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LLOYDS SHAREHOLDER CLASS ACTION

BRIEFING PAPER

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Lloyds shareholder class action

Mr Justice Norris has today delivered judgment in the first shareholder class action in England & Wales, dismissing a claim brought by a group of Lloyds shareholders against Lloyds and five of its former directors relating to its acquisition of HBOS in 2008.

The decision in *Sharp v Blank* [2019] EWHC 3078 (Ch) (also known as *The Lloyds/HBOS litigation*) provides clarity on some of the most important battlegrounds which arise in shareholder class actions as well as guidance for listed companies and their directors on various key aspects of capital markets and M&A transactions.

The trial featured a number of high profile figures and considered the extraordinary events in the lead up to, during and immediate aftermath of, the financial crisis in 2008. Although it will be a disappointment to historians of the financial crisis, the court resisted the temptation to undertake a "*public enquiry*" into the acquisition of HBOS by Lloyds, deciding instead that the task in hand was to consider the specific allegations which were made by the shareholders.

The key elements of the claim were that the directors negligently recommended to Lloyds' shareholders that they should vote in favour of the acquisition of its rival, HBOS, and that they failed to provide shareholders with sufficient information to make an informed decision on how to exercise that vote and/or made negligent misstatements about the merits of the acquisition.

Whilst the facts were unusual, the underlying principles at issue and the lessons for those who are active in capital and M&A markets are important. The court's approach to the claims, and the way in which a number of standard features of market practice were treated will re-enforce the importance of high quality execution on deals.

It remains to be seen what impact the judgment will have on the likelihood of future shareholder class actions in England & Wales. In dismissing both claims, the judgment illustrates how difficult such claims are to bring successfully, particularly given the complexity of proving that any defects in a recommendation or disclosure actually caused loss to shareholders. Those challenges plainly go to the heart of whether similar claims are financially viable from the outset.

Facts

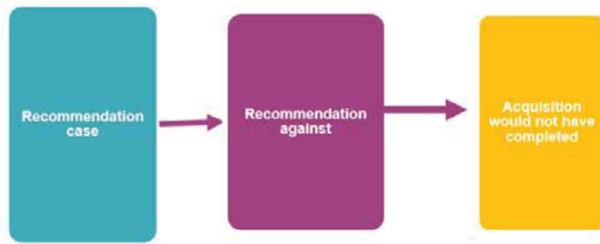
The claims were centred on the all-share acquisition by Lloyds of its rival, HBOS, at the height of the financial crisis in the Autumn of 2008. HBOS was, in the aftermath of the collapse of Lehman Brothers, subject to speculation about its ability to survive the crisis and in those circumstances Lloyds was given the opportunity to acquire HBOS (when in normal circumstances such a merger would likely have been prevented for competition reasons).

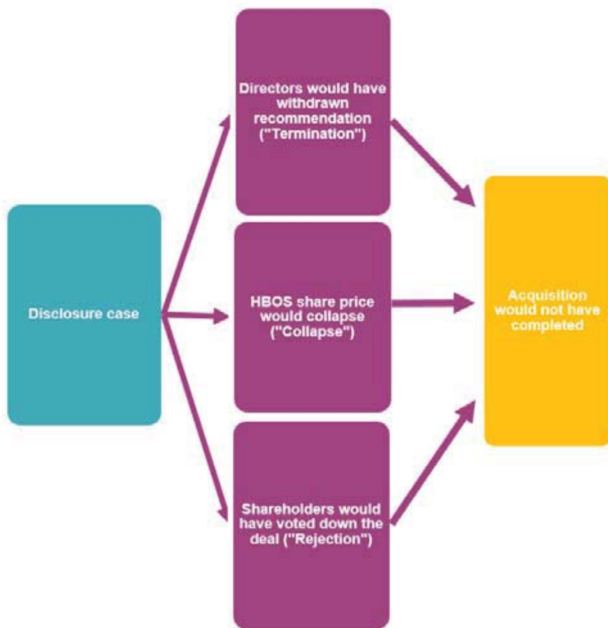
As a Class 1 transaction, Lloyds' shareholders were required to approve the acquisition at an Extraordinary General Meeting and, for that purpose, a shareholder circular was produced on 3 November 2008 explaining the benefits and risks of the acquisition and containing a recommendation from the Lloyds directors as to how shareholders should vote.

The claims were twofold:

- That the recommendation given to shareholders was negligent because it was based on insufficient due diligence, failed to take account of the funding and capital risks involved in acquiring HBOS at that time, and overplayed the risks of Lloyds continuing as a standalone entity ("**the recommendation case**").
- That the circular did not contain sufficient information about the risks of acquiring HBOS and/or contained negligent misstatements about HBOS and the acquisition, including that HBOS was in receipt of so-called Emergency Liquidity Assistance ("**ELA**") from the Bank of England and a £10bn loan facility from Lloyds itself, and that Lloyds had estimated impairments on HBOS's assets greater than market consensus ("**the disclosure case**").

The claimants' case was that, but for the negligent recommendation, the acquisition would not have gone ahead, and that had adequate disclosures been made, either the directors would have pulled out of the acquisition, disclosure would have triggered a collapse in the share price of HBOS or the shareholders would have voted against the acquisition at the Extraordinary General Meeting.





Findings

The recommendation case

- The court held that a reasonably competent chairman or executive director of a large bank could reasonably have reached the view, at the end of October 2008, that the acquisition was beneficial to Lloyds' shareholders and could reasonably have maintained that view until the shareholders' vote on the acquisition was taken.

The disclosure case

- The court found that the use of ELA ought to have been disclosed because the existence of the ELA facility was of potential concern to investors. This was not because it was an indicator that HBOS was a failed bank, or valueless (as had been alleged by the claimants) but because it presented a funding risk that would have to be absorbed by, and managed by, the combined entity.

- The court found that the £10bn loan facility provided by Lloyds to HBOS ought to have been disclosed because, given the non-standard features of the transaction, the existence of it was information which a shareholder should know.

- The court did not find that any of the other criticisms of the disclosure (including the omission of Lloyds' due diligence results) were justified.

Reliance and causation

- Notwithstanding that the court found there to have been two disclosure breaches, it nevertheless concluded that the claimants had not proven that these caused them any loss. This was because:

    - The court found that had the directors been required to disclose ELA and the £10bn loan facility in the circular, they would not have terminated the acquisition. Logically, the question of whether the acquisition was beneficial to shareholders did not depend on what shareholders would be told of the acquisition.

    - The court found that, although there may have been a mildly negative reaction to the disclosure of such information, such a decline would have been well short of a "*collapse*" in the share price of HBOS.

    - The claimants would have needed to prove that, had disclosure been made, more than 1.4 billion votes would have been voted differently. The evidence provided by the claimants was insufficient to support such an assumption.

- Accordingly both the recommendation case and the disclosure case were dismissed.

Loss

- In any event, on the evidence before the court, it would not have awarded any damages because:

    - In principle any shareholder seeking to recover such a loss as a result of the acquisition and recapitalisation would be met by an argument grounded in the principle of reflective loss.

- The court rejected all three bases upon which the claimants' expert had calculated loss on the basis of the value of Lloyds' shares.

> *"The evidence did not establish any overpayment, because the Claimants' evidence did not include a valuation and I have rejected the case actually run (that HBOS was worthless)."*
>
> **NORRIS J**

The recommendation duty

The court also gave guidance on the correct approach to an assessment of a recommendation given by directors to shareholders on a proposed transaction.

Deference afforded to directors' recommendations

In doing so the court emphasised that the relevant question is not whether any, or indeed many, competent directors would have disagreed with the decision taken by the board; providing evidence to support the view that an error of judgment was made does not establish negligence. In order to demonstrate negligence, claimants must show that no reasonably competent director could have shared the view of the board, such that their actions lay outside of the range of responses reasonably open to competent directors.

The court provided useful commentary upon the calibration of risks which ought to be factored into a board's decision making process. It confirmed that a board is not necessarily required to assume the worst about, and thereby ignore the potential benefits of, a proposed transaction unless that risk can be eliminated; a reasonably competent director would not base their judgment on extremes.

In a finding which will provide significant comfort to boards, the court noted that if directors have received advice from professional and experienced advisers, this will be an indicator that the board has not behaved negligently. It will not be necessary for them to redo that work absent some glaring omission in the analysis or factual foundation.

In an observation that will provide further comfort to boards, the court rejected the suggestion that "*the evidence of the events themselves*" is enough to demonstrate the existence of circumstances of such a character, so plain and so manifest, that any competent director of ordinary prudence would have been bound to decline to follow the recommended course of action notwithstanding the tenor of the advice that the board has received.

> *"As a reasonably competent director, you do not base your judgment on extremes or on one input, because "the risk management team do not run the business". It is necessary instead to take a fair and balanced view on what you think are the realities, based on probabilities."*
>
> **NORRIS J**

Reliance on advice from investment bank advisers

In order to counter the support for the recommendation which the directors received from the investment bank advisers, the claimants suggested that the advice of the investment bankers ought to be discounted because they are only paid if a transaction proceeds.

The court however held that, although there may be an overlap of interests, that does not necessarily mean that the investment bankers were not professionally objective. Indeed, the court found that a board which did not seriously consider the advice of an investment banker on a significant takeover would almost certainly be negligent.

Recommendation Standard – Key Points

- To establish negligence, claimants must be able to show that no reasonably competent director could have made the recommendation.
- It is not sufficient to establish that others might take a different view.
- Directors are not expected to re-do work performed by their advisers absent a glaring error in the analysis or factual assumptions.
- After the event circumstances are not sufficient evidence that the decision could not have been taken by a reasonably competent director; hindsight is to be avoided.

The applicable duties in the disclosure case

The court articulated what was required of directors in preparing the shareholder circular. Although this discussion was in the context of a circular, the guidance is likely to be influential in the approach which is taken to other documents published by issuers subject to disclosure duties (such as a prospectus or offering memorandum).

The sufficient information duty

The court found that, in order to comply with the sufficient information duty, the document in question must, when viewed objectively, give a fair, candid and reasonable account of the circumstances which will enable an informed decision to be made. The sufficient information duty requires the court to look at the document afresh and to subject it to scrutiny, rather than give deference to the judgment of those preparing (and advising on) the document as to the materiality of information.

However, the court confirmed the duty will not require disclosure of everything which fed into the directors' decision making process, or every single piece of information which may affect shareholder voting. Accordingly, the court will accept some selection of material that is put before the shareholders, particularly on matters of great complexity.

The court also provided guidance on the question of balance in the document. It must include both an assessment of the strengths of the acquisition, and its weaknesses in order to give focus and direction to the shareholders. A fair, candid and reasonable account must therefore include (although need not emphasise) those weaknesses. Interestingly, the court noted that it is a question of balance whether that is done through the risk factors or in the course of laying out the proposal itself (for example in the Chairman's letter).

Applying that to the claim, the court found that what was most important to the shareholders was HBOS's contribution to the merged entity, rather than HBOS's condition as a standalone entity and that the circular was right to strongly emphasise this:

> *"The concern of the shareholders was with what HBOS would be as part of the Enlarged Group, not with what it was if left on its own; with how good an ingredient HBOS was in a larger mix, not with what it would be like if left on the shelf."*

However, on balance, the weakness of HBOS's current position should have been disclosed:

> "*The assumed disclosures in the Circular recommending the Acquisition would thus have provided important incremental information about how far along the journey HBOS was, but the destination (absent the Acquisition) was already anticipated by many.*"

The court left open the question of whether there may be circumstances in which the sufficient information duty might be qualified. In the context of the claim, if the Tripartite had attached the condition of secrecy to the provision of ELA (for instance to maintain the integrity of the financial system), it may be that this would have given rise to a competing duty on the directors which would have qualified the duty of disclosure.

> *"Fair, candid and reasonable disclosure does not require the complete disclosure of everything which went into the decision-making process of the directors, nor every single piece of information that might affect shareholder voting."*
>
> **NORRIS J**

The duty not to negligently mis-state

The court contrasted the law on negligent misstatement with the sufficient information duty. The court held that a breach of the sufficient information duty will not necessarily give rise to a negligent misstatement by omission. The sufficient information duty is objective, and the honestly held views of the participants at the time cannot be determinative.

By contrast, in the case of negligent misstatement, a judgement call is made by the directors as to the materiality of the information. Accordingly, the process followed and the advice received at the time (or the absence of advice) will be important in helping the court to determine whether that judgement was reached negligently.

Announcements and presentations

The court considered whether the directors' disclosure duties to Lloyds' shareholders extended beyond the shareholder circular to the announcements of the merger and to statements made in presentations to and calls with analysts during the offer period.

The court held that it would be a "*big leap*" to impose a direct duty of care by each director to each shareholder for an announcement to the market by the company. To do so would run counter to the cardinal principles of company law that a company is a separate legal personality, and the directors owe their duties to the company rather than individual shareholders. In addition, the court found that an announcement is not made to provide shareholders with information to inform their investment decisions or even to inform whether they should support or vote against a transaction which will be put to them at a later point in time (following the publication of a circular). It is instead for the company to comply with a regulatory obligation to disclose price sensitive information.

In relation to statements made during analyst presentations, the court concluded that something more is required than showing that the statement was made by a director. Moreover, Lloyds clearly communicated that reliance should only be placed on the circular, not on the content of the presentations given.

Disclosure Standard – Key Points

- Directors must provide shareholders with a fair, candid and reasonable account of the circumstances to enable shareholders to make an informed decision on how to vote.
- However it is not necessary to provide all of the information on which they based their recommendation; some selection can be made of the key points.
- A fair, candid and reasonable account will include both the positives and the negatives of the proposed transaction, but need not necessarily emphasise the weaknesses.
- A process for considering whether something needs to be disclosed, including the receipt of advice, will be important in an assessment of whether a defect was negligent.

Record-keeping of judgements

The court provided the following guidance in relation to the record-keeping of decisions and discussions during a transaction:

- The absence of a full record (for example through a detailed board minute) does not necessarily indicate that there was no discussion on a particular topic.
- Where notes are not a verbatim record of what has been said, some care must be taken when interpreting the literal words on the page.
- The development of a document through drafts does not mean that every change from the first draft to the final draft is to be viewed as the "*suppression of legitimate doubt*" about the content of the document, and the course of action it proposes.
- Documents must be read alongside the body of work accompanying them, for example one board paper in a board pack must be read alongside the other board papers in the same pack, as well as alongside papers from other relevant meetings held at the time.
- Although there may be a temptation to say that a contemporaneous dissenting opinion, conveying concerns about risks which later eventuated, ought to have been given greater prominence at the time, that temptation is driven by hindsight and ought to be resisted.

Standards of due diligence

Lloyds was able to obtain greater access to HBOS than would ordinarily be the case in an acquisition of this kind. However, the due diligence was limited by demands of client confidentiality, competition issues and the acquisition timetable. The claimants argued that, given that it was subject to those limitations, the due diligence was inadequate and insufficient. Accordingly, the board's recommendation was said to have been negligent.

The court applied a two stage test when considering the standards which a board of directors must meet in relation to conducting due diligence:

- First, the court must consider whether the due diligence conducted fell short of the standards of established practice in bank takeovers.
- Second, putting to one side what is established practice, the court must then consider whether the claimants have demonstrated that, in this individual case, no

director of reasonable competence could have made the recommendation without taking additional steps beyond market practice.

The court concluded that Lloyds' due diligence processes were in line with market standard processes and that nothing in the circumstances required them to do more than that.

In relation to the former, the board will also be able to place reliance upon work conducted by its advisers in this context. For example, in this case:

- Linklaters had signed off on the relevant documents, including a 10b-5 process, without any qualification as to the adequacy of the due diligence which had been undertaken.
- The investment banks endorsed the circular.

Given the input from those advisers, the court concluded that it was "*impossible*" to say that no director of reasonable competence could have shared that view.

> *"The question for the board was: can we take the "due diligence" output into account in trying to form a reasonable judgment? In my view they reasonably did so."*
>
> **NORRIS J**

Analyst nomenclature

Some of the defendants' witnesses gave evidence regarding analyst lexicon, which had been used in certain of the HBOS announcements, and how this would have been understood by the market. For example, the replacement of the word "*strong*" with the word "*robust*" in a draft of the HBOS Interim Management Statement was said to have signalled a watering down of the HBOS assessment. However the court cautioned that, although institutional investors may understand the subtlety of the distinction, it is unlikely that any retail investor would pick up on such nuances.

Disclosure of forecasts

The claimants argued that the failure by Lloyds to publish internal estimates of HBOS's future impairments was a breach of the disclosure obligations.

The court found that the directors had acted reasonably in not publishing the impairment figures. In particular:

- It was appropriate to use the Risk Factors section of the circular to address the risks associated with the credit exposures within HBOS's loan portfolio; and
- It was not market practice to publish internally generated (forecast) impairment figures. Indeed, the claimants could not point to any instance of a bank releasing its own impairment figures to the market in annual or periodic statements, let alone an acquirer publishing its internal estimate of a target's impairments.

Reliance

The court found that the claimants' evidence did not properly engage with the need to prove that shareholders read and relied on the alleged misstatements when deciding whether to exercise their vote and whether to approve the acquisition.

It cautioned against claimants approaching litigation such as this by conducting a "*trawl*" through the circular to identify statements which might be misleading in the abstract, without addressing what shareholders read and how they relied on it, given the need to prove reliance (particularly in circumstances where 80% of shareholders did not read the circular).

The court also make some interesting observations on the potential alternative to individual reliance, namely the attempt to prove indirect reliance through an inference from shareholders having read press and analyst commentary which was based on the circular. The court considered that there were "*real difficulties*" with this approach, given the inherent problems of untangling raw material from the circular and journalistic comment. Moreover, if the journalist did not rely on the content of circular but instead anticipated a more gloomy outlook, for instance, the indirect reliance would not be made out.

Causation

The court criticised the claimants' evidential approach to causation. For example, in relation to the suggestion that the outcome of the shareholder vote would have been different, it held that there was no factual basis for inferring that a simple majority would have voted against the acquisition (as opposed to the 4% of those in attendance who voted against it) had ELA been disclosed. This was because there was:

- No properly structured survey evidence of those who did not vote or who voted in favour of the acquisition;

- No evidence adduced from big stakeholders with extensive voting rights;
- No reason to think that the small number of self-selected retail or institutional claimants (which accounted for 0.55% of the voting shares) were representative; and
- Even on the most generous assumptions about the evidence which the claimants adduced, this amounted to only 0.55% of the voting shares, from which it could not be inferred that a requisite swing in votes would have occurred.

Interestingly, the court gave guidance as to the nature of any counterfactual disclosure, concluding that, had the necessary disclosures been made, they would have been in "*carefully framed terms*" rather than the inflammatory language suggested by the claimants, with the intention of avoiding "*disproportionate emphasis*" on the issue which did not go to the heart of the voting recommendation. This would have likely limited the impact of those counterfactual disclosures (on the collapse of the HBOS shares or in the direction of voting).

> *"If ELA and the Lloyds Repo had been disclosed the HBOS share price would not have "collapsed"."*
>
> **NORRIS J**

Loss

The court's findings on loss illustrated the complexity of proving loss in cases of this sort.

The court concluded that it would not have awarded damages to the shareholders if the directors had been found to have overpaid for HBOS on grounds of the principle of reflective loss (i.e. the company rather than its shareholders has the right to recover the company's losses). Any diminution in value through dilution of old Lloyds shares would not have been recoverable by individual shareholders but instead by Lloyds itself.

In any event, the court dismissed each of the claimants' expert's methodologies for the calculation of loss. Given that the burden of proof falls on the claimants to prove their loss, this means that the court would have awarded no loss even if the claims had been made out.

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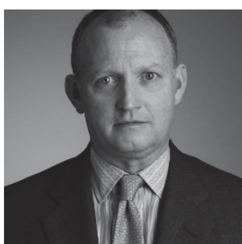

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