Trinity Term

[2016] UKSC 29

On appeal from: [2015] EWCA Civ 1257

JUDGMENT

BNY Mellon Corporate Trustee Services Limited (Appellant) v LBG Capital No 1 Plc and another (Respondents)

before

Lord Neuberger, President

Lord Mance

Lord Clarke

Lord Sumption

Lord Toulson

JUDGMENT GIVEN ON

16 June 2016

Heard on 21 March 2016

Appellant	Respondents
Robin Dicker QC	Mark Howard QC
Stephen Robins	Robert Miles QC
	Andrew De Mestre
	Gregory Denton-Cox
(Instructed by Allen & Overy LLP)	(Instructed by Norton Rose Fulbright LLP)

LORD NEUBERGER: (with whom Lord Mance and Lord Toulson agree)

1.
The issue in this case is whether Lloyds Banking Group ("LBG") is entitled to redeem £3.3 billion of loan notes which would otherwise carry a relatively high rate of interest, namely over 10% per annum. The loan notes are contingent convertible securities (perhaps inevitably known as "Cocos"), and are formally described as enhanced capital notes, or the ECNs. The ECNs are potentially convertible into fully paid up shares in LBG, and they were issued in November 2009, at a time when LBG, like many other banks, was in dire need of recapitalisation in order to protect its capital position and to comply with regulatory requirements.

2.
Before turning to the terms on which the ECNs were issued, it is necessary to understand a little about the Regulations as at that time, and, in order to understand the issues on this appeal, it is necessary to set out some of those terms and then explain a few of the changes effected to the Regulations in 2013 and the way in which they were applied.

The regulatory position when the ECNs were issued

3.
As at the time that the ECNs were issued, the capital requirements of financial institutions in the EU were governed by a 2006 Directive known as CRD I. This Directive was inevitably based on the current international banking accord, at that time the so-called Basel II. The relevant regulatory authority in the United Kingdom at the time was the Financial Services Authority, the FSA.

4.
Under CRD I, the capital of financial institutions was arranged in tiers. The highest tier of capital was Core Tier 1, known as CT1; the next tier was divided into Upper Tier 2 Capital and Lower Tier 2 Capital. CT1 included, inter alia, paid up shares and retained earnings. Lower Tier 2 Capital included dated subordinated debt. The FSA's practice was to require a financial institution to maintain a minimum ratio of CT1 assets and in addition to pass certain "stress tests", which involved subjecting the bank's balance sheet to hypothetical challenging market situations.

5.
In November 2008, the FSA issued a Statement which described a "Capital Framework" which it intended to apply to all financial institutions. The November 2008 Statement explained that the FSA "used as common benchmarks within this framework ratios of capital to risk weighted assets of total Tier 1 Capital of at least 8% and Core Tier 1 Capital, as defined by the FSA, of at least 4% after the stressed scenario". The November 2008 Statement also stated that the FSA "will be addressing the longer term capital regime for deposit takers in a discussion paper in the first quarter of 2009, the expectation being that this document will form part of the wider review of the global regulatory environment, which the FSA along with the other regulatory authorities, will be participating in".

6.
From time to time, the FSA issued further Statements and Guidance. Thus, in May 2009, it issued a Statement indicating that it had "[g]reatly increased the use of stress tests as an integral element of our ongoing supervisory approach". The May 2009 Statement also stated that the FSA "expected UK banks to maintain Core Tier 1 Capital, as defined by the FSA, of at least 4% of Risk Weighted Assets after applying an FSA defined stress test". The Statement added that "[t]his current framework will remain in place until the Basel accord, which is implemented through EU capital requirement directives, has been modified to reflect the lessons learned from recent events". The May 2009 Statement also explained that the stress tests "look forward over five years but with greater detail over the first three" and that the tests "are used to identify if at any time in the next five years there is a danger that under the stress scenario the level of capital will fall below the 4% Core Tier 1 minimum".

7.
In September 2009, in response to transitional legislation issued by the EU to control the use by financial institutions of hybrid securities as capital, the FSA issued another Statement making it "clear that the FSA will work to ensure the timing of the introduction of a new long-term capital regime …". The September 2009 Statement also stated that "hybrid capital instruments must be capable of

supporting Core Tier 1 by means of a conversion or write-down mechanism at an appropriate trigger. Instruments with these characteristics could be seen as a form of contingent Core Tier 1 Capital".

The issue of the ECNs

8.
Meanwhile, in March 2009, the FSA had stress-tested LBG, and had found that it had a shortfall in its CT1 Capital, in the light of the 4% minimum requirement referred to in the November 2008 Statement. As a result, the FSA required LBG to demonstrate that it had raised at least £21 billion which could qualify as CT1 Capital. After considering alternative options, LBG decided to raise £13.5 billion by issuing new fully paid-up shares through a rights issue, and £8.3 billion through the medium of the ECNs, to be issued in exchange for existing securities. These ECNs were intended to be Cocos which would satisfy what was said in the passage in the September 2009 Statement quoted at the end of para 7 above.

9.
This decision was duly implemented. The terms of the £8.3 billion ECNs were described in a so-called Exchange Offer Memorandum. The exchange invited in that Memorandum was taken up, and the ECNs were issued and subscribed in a number of different series in December 2009.

10.
The ECNs were loan notes whose terms were contained in a Trust Deed, which included in Schedule 4 detailed Terms and Conditions ("T&Cs"). In very broad terms, the ECNs (i) carried interest at varying rates depending on the series, but averaging about 10.33% per annum, (ii) subject to points (iii) and (iv), were redeemable only at certain specified dates under clause 8(a) of the T&Cs, which, depending on the series, varied between 2019 and 2032, but (iii) could be redeemed early by LBG, albeit only on a so-called "Capital Disqualification Event" under clauses 8(e) and 19 of the T&Cs, and (iv) were in the meantime potentially convertible into paid up shares in certain specified circumstances described in clause 7(a) of the T&Cs.

11.
Clause 7 of the T&Cs was concerned with "Conversion" of the ECNs. Clause 7(a) was headed "Conversion upon Conversion Trigger", and clause 7(a)(i) provided that "[i]f the Conversion Trigger occurs at any time, each ECN shall … be converted … into … Ordinary Shares credited as fully paid". The "Conversion Trigger" was defined as occurring at any time when "LBG's Consolidated [CT1] Ratio is less than 5 per cent". The 5% figure was 1% above the minimum 4% ratio required at the time by the FSA, as explained in the Statements cited in paras 5 and 6 above. The remainder of clause 7 was concerned with consequential machinery.

12.
Clause 8 of the T&Cs was headed "Redemption and Purchase". Clause 8(a) provided for the ECNs to be redeemed on the relevant "Maturity Date" (which was a date which varied between 2019 and 2032 depending on the particular series of the ECN) "[u]nless previously converted, redeemed or purchased and cancelled as provided in these Conditions". Clause 8(e) provided that "[i]f … a Capital Disqualification Event has occurred and is continuing, then [LBG] may … redeem … all, but not some only, of the ECNs at [a specified price]".

13.
Clause 19 of the T&Cs was headed "Definitions". It provided that "a 'Capital Disqualification Event' is deemed to have occurred":

“(1) if at any time LBG … is required under Regulatory Capital Requirements to have regulatory capital, the ECNs would no longer be eligible to qualify in whole or in part (save where such non-qualification is only as a result of any applicable limitation on the amount of such capital) for inclusion in the Lower Tier 2 Capital of LBG … on a consolidated basis; or

(2) if as a result of any changes to the Regulatory Capital Requirements or any change in the interpretation or application thereof by the FSA, the ECNs shall cease to be taken into account in whole or in part (save where this is only as a result of any applicable limitation on the amount that may be so taken into account) for the purposes of any ‘stress test’ applied by the FSA in respect of the Consolidated Core Tier 1 Ratio.”

14.
Certain other definitions in clause 19 of the T&Cs are also of some relevance. “Core Tier 1 Capital” was defined as “core tier one capital as defined by the FSA as in effect and applied (as supplemented by any published statement or guidance given by the FSA) as at 1 May 2009”. “Tier 1 Capital” and “Lower Tier 2 Capital” were each defined as having the “meaning given to it by the FSA from time to time”. “Regulatory Capital Requirements” was defined as meaning “any applicable requirement specified by the FSA in relation to minimum margin of solvency or minimum capital resources or capital”. The “FSA” was defined elsewhere in the Trust Deed as including any “governmental authority in the United Kingdom … having primary supervisory authority with respect to LBG”.

15.
The effect of this arrangement was that (a) the ECNs counted as Lower Tier 2 Capital so long as they were neither redeemed under clause 8 nor converted under clause 7, and (b) if the ECNs were converted under clause 7 they would count towards the CT1 Capital. That is because, as explained in para 4 above, CT1 Capital included paid up shares and Lower Tier 2 Capital included dated subordinated debt. If conversion was avoided, the current shareholders did not have their shareholdings diluted, but the ECN holders received a good rate of interest. And the conversion under clause 7 would only occur when LBG’s CT1 Capital fell below 5% of risk weighted assets - ie when it was getting near the minimum 4% set by the FSA.

Subsequent relevant regulatory developments

16.
With effect from 1 April 2013, the FSA was replaced as the body responsible for the regulation and supervision of UK financial institutions by the Prudential Regulation Authority, the PRA (which is wholly owned by the Bank of England).

17.
So far as EU regulatory requirements are concerned, CRD I was succeeded in 2010 and 2011 respectively by CRD II and CRD III, but neither of them made any changes relevant for present purposes. However, CRD IV, which was published in June 2013, and followed the so-called Basel III, made substantial changes. First, it replaced CT1 Capital with Common Equity Tier 1 capital (“CET1 Capital”), which is a significantly more restrictive category than was CT1 Capital. Secondly, it set the minimum core capital ratio at 4% CET1 from 1 January 2014, increasing to 4.5% CET1 from 1 January 2015. Thirdly, it introduced a new concept, Additional Tier 1 Capital, (“AT1 Capital”), which included contingently convertible loan stock, such as the ECNs. It provided that such stock would only qualify as AT1 Capital if the trigger for conversion was set at a CET1 ratio of at least 5.125%.

18.

In March 2013, the Financial Policy Committee of the Bank of England, the FPC, issued a news release recommending that the PRA should assess the current capital adequacy of financial institutions in accordance with the CRD IV and Basel III criteria, albeit subject to adjustments. In particular, it said that by the end of 2013, banks should hold capital falling within CET1 (as adjusted) equivalent to at least 7% of their risk-weighted assets (a 7% "adjusted CET1 ratio" standard), which was, according to the evidence, equivalent to requiring LBG to have an unadjusted CET1 Capital ratio of 10%.

19.
In June 2013, the PRA announced that LBG needed to raise a total of £8.6 billion further capital in order to meet the new 7% adjusted CET1 ratio standard. In August 2013, the PRA published a consultation paper, which dealt with the eligibility of Cocos and other convertible instruments to count as core capital. It stated that if financial institutions "issue AT1 instruments, the PRA expects them to set AT1 triggers … at a level higher than 5.125% CET1".

20.
By contrast, and crucially for present purposes, the evidence in this case establishes that the effect of the terms of the ECNs is that conversion of the ECNs into fully paid up LBG shares would only be triggered if LBG's CET1 ratio fell to 1%, which is, of course, far below the minimum required by the PRA under its 2013 Regulatory regime.

21.
In December 2013, the PRA published a "Supervisory Statement" effectively confirming as requirements what had been trailed by the FPC and the PRA earlier that year.

22.
In anticipation of the requirements in the December 2013 Supervisory Statement, LBG had substantially strengthened its capital position by the end of 2013. This involved a number of steps, including offering to exchange up to a maximum of £5 billion of the ECNs for new Cocos which would qualify as AT1 Capital, on the basis that they would convert to paid-up shares if LBG's adjusted CET1 Capital ratio fell to 7% or lower. As explained in the supporting memorandum issued by LBG, the 7% conversion trigger was selected because of "statements by the PRA … that a conversion trigger of 5.125% … may not convert in time to prevent the failure of a firm and that it expects major UK firms to meet a 7% CET1 ratio determined in accordance with … CRD IV". £5 billion of the ECNs were duly exchanged for these new Cocos in March and April 2014.

23.
In April 2014, the Bank of England announced that, in relation to stress testing, the previous CT1 4% capital ratio would be replaced by a "hurdle rate" of a ratio of 4.5% of CET1 to risk-weighted assets, although a stress test outcome was not dependent on a simple "pass/fail" exercise.

24.
In December 2014, the PRA reported that LBG's CET1 ratio at the end of 2013 was 10.1% and that its "minimum 'stressed' ratio in the stress test was 5%". The ECNs were not taken into account in either assessment. That was inevitable, as Gloster LJ pointed out in her judgment in the Court of Appeal, "because LBG remained above the minimum capital threshold in that stress test - in that its CET1 ratio did not fall below 4.5% - by reason of the strength of its capital position without any need to take into account the ECNs, the conversion trigger point for which was well below the new CET1 capital pass ratio".

These proceedings

25.
On 16 December 2014, LBG announced that the ECNs had not been taken into account in the December 2014 stress test and accordingly a Capital Disqualification Event (hereafter a "CDE") had occurred under para (2) of the definition in clause 19 of the T&Cs, and accordingly LBG was entitled to redeem the outstanding £3.3 billion ECNs in accordance with clause 8(e) of the T&Cs. The consent of the PRA to the redemption was required and was duly obtained. However, BNY Mellon Corporate Trustee Services Ltd ("the Trustee"), as trustee for the holders of the ECNs under the Trust Deed mentioned in para 10 above, challenged LBG's claim to be entitled to redeem the outstanding ECNs.

26.
Hence these proceedings, in which LBG contends that a CDE has occurred, so that it can redeem the outstanding ECNs, and the Trustee denies that a CDE has occurred. LBG argues that a CDE has occurred because para (2) of the definition of a CDE in clause 19 of the T&Cs ("the Definition") is satisfied. LBG's case is that "as a result of [a change] to the Regulatory Capital Requirements or any change in the interpretation or application thereof by the FSA", namely the implementation of CRD IV through the 2013 Supervisory Statement, "the ECNs [have ceased] to be taken into account … for the purposes of any 'stress test' applied by the [PRA] in respect of the Consolidated Core Tier 1 Ratio", as is evidenced by the stress tests carried out in 2014 in respect of LBG's financial position as at December 2013.

27.
The Trustee raises two arguments why this contention is wrong. First the Trustee contends that the December 2014 stress test was not "in respect of the Consolidated Core Tier 1 Ratio", as specified in para (2) of the Definition; rather, it was a stress test in respect of a CET1 ratio. Secondly and alternatively, the Trustee contends that the fact that the ECNs were not taken into account in the December 2014 stress test when assessing the Tier 1 Ratio is not enough to trigger a CDE; in order for para (2) of the Definition to apply, the ECNs must be disallowed in principle from being taken into account for the purposes of the Tier 1 Ratio before para (2) of the Definition can be invoked by LBG.

28.
At first instance, Sir Terence Etherton C, in a clear and careful judgment, rejected the Trustee's first argument, but accepted the Trustee's second argument - [2015] EWHC 1560 (Ch). Accordingly, he found in favour of the Trustee and held that the ECNs were not redeemable under clause 8(e) of the T&Cs. For reasons given in a very full judgment in the Court of Appeal, Gloster LJ agreed with Sir Terence on the first argument but disagreed with him on the second argument; Briggs LJ agreed with Gloster LJ for reasons given in a short judgment, and Sales LJ agreed with Gloster LJ. Accordingly, LBG won in the Court of Appeal, who concluded that the ECNs were redeemable under clause 8(e) of the T&Cs - [2015] EWCA Civ 1257. The Trustee now appeals to the Supreme Court.

The proper approach to interpretation

29.
Much of the argument before us was given over to the question whether, when construing the Trust Deed, and in particular the T&Cs, the Court of Appeal had been entitled to take into account statements in the substantial Exchange Offer Memorandum and in the lengthy letter from the chairman of LBG which accompanied it, and indeed the details of the statements and other documents issued by the FSA in 2008 and 2009.

30.
Over the past 20 years or so, the House of Lords and Supreme Court have given considerable (some may think too much) general guidance as to the proper approach to interpreting contracts and indeed other commercial documents, such as the Trust Deed in this case. What, if any, weight is to be given to what was said in other documents, which were available at the time when the contract concerned was made or when the Trust Deed in question took effect, must be highly dependent on the facts of the particular case. However, when construing a contract or Trust Deed which governs the terms upon which a negotiable instrument is held, as in the present case, very considerable circumspection is appropriate before the contents of such other documents are taken into account.

31.
In this connection, it is worth repeating the remarks of Lord Collins (with whom Lord Hope and Lord Mance agreed) in In re Sigma Finance Corp (in administrative receivership) [2010] 1 All ER 571, paras 36 and 37. Having pointed out that the trust deed in that case concerned “debt securities” issued to “a variety of creditors, who hold different instruments, issued at different times, and in different circumstances”, Lord Collins, at para 37, said “[c]onsequently this is not the type of case where the background or matrix of fact is or ought to be relevant, except in the most generalised way.” More generally, he said:

“Where a security document secures a number of creditors who have advanced funds over a long period it would be quite wrong to take account of circumstances which are not known to all of them. In this type of case it is the wording of the instrument which is paramount. The instrument must be interpreted as a whole in the light of the commercial intention which may be inferred from the face of the instrument and from the nature of the debtor’s business.”

32.
As Mr Dicker QC points out on behalf of the Trustee, the same point was made by Lord Macmillan when giving the decision of the Privy Council in Egyptian Salt and Soda Co Ltd v Port Said Salt Association Ltd [1931] AC 677, 682. Disapproving the trial judge’s reliance on “surrounding circumstances at the time when the memorandum was framed”, Lord Macmillan said that “the purpose of the memorandum is to enable shareholders, creditors and those who deal with the company to know what is its permitted range of enterprise, and for this information they are entitled to rely on the constituent documents of the company” and that the “intention of the framers of the memorandum must be gathered from the language in which they have chosen to express it”. (See also the observations of Lord Hoffmann to much the same effect in Attorney General of Belize v Belize Telecom Ltd [2009] 1 WLR 1988, para 36, Homburg Houtimport BV v Agrosin Private Ltd [2004] 1 AC 715, para 74, and Chartbrook Ltd v Persimmon Homes Ltd [2009] AC 1101, para 40).

33.
In the present case, the Trust Deed, and in particular those parts of clauses 7, 8 and 19 of the T&Cs which fall to be construed, cannot be understood unless one has some appreciation of the regulatory policy of the FSA at and before the time that the ECNs were issued. That is self-evident from the provisions of clause 19 which are set out in paras 13 and 14 above. Accordingly, I consider that at least the general thrust and effect of the FSA regulatory material published in 2008 and 2009 can be taken into account when interpreting the T&Cs. That would also accord with good sense: while the individual purchasers of the ECNs may not by any means all have been sophisticated investors, it is appropriate to assume that most of them would have had advice from reasonably sophisticated and informed advisers before they purchased such moderately complex financial products. The Exchange Offer Memorandum and the letter from the LBG chairman present more difficulties, and the answer

may depend on whether such documents would have been known about or in the minds of subsequent purchasers of the ECNs, a point on which there was no evidence, so far as I am aware.

34.
As it is, I do not consider that the terms of the Exchange Offer Memorandum or the letter from the LBG chairman take matters any further in this case. In my view, once one has in mind the general thrust and effect of the FSA regulatory approach in 2009, as summarised in paras 4 to 7 above, coupled with the commercial purpose of the ECNs as summarised in para 15 above, it is simply unhelpful on the facts of this case to cast one's eyes further than the T&Cs when resolving the issues on this appeal. I now turn to those two issues.

The first issue: did the possibility of a CDE fall away following CRD IV?

35.
I have no hesitation in agreeing with Sir Terence Etherton and the Court of Appeal in their conclusion that the reference to "the Consolidated Core Tier 1" in para (2) of the Definition should, in the events which have happened, be treated as a reference to "its then regulatory equivalent" - ie in the current context the Common Equity Tier 1 Capital. Etherton C and the Court of Appeal considered that this conclusion involves a departure from the strictly literal meaning of the definition of "Core Tier 1 Capital" in clause 19, but they concluded that such a departure was justified because it was "clear that something has gone wrong with the language and [it was] clear what a reasonable person would have understood the parties to have meant", applying the test laid down by Lord Hoffmann in Chartbrook, para 25.

36.
The reasons given by Gloster LJ in para 85 of her judgment for departing from what she considered was the literal meaning of the closing words of para (2) of the Definition were based on the arguments of Mr Miles QC. They were, in summary, that (i) it was notorious at the time of the issue of the ECNs that the regulatory requirements as to financial institutions' capital would be "strengthened and changed", (ii) it was envisaged in the T&Cs, in particular in clause 19, that expressions such as "Regulatory Capital Requirements" and "Core Tier 1 Capital" could change their meaning; (iii) indeed, it was inherent in the terms of the Definition that this was so; (iv) it was obvious that changes of substance might lead to changes of nomenclature; and (v) one of the essential features of the ECNs was that, if necessary, they could be converted into LBG core capital, whatever expression was used to define it.

37.
Gloster LJ concluded that, given these points, coupled with the existence of the ECN maturity dates, it made no commercial sense to limit the reference to "Core Tier 1 Capital" in para (2) of the Definition to CT1 Capital, as opposed to holding that it could, in the events which had happened (as summarised in paras 16 to 20 above), apply to CET1 Capital. She also considered that the error would "have been obvious to a reasonable addressee of the Exchange Offer Memorandum". She referred in this connection to another observation of Lord Collins in Sigma, where, in para 35, he said that in complex documents such as the Exchange Offer Memorandum, "there are bound to be ambiguities, infelicities and inconsistencies" and had gone on to warn against an "over-literal interpretation of one provision without regard to the whole", which may "distort or frustrate the commercial purpose".

38.
Subject to one point, I have no hesitation in agreeing with the analysis as summarised in paras 35 to 37 above. My only doubt is as to whether this conclusion really does involve a departure from the

literal meaning of the closing words of para (2) of the Definition, not least in the light of the definitions of "Core Tier 1 Capital" and "Tier 1 Capital" in clause 19. It may involve a departure from the literal meaning, but, if it does, it is on the basis of a rather pedantic approach to interpretation. I do not, however, propose to discuss the point further: it is completely arid.

39.
I would add, however, that if the Trustee's argument was correct, it seems to me that LBG would have had a powerful basis for saying that this appeal should be dismissed rather than allowed. That is because, as a matter of language at least, LBG could say that para (2) of the Definition applied on the grounds that the ECNs had, on any view "cease[d] to be taken into account … for the purposes of any 'stress test' applied by the FSA in respect of the Consolidated Core Tier 1 Ratio", because that ratio was no longer being used by the FSA.

The second issue: have the ECNs "ceased to be taken into account"?

40.
The critical question raised by the second issue is whether, as LBG contends, in the light of the regulatory changes and events as described in paras 17-24 above, "the ECNs [have] cease[d] to be taken into account in whole or in part … for the purposes of any 'stress test' applied by the [PRA] in respect of [what I will call the Tier 1] ratio". To put the point slightly differently, the question is whether the implementation of CRD IV by the PRA through the new Capital Requirements summarised in paras 17 to 21 above, and applied as described in paras 23 and 24 above, entitle LBG to say that a CDE has occurred because para (2) of the Definition has been satisfied.

41.
The nature of the dispute on this second issue was very well expressed by Briggs LJ in para 114 in the Court of Appeal, in these terms:

"In order to resist early redemption of the ECNs is it sufficient that they continue to be taken into account for some purpose or purposes in the stress-test now applied by the [PRA], which in my view they do, or must they play a part in enabling LBG to pass that test, which they clearly no longer do, because of the change in the Regulatory Capital Requirements which had the effect of elevating the pass ratio to a level above the Conversion Trigger."

42.
I also agree with what Briggs LJ said in the next paragraph of his judgment, namely that this is a difficult question to resolve, and I find it unsurprising that Sir Terence and the Court of Appeal took different views, and indeed that there is a difference of view in this court.

43.
LBG argues that the essential point is that "the Regulatory Capital Requirements" changed in 2013 with the consequence that the ECNs could no longer be taken into account in assisting LBG in passing the stress test, because the conversion trigger under the terms of the ECNs was at a level lower than the minimum required by the PRA, as explained in para 20 above, and, in any event, the PRA did not in any way rely on the ECNs when conducting its stress tests on LBG in 2014.

44.
By contrast, the Trustee's argument is that, notwithstanding the regulatory changes in 2013, the ECNs can continue to be taken into account as part of the Tier 1 Capital by automatically converting into paid-up shares in LBG, albeit that this would only occur when the CET1 Capital ratio fell to 1%.

45.

I prefer LBG's argument, as advanced by Mr Howard QC, for the following reasons. First, it appears to me that the Trustee's argument does not give full weight to the phrase "any 'stress test' … in respect of the [Tier 1] Ratio". I accept that, under the new Regulations introduced in 2013, the ECNs could be taken into account in a "stress test", and I accept that there could be circumstances in which the ECNs could convert into ordinary shares so as to become part of Tier 1 capital. However, if and when a stress test is applied to see if LBG satisfies the Tier 1 Ratio, it appears to me that the vital point is that, under the Regulations introduced in 2013, the ECNs cannot be taken into account so as to do the very job for which their convertibility was plainly designed, namely to enable them to be converted before the regulatory minimum Tier 1 Ratio is reached. That, to my mind, is what the expression "taken into account … for the purposes of any 'stress test' … in respect of the [Tier 1] Ratio" is concerned with.

46.

Secondly, the question which has to be asked under para (2) of the Definition is whether the ECNs have "cease[d] to be taken into account" for the specified purpose. This is in marked contrast with the wording of para (1) of the Definition, where the question is whether the ECNs are "no longer … eligible to qualify" for the purpose specified in that paragraph. It seems to me that eligibility to qualify depends on what the Regulations say, whereas being taken into account depends more on what happens in practice - no doubt pursuant to the Regulations. That view is reinforced by the fact that para (1) is based simply on the requirements of "Regulatory Capital Requirements", whereas para (2) is also based on "any changes to the Regulatory Capital Requirements or any change in the interpretation or application thereof". It seems to me that the way on which the Trustee puts its case, as summarised in para 44 above, is ultimately concerned with the eligibility of the ECNs for the purpose described in para (2) of the Definition, whereas LBG can fairly rely on the fact that the ECNs were not, as a matter of fact (and it does not signify whether it was due to the terms of the 2013 Regulations, or the PRA's application of those Regulations) invoked for the purpose described in para (2) - see para 24 above.

47.

Thirdly, if the Trustee's interpretation is correct, it is very difficult to envisage circumstances in which it could have been thought that para (2) of the Definition could ever be invoked. The notion that fully paid up share capital could ever be excluded from the definition of Tier 1 Capital (whether CT1, CET1, adjusted CET1 or any other possible definition) seems fanciful. Accordingly, it is hard to see how the parties could have envisaged that a Coco, ie a loan note which automatically converted into paid-up share capital, could be excluded, in the sense that the Trustee's case requires, from being "taken into account … for the purposes of any 'stress test' … in respect of the [Tier 1] Ratio".

48.

While some of them are not without force, the arguments which have been raised against LBG's case do not persuade me the other way. There is, I accept, some force in the point that, if LBG's reading of para (2) of the Definition is correct, it must have been foreseeable when the ECNs were issued that a CDE would be likely to occur in the not-too-distant future. That is because it was well known that the capital requirements of financial institutions were to be strengthened (see paras 5 to 7 above), and so, runs the argument, it must have been appreciated that the minimum permitted Tier 1 Ratio was likely to go above the equivalent of a CT1 ratio of 5%. There are, however, two answers to this point. First, it was by no means certain that the increased capital requirements would involve increasing the minimum Tier 1 Ratio above the equivalent of a CT1 ratio of 5%. Apart from anything else, the new

requirements could have retained or only slightly increased this minimum, while introducing a new intermediate tier between what was CT1 and Upper Tier 2: that that is not a fanciful possibility is demonstrated by the actual introduction of the new concept of AT1 Capital (see para 17 above). Quite apart from this, the notion that it must have been perceived as likely that the ECNs would be redeemable well before their respective maturity dates is not a particularly surprising proposition, especially as clause 8(e) operated not as an automatic redemption, but merely gave rise to an option in LBG to redeem.

49.
The expression “Capital Disqualification Event” does not strike me as an inapt description of what has happened on LBG’s case. Thus, the effect of the change in the Regulations in 2013 and the application of those changed Regulations in 2014 can fairly be said to have “disqualified” the ECNs from having the potentially saving effect on the Tier 1 Ratio which they were intended to have, and could properly have had under the Regulations as they stood in 2009.

50.
The argument that the 2013 Regulations have not made any difference because the ECNs might not have ensured that LBG had a sufficiently high Tier 1 Ratio even under the 2009 Regulations appears to me to involve a mischaracterisation of LBG’s case. That case is not that the convertibility of the ECNs could be guaranteed to save the day under the 2009 Regulations. It is that their convertibility could be invoked to increase the Tier 1 Ratio before that ratio had fallen below the minimum under the 2009 Regulations of a CT1 Capital ratio of 4%. Thus, in 2009, the convertibility of the ECNs had the ability to enable LBG to keep above the minimum Tier 1 Ratio, whereas that was no longer possible under the 2013 Regulations. The force of the point is underlined by the PRA’s requirement in 2013 that the Tier 1 Ratio conversion trigger for any qualifying Cocos should be at least 5.125% (see paras 17 and 19 above).

51.
I am also unimpressed with the point that, on LBG’s argument, the ECNs may be redeemed under clause 8(e) because they have “cease[d] to be taken into account” on one stress test (as in 2014), notwithstanding that they might have been taken into account on a subsequent stress test. Such a possibility is inherent in para (2) of the Definition, whatever meaning one gives it. Thus, if para (2) is simply concerned with the ECNs’ eligibility to convert into Tier 1 Capital, as the Trustee contends, and the Regulations were changed to provide that they could no longer do so (highly improbable to say the least, as already pointed out), it could always be said that the Regulations might change back.

52.
It is said that LBG’s case leads to arbitrary results, as it may depend on the practices and assumptions of the PRA when applying a particular stress test or set of stress tests. There are two answers to that. The first is that, on the facts of this case, that is not a fair charge: given that the minimum Tier 1 Ratio has changed so that the ECNs cannot convert to Tier 1 capital until that capital has fallen below, indeed substantially below, the permissible minimum as a result of the changes effected by the 2013 Regulations, para (2) of the Definition applies. Quite apart from that, given the reference to the “application” of the Regulations “by the FSA … for the purposes of any ‘stress test’ applied by the FSA”, it is inherent in para (2) that the PRA’s practices could determine whether the paragraph is satisfied.

53.

Finally, there is also some force in the argument that the wording of para (2) of the Definition is not wholly clear and that, in the event of doubt, it should be construed against LBG, as the person responsible for drafting the Trust Deed, the proferens. The closing words "in respect of the … Tier 1 Ratio" are inherently imprecise: identifying the precise ambit of the expression "in respect of" frequently leads to arguments. However, the contra proferentem rule is very much a last refuge, almost an admission of defeat, when it comes to construing a document, and, in this case, for the reasons which I have attempted to give in paras 45-52 above, I do not think that it is necessary, or indeed appropriate, to resort to it in this case.

Conclusion

54.
Accordingly, I would dismiss the Trustee's appeal, on the basis that I consider that a Capital Disqualification Event has arisen under para (2) of the Definition of that expression in clause 19 of the T&Cs.

LORD SUMPTION: (dissenting) (with whom Lord Clarke agrees)

55.
This case is of considerable financial importance to the parties but raises no questions of wider legal significance. There is therefore no point in dissenting at any length. But since I would have held that that these securities are not redeemable, I should, however briefly, explain why.

56.
The notes are contingent share capital. Their immediate purpose as far as Lloyds Banking Group was concerned was to enable it to satisfy the FSA at the time of their issue that it would have a ratio of Consolidated Core Tier 1 Capital to risk-weighted assets of at least 4% in a hypothetical stressed scenario. Consolidated Core Tier 1 Capital included ordinary shares but not loan notes. The issue of these notes did not therefore actually strengthen the Bank's Tier 1 Capital. But because they would automatically convert to ordinary shares if in the hypothetical stress scenario the ratio fell to within one percentage point above the then minimum, they assisted the Bank to satisfy its regulators. The effect of the subsequent regulatory changes was that the definition of top tier capital was tightened up and the required ratio of adjusted top tier capital ("Common Equity Tier 1") to risk weighted assets was increased to 7%. This meant that the notes were no longer as useful to the Bank, because if its affairs deteriorated it would fail a stress test long before the trigger for conversion was reached. From the investors' point of view, however, that did not matter, provided that the Bank remained solvent. The attraction of the notes for them lay in their long maturity date and high coupon, both features that were critical to their market value.

57.
The notes are redeemable if as a result of regulatory changes they "cease to be taken into account" for the purposes of any stress test in respect of the Consolidated Core Tier 1 Ratio (for which, now read the Common Equity Tier 1 Capital ratio). The question is whether being "taken into account" means (i) that in the hypothetical stress scenario they would convert and play a part in enabling the Bank to pass the stress test; or (ii) that they must be eligible, in the sense that notwithstanding their status as Lower Tier 2 Capital the regulator would treat them as top tier capital in the hypothetical event of the Bank's affairs deteriorating to the point where the conversion trigger was attained, so that the stress scenario can be modelled on that basis. The difference is that (i) depends on how the Bank fared in an actual stress test, whereas (ii) turns on the regulator's rules and practices for conducting such tests.

58.
Sir Terence Etherton concluded that (ii) was correct, because the definition "is not looking at the happenstance of the particular strength of LBG's capital and the particular composition of its capital at any one particular moment of time in the context of a particular stress test imposed by the regulator at that time", but at the position as a matter of principle (para 46). I think that he was right.

59.
In the first place, it was always implicit in the terms that the notes might be irrelevant to the Bank's ability to pass a stress test. Whether or not there were changes to the regulatory capital requirements, the Bank's capital position might be strong enough to meet the minimum top tier capital ratio even if the notes did not convert. Or it might be so weak that the notes would not save the situation even if they did convert. If the notes would not necessarily play a part in enabling the Bank to pass a stress test in the situation obtaining when they were issued, I cannot see why it should be supposed that the parties intended to allow early redemption if the same situation obtained as a result of a change in regulatory capital requirements. The situation introduced by such a change is no different in principle from the situation that existed before. The change might make it more or less likely that the notes would be critical to the outcome of a stress test, but there is no change in the way that the scheme works.

60.
Secondly, a test dependent on how the notes affected the outcome of an actual stress test would be wholly uncertain. Stress testing is not a fixed or ascertainable concept. Its outcome will depend not just on the rules and practises of the regulator, but on what the hypothetical conditions assumed in a particular stress test are, on where the regulator pitches the stress test hurdle (not necessarily the same as the minimum regulatory top tier capital ratio), and what is the value and composition of the Bank's assets at the time of the test. Moreover the hypothetical stress scenario will test the strength of the Bank's capital over a substantial period of time, during which it may fail the test throughout or for a day or two. The significance of that will be a question of regulatory judgment. It is not just a simple question of pass or fail. Of course, the regulatory changes which actually occurred mean that the notes will in practice make little difference to the outcome on any reasonably foreseeable view about these matters. But although it was anticipated that there would be a tightening of the capital adequacy requirements, the details were not known at the time that the securities were issued, and the terms cannot be construed in the light of the subsequent changes.

61.
Thirdly, nothing in the definition of a "Capital Disqualification Event" supports the suggestion that it was intended to depend on the part played by the notes in enabling the Bank to pass an actual stress. The clause's title is concerned with "disqualification", ie with a state of affairs in which the notes are no longer eligible in principle to perform their function as contingent capital. As regards Lower Tier 2 Capital, dealt with in sub-clause (1), this is clear from the reference to capital being "eligible to qualify". The only reason why the word "eligible" is not used in sub-clause (2) of the definition, dealing with top tier capital, is that whereas the status of Lower Tier 2 Capital depends simply on whether it satisfies the relevant regulations, the status of top tier capital depends on the practices and judgments of regulators as well, a context in which it was appropriate to speak of the securities being taken into account, rather than being eligible.

62.
These were long-dated securities, which cannot have been intended to be redeemed early except in some extreme event undermining their intended function and requiring their replacement with some

other form of capital. The function of the notes was to be available to boost the Bank’s top tier capital in the hypothetical event that the ratio of top tier capital to risk-weighted assets fell below the conversion trigger. They have always served that function and still do. Whether that function remains as important to the Bank as it was in 2009 is irrelevant.