**the Statutory Interest Issue**”).
- (c) The treatment of derivative financial instruments by the Administrator in the hypothetical administration (“**the Derivatives Issue**”).
- (d) The treatment of covered bonds by the Administrator in the hypothetical administration (“**the Covered Bonds Issue**”).
- (e) The treatment of medium term notes by the Administrator in the hypothetical administration (“**the Medium Term Notes Issue**”).
- (f) The value attributable to Northern Rock’s branch and operating platform by the Administrator (“**the Branch and Operating Platform Issue**”).

(g) The ultimate valuation of the preference shares (“**the Preference Shares**”) in Northern Rock (and compensation for former preference shareholders) (“**the Ultimate Valuation Issue**”). This issue by necessity incorporates all of the Issues.

6. Aside from the Issues, the evidence in the Expert Reports either relates to instruction/sources/information (see Appendix A), areas that appear to be common ground between the parties (see Appendix B) or areas which are or may be relevant to the Ultimate Valuation Issue, but where Harbinger does not currently know enough about the sources of information/methodology used by Mr Caldwell to understand the extent to which these sections are truly in issue or the full valuation consequences of any difference of approach (see Appendix C).
7. Harbinger reserves the right to refer to the contents of Appendix C in the event that Mr Caldwell suggests that a different approach should be taken in the valuation exercise in the sections referred to or that any difference in approach gives rise to a material difference on the Ultimate Valuation Issue.

Relevance/Admissibility

8. The Issues are all relevant to the subject-matter of the references i.e. the question of whether Mr Caldwell’s decision as to the amount of compensation was reasonable. They are also relevant to the question of what (if any) further directions the Tribunal may consider appropriate when remitting the matter to Mr Caldwell for reconsideration⁷.

⁷ Harbinger relies in this regard on section 133 (3) of the Financial Services and Markets Act 2000: “On a reference the Tribunal may consider any evidence relating to the subject-matter of the reference, whether or not it was available to the Independent Valuer at the material time”.

9. The applicable sections of the Expert Reports (as set out in more detail below) all constitute evidence that is admissible in relation to each of the Issues, and none of the Issues are ultimate issues on which expert evidence may not be given.⁸ In particular:

(a) In the case of the Interpretation Issue, the relevant paragraphs of the Expert Report are admissible because they allow the Tribunal to consider the competing constructions submitted by the parties in their proper context rather than in a vacuum. In particular, they indicate that the fire-sale of assets posited by the Repayment Interpretation is a factual scenario that would never occur upon a demand by the Bank for repayment of the financial assistance and that the Repayment Interpretation and its underlying methodology are necessarily inappropriate and unrealistic.

(b) In the case of the other Issues (with the exception of the Ultimate Valuation Issue), the applicable parts of the Expert Reports are admissible because they illustrate, for the benefit of the Tribunal, how the reasonably competent administrator would have conducted the hypothetical administration of Northern Rock, and that the approach adopted by Mr Caldwell is not a reasonable one.

(c) In the case of the Ultimate Valuation Issue, the applicable parts of the Expert Reports are admissible because they show that Mr Caldwell's decision as to the amount of compensation was not a reasonable one.

⁸ See *Expert Evidence: Law & Practice* (3rd edition, Hodgkinson & James), paragraphs 9.33 to 9.51.

First Expert Report

10. The requirements of the Order in relation to the First Expert Report are set out below in tabular form for the benefit of the Tribunal.

Part Relied Upon	Relevant Issue	Basis of Reliance
<i>Paragraphs 3.1 to 3.17</i>	<u>The Ultimate Valuation Issue</u>	This section is relevant and admissible as it sets out the conclusions of the First Valuation ⁹
<i>Paragraph 5.15</i>	<u>The Statutory Interest Issue</u>	This section is relevant and admissible because it shows that in the hypothetical administration the Administrator would need to consider the availability of options other than the strict application of Rule 2.88 of the Insolvency Rules 1986 which were consistent with the second statutory objective
<i>Paragraphs 5.29 to 5.40 and 5.42</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible because it shows the consequences of the Repayment-in-Kind Interpretation on the opening balance sheet of Northern Rock at the beginning of the

⁹ Since this section is an executive summary, it necessarily incorporates the entirety of the First Expert Report, and therefore is relevant to each of the Issues.

		hypothetical administration
<i>Paragraph 6.2</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible because it shows that factual scenario posited by the Repayment Interpretation would not be achievable
<i>Paragraph 6.20</i>	<u>The Ultimate Valuation Issue</u>	This section incorporates Appendix A
<i>Paragraphs 6.21 to 6.35</i>	<u>The Covered Bonds Issue</u>	This section is relevant and admissible because this methodology issue affects available cash-flows in the hypothetical administration and ultimate value for preference shareholders (and because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 6.74 to 6.76</i>	<u>The Derivatives Issue</u>	This section is relevant and admissible because this methodology issue affects available cash-flows in the hypothetical administration and ultimate value for preference shareholders (and because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 6.88 to 6.90</i>	<u>The Statutory Interest Issue</u>	This section is relevant and admissible because the methodology adopted in relation to the payment of interest is determinative of value for

		preference shareholders (and because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 6.134 to 7.8</i>	<u>The Ultimate Valuation Issue</u>	This section is relevant and admissible as it sets out the conclusions of the First Valuation
<i>Appendices A and B</i>	<u>The Ultimate Valuation Issue</u>	These appendices are relevant and admissible as they illustrate the cash-flows in the hypothetical administration on which the First Valuation is premised ¹⁰

Second Expert Report

11. The requirements of the Order in relation to the Second Expert Report are set out below in tabular form for the benefit of the Tribunal.

Part Relied Upon	Relevant Issue	Basis of Reliance
<i>Paragraphs 3.1 to 3.15</i>	<u>The Ultimate Valuation Issue</u>	This section is relevant and admissible as it sets out the conclusions of the Second Valuation ¹¹
<i>Paragraphs 5.21 to</i>	<u>The Interpretation Issue</u>	This section is relevant and

¹⁰ The appendices therefore incorporate the other Issues as well.

¹¹ Since this section is an executive summary, it necessarily incorporates the entirety of the Second Expert Report, and therefore is relevant to each of the Issues.

5.57		admissible because it shows why the factual scenario posited by the Repayment Interpretation would never occur in reality
<i>Paragraphs 5.58 to 5.102</i>	<u>The Interpretation Issue</u> <u>The Statutory Interest Issue</u>	This section is relevant and admissible because it shows the consequences of the Demand Interpretation within the hypothetical administration and the course of action that the Bank (and other creditors) would have considered in relation to the treatment of interest on debts
<i>Paragraphs 5.103 to 5.110</i>	<u>The Statutory Interest Issue</u>	This section is relevant and admissible because the methodology adopted in relation to the payment of interest is determinative of value (and because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 5.111 to 5.114</i>	<u>The Branch and Operating Platform Issue</u>	This section is relevant and admissible because this methodology issue affects available cash-flows in the hypothetical administration and ultimate value for shareholders (and because the approach of Mr Caldwell is unreasonable and/or wrong)

<i>Paragraphs 5.115 to 5.118</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible because it shows why the factual scenario posited by the Repayment Interpretation would never occur in reality
<i>Paragraphs 5.124 to 5.125</i>	<u>The Derivatives Issue</u>	This section is relevant and admissible because this methodology issue affects available cash-flows in the hypothetical administration and ultimate value for preference shareholders (and because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 5.126 to 5.132</i>	<u>The Covered Bonds Issue</u>	This section is relevant and admissible because this methodology issue affects available cash-flows in the hypothetical administration and ultimate value for preference shareholders (and because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 5.133 to 5.140</i>	<u>The Medium Term Notes Issue</u>	This section is relevant and admissible because this methodology issue affects available cash-flows in the hypothetical administration and ultimate value for preference shareholders (and because the approach of Mr Caldwell is

		unreasonable and/or wrong)
<i>Paragraphs 6.1 to 6.3</i>	<u>The Ultimate Valuation Issue</u>	This section is relevant as it sets out the conclusions to the Second Valuation
<i>Appendix A</i>	<u>The Ultimate Valuation Issue</u>	This appendix is relevant and admissible as it illustrates the cash-flows in the hypothetical administration on which the Second Valuation is based ¹²

Thompson Report

12. The requirements of the Order in relation to the Thompson Report are set out below in tabular form for the benefit of the Tribunal.

Part Relied Upon	Relevant Issue	Basis of Reliance
<i>Paragraphs 2.4 to 2.11</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible as it explains why the factual scenario posited by the Repayment Interpretation would never occur in reality
<i>Paragraphs 2.12 to 2.14</i>	<u>The Statutory Interest Issue</u>	This section is relevant and admissible as it explains that the Bank would have been willing to be paid interest current and would not have required the payment of statutory interest (and that the approach of Mr

¹² The appendix therefore incorporates the other Issues as well.

		Caldwell is unreasonable and/or wrong)
<i>Paragraphs 5.1 to 5.12</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible because it sets out the expert's evidence on how, in the normal course of events, lending banks deal with demands for repayment from customers in financial distress, and how in the case of Northern Rock these norms would also have applied
<i>Paragraphs 5.13 to 5.16</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible because it sets out the expert's evidence on why, in the face of a demand for repayment from the Bank, the Board would not have repaid the full amount immediately
<i>Paragraphs 5.17 to 5.21</i>	<u>The Interpretation Issue</u>	This section is relevant and admissible because it sets out the expert's evidence on what action the Bank would seek to take before and during the hypothetical administration
<i>Paragraphs 5.22 to 5.23</i>	<u>The Statutory Interest Issue</u>	This section is relevant and admissible because the methodology adopted in relation to the payment of interest is determinative of value for preference shareholders (and

		because the approach of Mr Caldwell is unreasonable and/or wrong)
<i>Paragraphs 5.24 to 5.30</i>	<u>The Statutory Interest Issue</u>	This section is both relevant and admissible because the methodology adopted in relation to the payment of interest is determinative of value (and because the approach of Mr Caldwell is unreasonable and/or wrong)

APPENDIX A

This appendix is composed of sections containing the background materials on which the Expert Reports are based.

Report/paragraph	Description of Contents
<i>First, paragraphs 1.1 to 1.18</i>	Introduction to First Report
<i>First, paragraphs 2.1 to 2.2</i>	Instructions for First Report
<i>First, paragraphs 4.1 to 4.23</i>	Sources of information for First Report
<i>First, paragraphs 8.1 to 8.5</i>	Statement of truth/expert's declaration
<i>First, appendices C to E</i>	Appendices to First Report
<i>Second, paragraphs 1.1 to 1.10</i>	Introduction to Second Report
<i>Second, paragraph 2.1</i>	Instructions for Second Report
<i>Second, paragraphs 4.1 to 4.6</i>	Sources of information for Second Report
<i>Second, paragraphs 7.1 to 7.5</i>	Statement of truth/expert's declaration
<i>Second, appendices B to C</i>	Appendices to Second Report
<i>Thompson, paragraphs 1.1 to 1.4</i>	Introduction to Thompson Report
<i>Thompson, paragraphs 2.1 to 2.3, paragraphs 3.1 to 3.2</i>	Instructions for Thompson Report
<i>Thompson, paragraphs 4.1 to 4.5</i>	Sources of information for Thompson Report
<i>Thompson, paragraph 6</i>	Statement of truth/expert's declaration
<i>Thompson, appendix A</i>	Appendices to Thompson Report

APPENDIX B

This appendix is made up of sections where there appears to be common ground between the parties.

Report/paragraph	Description of Contents
<i>First, paragraphs 5.1 to 5.14</i>	Effect of Going Concern Assumption on hypothetical administration
<i>First, paragraphs 5.19 to 5.22</i>	Choice of statutory objective in relation to Administration Assumption
<i>First, paragraphs 5.25 to 5.28</i>	Adoption of run-off as a consequence of Administration Assumption
<i>First, paragraph 5.41</i>	The guarantees are irrelevant for valuation purposes
<i>First, paragraphs 5.43 to 5.45</i>	Impact of any further financial assistance after the Relevant Date is irrelevant for valuation purposes
<i>First, paragraphs 6.3 to 6.4</i>	Valuation of shares on net asset basis (based on surplus for shareholders after run-off in administration)
<i>First, paragraph 6.19</i>	Adoption of a five-year run-off

APPENDIX C

This appendix is composed of sections which either are or potentially are relevant to the Ultimate Valuation Issue, and which need to be read as part of the whole. Harbinger does not currently know enough about Mr Caldwell's sources of information/methodology to understand the extent to which these sections are in issue or the full valuation consequences of any difference of approach.

Report, paragraph	Description of Contents
<i>First, paragraphs 5.15 to 5.18, 5.23 to 5.24</i>	The general conduct of the hypothetical administrator on the application of the Repayment-in-Kind Interpretation
<i>First, paragraphs 6.5 to 6.15</i>	Opening net equity position on which First Valuation is modeled
<i>First, paragraphs 6.16 to 6.18</i>	The general conduct of the hypothetical administrator on the application of the Repayment-in-Kind Interpretation and the Model
<i>First, paragraphs 6.36 to 6.61</i>	Approach to timing of repayments to the holders of notes in the Granite securitization scheme
<i>First, paragraphs 6.62 to 6.68</i>	Approach to costs incurred in the run-off of assets and liabilities of Northern Rock and the costs of administration generally
<i>First, paragraphs 6.69 to 6.85</i>	Approach to realization of all other assets and liabilities (except Covered Bonds, Granite and costs) in run-off of Northern Rock
<i>First, paragraphs 6.86 to 6.87 and 6.91 to 6.133</i>	Approach to performance bases for realization of assets and payment of liabilities in run-off of Northern Rock

<i>Second, paragraphs 5.1 to 5.20</i>	Opening net equity position on which Second Valuation is modeled
<i>Second, paragraphs 5.100 to 5.102</i>	Applicable interest rates to financial assistance
<i>Second paragraphs 5.119 to 5.120</i>	Approach to Northern Rock credit rating
<i>Second, paragraphs 5.121 to 5.123</i>	Approach to performance bases