

IN THE UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER
FINANCIAL SERVICES

IN THE MATTER OF NORTHERN ROCK PLC

AND IN THE MATTER OF THE NORTHERN ROCK PLC COMPENSATION
SCHEME ORDER 2008

HARBINGER CAPITAL PARTNERS

Applicant

- AND -

(1) ANDREW CALDWELL

(As the Independent Valuer of Northern Rock plc)

(2) HM TREASURY

Respondents

APPLICANT'S REPLY TO THE RESPONDENTS'
STATEMENTS OF CASE

Brown Rudnick LLP
A Limited Liability Partnership
8 Clifford Street
London, W1S 2LQ
United Kingdom
Tel: + 44 207 851 6000
Fax: +44 207 851 6100

A. INTRODUCTION

1. This is the Reply (“**the Reply**”) of Harbinger Capital Partners (“**the Applicant**”) to the Statement of Case of Andrew Caldwell, the independent valuer of Northern Rock (“**the First Respondent**”) dated 10 December 2010, and of HM Treasury (“**the Second Respondent**”) dated 17 December 2010 (together, “**the Statements of Case**”).
2. The Statements of Case both respond to the Applicant’s Grounds of Referral (“**the Grounds of Referral**”) dated 29 October 2010.
3. The Reply is filed pursuant to paragraph 9 of the Case Management Order (“**the CMO**”) and paragraph 21 of the Case Management Memorandum (“**the CMM**”) of Andrew Bartlett QC, both dated 18 November 2010.
4. In the Reply (and unless otherwise stated) the Applicant adopts the abbreviations used in the Grounds of Referral.
5. The paragraph cross-references in the Reply are, save where otherwise stated, to the First Respondent’s Statement of Case. Save where otherwise stated, the bundle cross-references in the Reply are to the Grounds of Referral and the six bundles of documents served with them. In addition, there is a further bundle of documents served with the Reply (marked Volume 7).
6. Where the Applicant does not expressly accept any aspect of the Statements of Case, no acceptance is to be implied.

B. REPLY TO THE FIRST RESPONDENT

The Valuation Assumptions

7. The First Respondent asserts, at paragraph 23, that the so-called Primary Valuation Assumptions do not need to be construed in the context of the so-called Secondary

Valuation Assumptions, and that they must have “the same meaning” for all schemes. The Applicant does not accept this. In particular:

- (a) The 2008 Act must be construed as a whole. The First Respondent appears to recognise this when he concedes that the Secondary Valuation Assumptions do in fact “inform” the meaning of the Primary Valuation Assumptions. Further, the Primary Valuation Assumptions must be construed in a manner that is consistent with each and every one of the Secondary Valuation Assumptions.
 - (b) Though its construction must be consistent for all schemes, it is plain that the Withdrawn Assumption may not have the same results in all cases. The terms of the financial assistance provided will vary. The practical consequences of “withdrawal” will differ according to the terms of the financial assistance. However, that does not mean that the construction of the Withdrawn Assumption is different, just that the terms of the financial assistance are different.
8. In relation to paragraphs 26 and 27, in the judicial review proceedings the Claimant shareholders challenged the compatibility of the Legislative Framework with AIP1 on the basis that it was bound to produce a nil or nugatory sum of compensation. It is important to note that the judicial review proceedings did not involve the consideration of the value of the Preference Shares in Northern Rock as at the Valuation Date. The Applicant has filed detailed evidence in support of its case that the Preference Shares are to be valued at £322.5 million.

Competing Interpretations of the Withdrawn Assumption

9. The First Respondent is correct in his statement that there are three competing interpretations of the Withdrawn Assumption before the Tribunal. However, it is unfortunate that the First Respondent has mischaracterised the case of the Applicant in relation to what he calls the “No Assistance Interpretation”. In this regard:

- (a) As is clearly stated at paragraph 138 of the Grounds of Referral¹, on the Applicant's primary analysis of the Withdrawn Assumption the correct construction is that 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. The effect of this is to re-create a position similar to that before the provision of financial assistance on 13 September 2007 i.e. it is as if the financial assistance had never been provided.

- (b) This is not the first time that the First Respondent has mischaracterised the Applicant's primary analysis: for example, see paragraphs 17 to 21 of the Second Supplemental Submissions², responding to paragraph 4.36 of the Consultation Document.

- (c) The abbreviation the "**No Assistance Interpretation**" applied by the First Respondent throughout its Statement of Case is inaccurate and should not be adopted. The Applicant suggests the appropriate label is the "**Repayment-in-Kind Interpretation**" (and invites both the Respondents and the Tribunal to adopt it).

10. In relation to paragraphs 33 (1) and 34, the Applicant denies that the point referred to is a variation of its own submissions based on the HRA and A1P1 (either for the reasons set out in footnote 10, or at all).

¹ See page 40.

² File 2, Tab 9, pages 7 to 8.

Financial Impact of the Competing Interpretations

Effect of the Repayment Interpretation

11. The First Respondent is wrong to contend at paragraphs 38 to 42 that the fire-sale contemplated by the Repayment Interpretation is at current market value. Rather, it is a without notice sale in distressed circumstances.
12. The fire-sale does not contribute to a net asset deficit of £2.4 billion “at the end of the valuation”. Rather, it means that, at the start of the assumed administration of Northern Rock, the company’s balance sheet would have been reduced from a surplus of £1.629 billion (the actual balance sheet at the Valuation Date) to a deficit of £2.440 billion (the adjusted balance sheet at the Valuation Date). This £4 billion loss is not value attributable to the financial assistance. It only arises because of the method of repayment chosen by the First Respondent. Accordingly, it can be seen that the First Respondent’s conclusion of a nil value is generated by reason of his adoption of an absurd interpretation of the Withdrawn Assumption.
13. Moreover, the First Respondent is wrong to contend that £25 billion is “the realisable value of the assets in question”: it merely represents the fire-sale value of those assets.

Effect of the Repayment-in-Kind Interpretation

14. At paragraphs 43 to 44, the First Respondent again mischaracterises the Applicant’s case: the Applicant refers to and repeats paragraph 9 (above). The modelling in the First Expert Report is consistent with the Repayment-in-Kind Interpretation.
15. In relation to paragraphs 45 to 47, the Applicant denies that the approach gives shareholders a continuing uplift: it ensures that the financial assistance has been repaid at the time of the Valuation Date. In particular:

- (a) The reference to a “notional payback” is not understood. The realisation of these assets would have generated sufficient funds to repay the loan and would have generated a substantial ongoing incremental cash-flow (i.e. the yield spread) in the period prior to realisation. Accordingly, the financial assistance is repaid by operation of the Repayment-in-Kind Interpretation in a value-neutral manner (and the assets would have provided an additional income stream in the meantime).
- (b) The residential mortgages that repay the financial assistance in kind are made up of a representative sample of Northern Rock’s better-quality assets (with a lower likelihood of impairment). There would be no need for a write-down or discount of those assets. However, equally the Bank could have been repaid-in-kind through a combination of gilts, cash and mortgage assets (and this would have no material impact on the run-off of the remaining assets and subsequent distributions as modelled in the First Expert Report).
- (c) By contrast, the remaining assets run-off during the course of the administration are made up of the rest of Northern Rock’s loan portfolio (including poorer-quality unsecured loans with the greatest likelihood of impairment).
- (d) The description of “a steep recession and collapse in house prices” is an inaccurate description of the UK economy at the Valuation Date. In Q1 of 2008 the UK had GDP growth of 0.3%³ (i.e. it was not in recession).
- (e) There is no inconsistency in the Applicant’s approach to book value. The one-day repayment-in-kind of the financial assistance (i.e. on the Valuation Date) is totally different to the run-off of assets in administration. The former adopts book values to “withdraw” financial assistance in a value neutral manner: the latter factors in the associated inflows and costs/losses of realising a mortgage-book over a 5-year period.

³ See the Office for National Statistics Quarterly National Accounts for the first quarter of 2008: File 7, Tab 51, page 1.

- (f) It is incorrect to say that the approach adopted in the First Valuation excludes the PIK facility. This aspect of the financial assistance is treated as having been withdrawn: see paragraphs 5.34 to 5.40 of the First Expert Report⁴.

16. For the reasons set out above, it is denied, as alleged in paragraph 48, that the value of the Northern Rock shares would be uplifted in either of the ways suggested. The Repayment-in-Kind Interpretation operates in a value neutral manner.

Effect of the Demand Interpretation

17. There are a number of errors in the analysis set out at paragraphs 50 to 52. For example:

- (a) The First Respondent inaccurately claims that the Demand Interpretation ascribes value to shareholders as a result of Northern Rock's "continued holding" of government funds. In fact, the LOLR funds were used to repay maturing debt and customer deposits. The Northern Rock shares are ascribed no more value than they had before the provision of support. The LOLR funds merely replaced other liabilities of NR which existed before the assistance was provided.
- (b) The Bank does not (as alleged) "give up its security rights". It is still treated as the most senior creditor for repayment purposes. Further, it is common in restructurings for secured creditors to consider compromising their security positions in order to preserve value and maximise their overall recoveries (and in this case the Bank would need to consider recovery of its subordinated PIK facility)⁵.

⁴ File 2, Tab 7, page 16 ff.

⁵ See the Second Expert Report, paragraphs 5.71, 5.76, 5.78 and 5.84 to 5.92: File 2, Tab 10.

- (c) The Administrator does use the “threat” of non-payment. As an officer of the Court he would discuss such a compromise with all creditors. Nor is he (as alleged) “reluctant” to repay the Bank on the terms of the financial assistance. It is not the nature of administration for secured/unsecured loan creditors to be paid in exact accordance with the conditions on which they have lent money. Moreover, the First Respondent wrongly ignores the fact that the PIK facility is subordinated to the debts of the unsecured creditors of Northern Rock. The negotiated agreement which is detailed in the Second Expert Report represents a workable structure whereby all secured/unsecured creditors are paid 100 p in the £ plus contractual interest in full.

Ordinary Meaning of the Withdrawn Assumption

18. At paragraph 57, the First Respondent refers to the so-called “primary” meaning of “withdraw”. However, the dictionary definitions referred to are alternatives, carrying equal weight, and dependent on context. Thus, the definition “[to] *take (money) out of an account*” is peculiar to the “withdrawal” by a depositor of cash from a current account and does not inform the ordinary meaning of the “withdrawal” of financial assistance. By contrast, the definition “[to] *discontinue or no longer provide (something previously supplied or offered): [e.g.] the party threatened to withdraw its support for the government*” refers to the withdrawal of support through discontinuance, and is clearly relevant to the Bank’s hypothetical termination of the liquidity support offered to Northern Rock.
19. Contrary to the approach taken at paragraph 59, the express language of Section 5 (4) does not specify whether the demand needs to be satisfied: only that the demand constitutes “withdrawal” for the purpose of the Withdrawn Assumption. The word “withdraw” does not “generally” involve actual removal: that is merely one of several dictionary definitions of equal weight (and is context-specific).

20. In paragraphs 60 to 64, the First Respondent attempts to distinguish between the withdrawal of “monies” as opposed to “terms” (upon which such monies are provided), and the withdrawal of “[financial] assistance” as opposed to the “loan facility”/“facilities” (under which the monies were lent). It is suggested by the First Respondent that the Withdrawn Assumption can only refer to the former, and that the Demand Interpretation only deals with the latter. The Applicant makes the following submissions in relation to this:

- (a) This is a false distinction. As defined at Section 15 of the Banking Act, the expression “financial assistance” includes “assistance provided by way of a loan, guarantee or indemnity” (emphasis added) i.e. it includes a loan facility.
- (b) The First Respondent’s approach to the ordinary meaning of “withdrawn” is misconceived. He claims (erroneously) that “in the absence of repayment, the recipient continues to enjoy the assistance.....even in the event of a supervening administration”. This offers no assistance to the linguistic construction of the statute.
- (c) The Repayment Interpretation does not represent the ordinary meaning of the Withdrawn Assumption. So much is clear from the express wording of the provision. Significantly, if the draftsman had intended the Repayment Interpretation, he would have used the word “repaid” rather than the word “withdrawn”.

Relevance of Words in Brackets

21. The First Respondent asserts, at paragraph 66, that the bracketed words (“*whether by a demand for repayment or otherwise*”) are not intended to define what constitutes withdrawal, rather they refer to the mechanisms by which withdrawal can be initiated. This is at odds with the plain meaning of the language i.e. that a demand for repayment constitutes “withdrawal”. The words “*or otherwise*” refer to the withdrawal of financial

assistance provided other than by way of a loan e.g. by guarantees or indemnity. As a matter of common sense these are not “withdrawn” “*by a demand for repayment*”: for example, a guarantee is “withdrawn” by its revocation/termination.

22. In paragraph 67, the First Respondent refers to other so-called mechanisms whereby withdrawal can be initiated e.g. enforcement and sale (where the loan is secured by fixed charge), and relies on the “effect” of this alternative “withdrawal” being repayment in full. This is again misconceived. The “withdrawal” of assistance provided pursuant to a fixed charge/debenture would be through the demand for repayment: once “withdrawn” the ultimate “effect” would be either partial or total repayment e.g. once a receiver appointed under the terms of the debenture/by the Court has realised value through possession/sale.
23. At paragraph 68, the First Respondent appears to argue that, as Northern Rock would be contractually entitled to ignore the demand for the PIK, a demand cannot constitute withdrawal. If this were correct, it is not understood how or why the PIK (as the First Respondent maintains) could or would be repaid immediately before administration (if, as suggested, it is not repayable on demand).

Purpose of the 2008 Act

24. The Applicant accepts that the purpose of the Withdrawn Assumption is set out in the Explanatory Notes. This has elsewhere been described as: “...*the former shareholders are not entitled to be compensated for value created or enhanced by the provision of public financial assistance*” (see paragraph 48 (d) of the Grounds of Referral).
25. The Applicant’s position in relation to the purpose of the 2008 Act is set out in its earlier submissions. In summary:
- (a) The purpose of the Withdrawn Assumption is to address a real-world policy problem i.e. that at the time of nationalisation Northern Rock was in a better

position than it was before the provision of financial assistance, and private shareholders should not benefit from this through compensation from public funds.

- (b) This problem is addressed by the hypothetical scenario created in the Valuation Assumptions. In particular, the Withdrawn Assumption ensures that Northern Rock shareholders are in no better position than they would have been but for (i.e. before) the provision of financial assistance.
- (c) The Repayment Interpretation does not achieve this purpose. The First Respondent alleges that it does because “the actual value associated with the ongoing receipt of financial assistance....has been removed from the balance sheet”. There are several problems with this analysis.
 - (i) Firstly, it is unclear whether the “actual value” purportedly removed from the balance sheet is £29.445 billion (assets realised), £25.377 billion (financial assistance) or £4.1 billion (diminution in value through fire-sale). It is also unclear how any of these sums can be said to represent the “actual” (or any) value associated with “the ongoing receipt of financial assistance”.
 - (ii) Second, the fire-sale adopted by the First Respondent destroys the pre-administration value of Northern Rock in the hypothetical scenario of the Valuation Assumptions (changing a balance sheet surplus of £1.6 billion to a balance sheet deficit of £2.4 billion). In reality Northern Rock was never balance-sheet insolvent.
- (d) This value destruction under the assumed conditions of the Valuation Assumptions does not solve the real-world policy problem. It does not remove the value that exists only because of public support: it simply wipes £4 billion from the balance sheet, illogically ascribing that value to the “ongoing receipt of financial

assistance”. Just as shareholders should not benefit from the financial assistance, nor should they suffer as a result of it⁶.

- (e) By contrast, the Repayment-in-Kind Interpretation and the Demand Interpretation both achieve the purpose set out in the Explanatory Notes: shareholders are in no better position than they would have been in but for (i.e. before) the provision of financial assistance.

Relevance of the Judicial Review Proceedings

26. At paragraph 81, the First Respondent states that “there was nothing disproportionate in requiring the Valuer to adopt assumptions that would reflect the situation that would have prevailed had that assistance not been provided”. The Applicant agrees that this factual situation (i.e. a valuation of Northern Rock as if assistance had not been provided) is what the Withdrawn Assumption is intended to achieve. Both the Repayment-in-Kind Interpretation and the Demand Interpretation achieve it: the Repayment Interpretation does not.

27. The purpose of the Withdrawn Assumption was considered in the judicial review proceedings: see the opening lines of the Second Respondent’s oral submissions, “...the object and I submit the effect of the valuation provisions of this Act is to put the shareholders in exactly the position that they would have been in if the deposit taker had received no financial support from the public sector”⁷ (emphasis added). The stated object/effect was common ground between the parties: and was twice adopted by Laws LJ in his judgment.⁸ The Applicant has never asserted that this is a binding statement as to interpretation: only that it is persuasive authority for the intended purpose of the Withdrawn Assumption, which purpose the Repayment-in-Kind Interpretation and the Demand Interpretation (but not the Repayment Interpretation) both achieve.

⁶ See paragraph 27 (below).

⁷ Transcript: Day 2, page 74, line 15 ff: File 7, Tab 52.

⁸ See the Court of Appeal judgment, paragraphs 62 and 84: File 4, Tab 22.

28. The Applicant rejects the suggestion, which is contained at paragraphs 86 to 88, that it has taken the Second Respondent's evidence out of context or that it relies on the italicised passage to imply that the Second Respondent "had rejected the Repayment Interpretation". In particular:

- (a) The Applicant has already accepted that the reference to "withdrawn" in the evidence was to withdrawal in the "real-world".⁹ However, the evidence illustrates the ordinary "real-world" meaning of the phrase "public assistance had been withdrawn" i.e. withdrawal would have resulted in an inability to repay the Bank (rather than constituting repayment of the Bank).
- (b) The Applicant is not aware that the Second Respondent even considered the Repayment Interpretation in either its evidence or submissions in the judicial review proceedings. It simply points out that the Repayment Interpretation is inconsistent with the Second Respondent's evidence/submissions in the judicial review proceedings.

Need for Uniform Application

29. The First Respondent asserts, at paragraph 90, that Parliament cannot have intended shareholders to be treated differently according to how the company in question was assisted. This assertion is unfounded. The terms of the financial assistance are a matter of negotiation between the tri-partite authorities and the directors of the relevant deposit-taker and will differ according to the circumstances of each case. If financial assistance is provided in different ways, so too the consequences of its "withdrawal" will not necessarily be the same. There is no blanket requirement for so-called non-discrimination. That phrase applies to individuals who assert the right to be treated the same as others despite differences that are not of their own making. It is not applicable

⁹ See the Grounds of Referral, paragraph 49 (b) and (c).

to the shareholders of different companies which have received financial assistance from a lender of last resort on different terms.

30. In paragraph 91, it is suggested that the Repayment-in-Kind Interpretation does not meet the so-called non-discrimination requirement because, to the extent that assistance is granted by means of a fixed-term loan, no effect is given to the Withdrawn Assumption. This is inaccurate, for the reasons set out in paragraph 12 (e) (above). As set out in the First Expert Report¹⁰, the PIK element is treated as being “withdrawn” at the Valuation Date.

31. At paragraphs 92 to 94, it is claimed that the Demand Interpretation is discriminatory, as it gives a different outcome according to the means by which the Bank may enforce repayment. The First Respondent places considerable reliance on the B&B Compensation Scheme; in particular, the B&B Assessment Notice treated the ultimate consequences of “withdrawal” as the selling of collateral held by the Bank at a default market rate. The Applicant makes the following points in relation to this:

- (a) First of all, it reserves its position in relation to the treatment of the Withdrawn Assumption in the B&B Assessment Notice. This document is not a Revised Assessment Notice, it has not been referred to the Tribunal and, in any event, it does not bind the Applicant, the First Respondent or the Tribunal.
- (b) The security provided by B&B (and its means of enforcement) was peculiar to B&B. The directors of B&B agreed to post collateral with the Bank which could be sold at default market rate in the event that the financial assistance was “withdrawn” (i.e. terminated). By contrast, the financial assistance provided to Northern Rock was secured by fixed and floating charge/debenture, and was enforceable through a qualifying charge-holder appointment of an administrator pursuant to paragraph 14, Schedule B1 of IA86. The reason the shareholders of

¹⁰ See the First Expert Report, paragraph 5.40: File 2, Tab 7, page 17.

B&B would have “no choice” is because the directors of B&B agreed on behalf of the company to collateralise the financial assistance under the terms of the SLS.

European Community Law

32. At paragraph 96, in the last sentence the aid may be continued subject to conditions in the event of a restructuring or a liquidation plan.

33. In paragraph 97, the European Commission responded to the UK government on 5 December 2007 (not 2008).

34. At paragraph 98, though it is admitted that as from 17 March 2008 the UK government would have been under the obligations described (absent a liquidation or restructuring plan), even if a recovery order had been made by the European Commission at some time after 18 March 2008, the UK would have had a further four months from the date of the order to comply with that decision (and a national Court seized of the matter at the instance of a third party would have allowed a similar time to ensure compliance)¹¹. Even if no liquidation plan had been notified to the European Commission by that date, neither it nor a national Court would, realistically, have been in a position to make such an order until some time after 18 March 2008. But if a liquidation plan had been notified to the European Commission by the UK before that date then, as appears to be accepted, the guidance referred to made it clear that it could have extended the rescue aid period beyond 17 March 2008: and it would have done so had the liquidation plan appeared to be one that had at least a reasonable chance of being declared compatible under Article 87 (3) of the EC Treaty.

35. In paragraphs 101 to 103, the Applicant accepts that the assumed administration of Northern Rock required by the Valuation Assumptions (and the steps leading up to it) would need to be conducted in accordance with European law (in the same way that the

¹¹ See the European Commission 2007 Notice on Recovery of Unlawful and Incompatible State Aid: OJ C272 15.11.2007, paragraph 42: File 7, Tab 48.

steps leading up to it should comply with English company/insolvency/regulatory law).¹² However, it is denied that either the Repayment-in-Kind Interpretation or the Demand Interpretation is at odds with European law, or that the Repayment Interpretation best represents its policy requirements. In particular:

- (a) It is incorrect that the financial assistance would necessarily have to be repaid “within a short timescale”. As the First Respondent recognises and as the guidance referred to in paragraph 99 makes clear, a restructuring or liquidation plan may be authorised by the European Commission under Article 87 (3) of the EC Treaty and Article 4 (3) or 7 (3) of Council Regulation 659/99/EC. If it is so authorised, then the State aid at issue need not be repaid until the time set out in the liquidation plan. The controlled winding up of Northern Rock’s business through the 5-year run-off modelled in the two Expert Reports would constitute a liquidation plan which could have been authorised by the European Commission and would have had, at least, a reasonable chance of being authorised.
- (b) The Repayment-in-Kind Interpretation involves full repayment (including the PIK element) having been made by the time of the Valuation Date.
- (c) The Demand Interpretation envisages repayment of the secured (i.e. non-PIK) element of the financial assistance within two years. If the liquidation plan set out in the Second Expert Report had been notified to the European Commission, it is (at least) reasonably likely that the European Commission would have (a) extended the authorisation contained in its decision of 5 December 2007 pending consideration of that liquidation plan (see paragraph 34 above); and then (b) authorised that liquidation plan, thereby extending the time for repayment to two years. Moreover, the First Respondent is not in a position to say that the European Commission would not have approved/extended the time for repayment under the liquidation plan. This is for the following reasons:

¹² See the Grounds of Referral, paragraphs 60 to 81.

- (i) The European Commission would have a very broad discretion in relation to initial approval/subsequent extension of the time for repayment.
 - (ii) Its primary policy concern would be two-fold: the avoidance of competitive distortion and the protection of the wider financial sector.
 - (iii) The Demand Interpretation does not envisage Northern Rock conducting any new business. On that basis repayment in two years does not and cannot distort competition throughout the European financial sector.
 - (iv) The Demand Interpretation (unlike the Repayment Interpretation) does not swamp the European mortgage-backed security market with £29 billion of heavily-discounted assets, driving down values and creating market turmoil. By contrast, the controlled run-off of the Northern Rock portfolio protects the public interest through stabilising financial and capital markets.
- (d) Neither the Repayment-in-Kind Interpretation nor the Demand Interpretation ascribes the benefit of any aid to the financial advantage of shareholders. Under both interpretations the shareholders of Northern Rock are in neither a better nor worse position than they were but for (i.e. before) the provision of financial assistance in September 2007 i.e. the interpretations are both value neutral.
- (e) In fact it is the Repayment Interpretation that is inconsistent with the policy objectives of European law. It destroys value, requires subordinate government creditors to be paid 100 pence in the £ in priority to ordinary depositors and generates havoc in the European mortgage-backed security market.
- (f) There is therefore no basis for the suggestion at paragraph 101 that Parliament would have assumed, when it enacted the Banking Act, that any financial assistance would necessarily have to be repaid in full within a short timescale in order to comply with Community law: in fact, Community law, and the European

Commission's policy in applying Article 87 (3) EC, at the very least left open a real prospect that a liquidation plan such as that set out in the Second Expert Report would be authorised by the Commission and Parliament should be taken to have had that point in mind.

European Convention Rights

36. In paragraph 111, it is erroneously suggested that the First Respondent could not have done otherwise than adopt the Repayment Interpretation and that Section 6 (1) of the HRA does not apply at all. This misunderstands the nature of the Applicant's case. There is a fundamental difference between the Valuation Assumptions on the one hand and the interpretation of the Withdrawn Assumption which the First Respondent chose to adopt on the other.
37. As demonstrated by the Grounds of Referral, there are several competing interpretations of the Withdrawn Assumption and it was open to the First Respondent to adopt a construction which is compatible with the Applicant's Convention rights. Indeed, given Section 6 (1) of the HRA, the First Respondent was bound to adopt an interpretation of the Withdrawn Assumption which is compatible with the Applicant's Convention rights. The First Respondent could therefore have acted differently than he did and Section 6 (2)(a) of the HRA does not assist him.
38. As a matter of law, it makes no difference whether this outcome is reached through the application of Section 3 or Section 6 (1) of the HRA to the task of interpreting the Withdrawn Assumption: they both produce the same result (as one would expect). As such, the First Respondent was wrong to adopt an interpretation of the Withdrawn Assumption which is inconsistent with the Applicant's Convention rights and attaches no weight to them.

Other Principles of Interpretation

39. At paragraph 112, it is stated that the Applicant relies on two further principles of statutory interpretation, the presumption of legality and the presumption against absurdity. This is inaccurate: it relies merely upon the implied ancillary rule¹³ and the presumption against absurdity.

40. In paragraph 114, the First Respondent denies that statutes should not be interpreted in such a way as to necessitate a breach of English law. It relies upon the principle of implied repeal. Unfortunately, the First Respondent appears to have misunderstood the Applicant's case. The Applicant nowhere suggests that the Legislative Framework has the effect of repealing parts of the Companies Act 2006, the Insolvency Act 1986 and the FSA Listing Rules. The Applicant relies upon the fact that in the absence of a clear indication of contrary intention, Parliament is taken to intend general rules of law to apply in the interpretation of the Legislative Framework, which by implication imports any principle or rule of law which prevails in the territory to which it extends¹⁴ (e.g. corporate insolvency).

41. At paragraph 116, it is stated that neither of the principles relied upon by the Applicant are applicable. The First Respondent places particular reliance on the so-called hypothetical nature of the breaches and absurdity referred to, and asserts that there is no principle requiring statutes to be interpreted in a manner that avoids "a purely imaginary state of affairs". This is misconceived.

- (a) The breaches and absurdity are not entirely hypothetical. Though they occur in a hypothetical scenario established by the Legislative Framework for valuation purposes, the law of England (as the First Respondent well recognises¹⁵) is in

¹³ See generally *Bennion*, Part XXIII: File7, Tab 53.

¹⁴ See *Bennion*, Part XXIII, page 1033: File 7, Tab 53.

¹⁵ See e.g. paragraphs 4.49 to 4.53 of the Consultation Document, which set out some of the key principles of the English law of administration and administrators: File 1, Tab 1, page 41.

force in that hypothetical scenario, and, as a matter of fact, a hypothesis is something that did not happen rather than could not happen (and should be realistic rather than willfully fanciful).

- (b) By analogy, the “hypothetical sale” is a common device in the context of valuing property (where there has been a compulsory purchase order) and private shareholdings (where there has been a finding of unfair prejudice as between company members). These hypothetical sales are assumed rather than real. However, they are conducted in a manner that is consistent with English law, and are not based on factual absurdity.
- (c) It is accepted that the principles relied upon by the Applicant will not apply where there is a clear indication from Parliament of a contrary intention. However, the First Respondent has failed to identify evidence of such an intention.

42. At paragraph 118, the First Respondent states that the Valuation Assumptions are deeming provisions, and that the obligation is to apply them without regard to whether the deemed state of affairs came about lawfully or otherwise. The Applicant accepts that they are deeming provisions only inasmuch as they assume a hypothetical state of affairs: however, where such a provision is clearly capable of an interpretation that does not directly contravene the implied ancillary rule or the presumption against absurdity (i.e. the Repayment-in-Kind Interpretation or the Demand Interpretation), such an interpretation is to be preferred to an alternative, but contravening interpretation (i.e. the Repayment Interpretation).

43. The Applicant rejects the suggestion, at paragraph 119, that the Demand Interpretation gives primacy to shareholder’s interests. For the reasons detailed in the Grounds of Referral, the Demand Interpretation simply places the shareholders in no better (or worse) position than they would have been but for (i.e. before) the provision of financial assistance, whilst (unlike the Repayment Assumption) not requiring the directors to breach company/insolvency/regulatory law.

44. At paragraph 122, it is not accepted that an administration “cannot be assumed in advance”. Both the Applicant and the First Respondent value Northern Rock on the basis of an administration. The reference to liquidation and “playing for time” in the footnote are not understood.
45. The contention made at paragraph 123 is not understood. The First Respondent is not required to consider all the different ways the Bank might seek to obtain repayment: only enforcement in the current case i.e. a demand for repayment and a subsequent administration.
46. Contrary to the assertion at paragraph 124, there is nothing “unreal” about the hypothetical exercise: the assumed circumstances are provided by the Legislative Framework. The Thompson Report is based upon the premise that the Bank would not have acted in an un-commercial fashion. Furthermore, the Second Expert Report sets out in detail the considerations that the Bank would have entertained in circumstances where it was not at the margin of recovery and was acting in the wider interests of the general public¹⁶.

Degree of Discretion Afforded to the First Respondent

47. In paragraphs 132 to 133, it is suggested that the First Respondent has a considerable discretion and that the Applicant’s contentions that he should adopt a specific methodology must therefore be rejected. This is not accepted. The Administration Assumption requires the First Respondent to value Northern Rock on the basis of a hypothetical administration. It is to be assumed that the administration would be conducted by a reasonably competent administrator. The two Expert Reports represent how a reasonably competent administrator would have carried out the hypothetical administration: the Consultation Document and Final Document do not.

¹⁶ E.g. paragraphs 5.89 to 5.90: File 2, Tab 10, page 23.

Specific Points Raised by the Applicant

48. The Applicant rejects the suggestion, at paragraphs 135 to 136, that its methodology submissions are premised on its alternative interpretations of the Withdrawn Assumption. Only the First Respondent's approach to discounted values depends upon the application of his interpretation of the Withdrawn Assumption. All the other points on methodology are independent of the question of interpretation. It is not the case (as suggested) that if the First Respondent is directed to adopt a changed interpretation he needs an opportunity to re-consider his approach to methodology. This is because the Applicant's criticisms of (a) the Repayment Interpretation and (b) the First Respondent's methodology (set out at paragraph 137 of his Statement of Case) are distinct: if the Tribunal concludes that a different construction of the Withdrawn Assumption is to be preferred, that will have no bearing on the methodological issues the Applicant has raised. It is in the interests of time and costs that all the issues should be heard together.¹⁷

49. At paragraphs 137 to 139 the First Respondent sets out the Applicant's criticisms of his methodology. These are set out in full at paragraphs 5.103 to 5.140 of the Second Expert Report¹⁸.

Application of Rule 2.88

50. The First Respondent describes the Applicant's treatment of statutory interest as "speculative". The alleged reason for this is that "it cannot be assumed that all or any creditors would have agreed to give up the enhanced statutory rate of interest in return for prompter payment". This is misconceived for the following reasons:

¹⁷ The Applicant suggested in a letter dated 24 December 2009 that the construction of the Withdrawn Assumption be taken as a preliminary issue in the Chancery Division; the First Respondent rejected the need for this in his letter dated 11 January 2010; File7, Tab 54.

¹⁸ File 2, Tab 10, pages 25 to 31.

- (a) It is common ground that the statutory objective of the assumed administration would be to achieve a better result for Northern Rock's creditors as a whole than would be likely if the company were wound up (without first being in administration).
- (b) As set out at paragraphs 6.87 to 6.96 of the First Expert Report¹⁹ and paragraphs 5.103 to 5.110 of the Second Expert Report²⁰, through the alternative settlement structure described therein, all creditors (i.e. secured and unsecured) would receive 100 pence in the £ plus contractual interest in full.
- (c) By contrast, a rigid application of rule 2.88 of IR86 would, on the First Respondent's valuation, lead to a rolled-up liability of £7.045 billion at the end of administration, which in turn would be the main contributor to a £5.676 billion deficiency²¹ (i.e. creditors would not be repaid principal and interest in full).
- (d) The alternative settlement structure would achieve a better result for Northern Rock's creditors as a whole than would be likely if the company were wound up (without first being in administration).
- (e) The reasonably competent Administrator of Northern Rock would be duty-bound to put proposals to secured and unsecured creditors that would best achieve the second statutory objective of administration.
- (f) As set out at paragraphs 5.83 to 5.93 of the Second Expert Report²² there are sound commercial reasons why creditors would have agreed for interest to be paid current and for the application of rule 2.88 of IR86 to be waived (i.e. 100%

¹⁹ File 2, Tab 7, pages 33 to 35.

²⁰ File 2, Tab 10, pages 25 to 26.

²¹ See the Consultation Document, Figure 2, at page 19; File 1, Tab 1.

²² File 2, Tab 10, pages 22 to 24.

payment of principal and accelerated payment of contractual interest in full). See also paragraphs 2.13 to 2.14 of the Thompson Report²³.

- (g) Accordingly, the First Respondent's treatment of statutory interest is not reasonable, since it is not one that a reasonably competent administrator would have taken in circumstances where an alternative settlement structure would have achieved the best result for creditors as a whole and where the Administrator is faced with an opening net asset position indicating that a substantial equity surplus is potentially available.

51. In paragraph 143, the First Respondent refers to the B&B Scheme Assessment Notice and the approach to statutory interest therein. The B&B Assessment Notice has no relevance to the question of how the Administrator would have conducted the administration of Northern Rock.

Discounted Sale Values

52. The Applicant acknowledges that the First Respondent's assumption of substantial discount was adopted only in the context of the Withdrawn Assumption, rather than during the 5-year notional administration. As set out above, the approach of the First Respondent was wrong as a result of his operation of the Repayment Interpretation.

Covered Bonds

53. The First Respondent contends that there is nothing unreasonable about his having treated the Covered Bonds as having been repaid in accordance with their terms. The Applicant does not accept this. In view of the position of the capital markets at the time and the inherent uncertainties associated with administration the Covered Bond holders would have sought early repayment of their liabilities. It is unrealistic to assume that the bondholders would have been tied to their investment until the end of the assumed

²³ File 2, Tab 12, page 5.

administration. They would have sought to vary the contractual arrangements through an extraordinary resolution²⁴.

54. The First Respondent's treatment is unreasonable as it bears no reflection on what in reality would have happened.

Derivatives

55. The First Respondent is wrong to assert that there is nothing unreasonable about his approach to derivatives. In assuming that all derivatives would be held for the duration of the administration, he failed to consider that (a) "out of the money" counterparties might terminate to avoid further losses and (b) counterparties' decision-making would be influenced by the inherent uncertainty of administration (i.e. to reach an extra-contractual agreement with the Administrator). The Applicant's valuation allows for early realisation in order to pay down liabilities and fulfill the secondary statutory purpose of administration.

56. The First Respondent's treatment is unreasonable as it bears no reflection on what in reality would have happened.

Medium Term Notes

57. The First Respondent criticises a perceived inconsistency in the Applicant's approach to the MTN programme (as set against his approach to the Covered Bond programme). The Applicant makes the following submissions in response to this:

- (a) The Applicant reserves its position pending disclosure of the underlying documentation²⁵.

²⁴ See Schedule 4 of the Trust Deed: File 7, Tab 47, page 131.

²⁵ In particular, the Applicant does not have access to the relevant default interest rate.

- (b) The Applicant's approach is no more inconsistent than that of the First Respondent: on the one hand the First Respondent argues that MTN holders take pro-active action to accelerate repayment, whereas on the other hand he asserts that Covered Bond holders would not.
- (c) The MTN holders would most likely seek accelerated payments of principal amounts and the payment of interest on a pay-as-you-go basis in order to avoid the potential uncertainties of a prolonged administration: see the First Expert Report, paragraphs 6.88 to 6.90²⁶, and the Second Expert Report, paragraphs 5.93 to 5.96²⁷.

58. The First Respondent's treatment is unreasonable as it bears no reflection on what in reality would have happened.

C. REPLY TO THE SECOND RESPONDENT

59. The Applicant makes the following short points in response to the Statement of Case filed by the Second Respondent:

- (a) It is noted that the Second Respondent asserts that it supports the application of the Repayment Interpretation by the First Respondent. The Applicant maintains that this construction of the Legislative Framework is fundamentally inconsistent with the purpose of the Withdrawn Assumption espoused by the Second Respondent in the judicial review proceedings (i.e. that the purpose of the Withdrawn Assumption is "to put the shareholders in exactly the position that they would have been in if the deposit taker had received no financial support from the public sector"²⁸).

²⁶ File 2, Tab 7, pages 33 to 34.

²⁷ File 2, Tab 10, page 24.

²⁸ See the opening submissions of Jonathan Sumption QC: Day 2, page 74, lines 15 ff: File 7, Tab 52.

- (b) At no stage has the Applicant suggested that the Second Respondent's case in the judicial review proceedings was that the Valuation Assumptions sought to replicate a position where Northern Rock would have gone into administration in September 2007 without its best assets being realised in a fire-sale. There was no evidence before the High Court or the Court of Appeal about what the position would in fact have been if no financial assistance had been provided.
- (c) It is unfortunate that the Second Respondent has mischaracterised the nature of the evidence filed by Mr Ashton and Mr Katz in the judicial review proceedings: that evidence claimed that the combined effect of all the Valuation Assumptions (i.e. the Withdrawn Assumption and the Administration Assumption, not the Withdrawn Assumption alone) was a fire-sale in administration.²⁹ The Applicant has already made submissions about this misconception: see its Supplemental Submissions, paragraph 11 ff³⁰.
- (d) The Grounds of Referral do not suggest the Second Respondent made any such contention about the Withdrawn Assumption: paragraph 55 represents the Applicant's own view (based on expert evidence) of what would have happened in September 2007 if, as posited by the Court of Appeal, "no LOLR support had been provided". However, there was no evidence about the position 'but for' the financial assistance filed in the judicial review proceedings.

MARK PHILLIPS QC
GEORGE PERETZ
DAVID ALLISON
IVAN HARE
WILLIAM WILLSON
BROWN RUDNICK LLP

²⁹ See the 6-page witness statement of Mr Katz, paragraphs 12 ff ("Administration without the continuation of Support"), referred to in the witness statement of Mr Ashton, paragraphs 92 ff: File7, Tab 49 and File 7, Tab 50.

³⁰ File 2, Tab 8, page 5 ff.