Alert: BNY Mellon Corporate Trustee Services Ltd v LBG Capital

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Court confirms approach to interpretation of Lloyds' enhanced capital notes trust deed, and corrects an obvious drafting mistake.

In *BNY Mellon Corporate Trustee Services Limited v LBG Capital No 1 Plc & another*, the High Court confirmed that the Defendants ("LBG"), who are subsidiaries of the Lloyds Banking Group, were not entitled to redeem enhanced capital notes ("ECNs") early. A mistake in the ECN trust deed was corrected and the relevant clause interpreted strictly.

Facts

Lloyds Bank issued approximately £8.3 billion of enhanced capital notes ("ECNs") in 33 series in late 2009. The ECNs, a form of hybrid security also known as contingent convertible bonds, were intended to increase Lloyds' contingent core tier one capital ("CT1 Capital") after it was found by the FSA to have a shortfall of CT1 Capital against risk weighted assets in a March 2009 stress test. The ECNs were the first contingent convertible bonds to be issued by any financial institution. They would initially form part of Lloyds' lower tier 2 capital, converting into CT1 Capital only if the bank's capital position deteriorated. The Claimant, BNY Mellon, is the trustee of the ECNs.

£5.3 billion of the ECNs have been exchanged for other instruments. The remaining £3.3 billion remain in their original form, and have maturity dates ranging from 2019-2032. Until the maturity date, interest is payable on the ECNs at a very high rate (averaging over 10% across all ECNs). The total coupon payments for the remaining ECNs amount to some £940,000 per day.

The ECNs were constituted by a trust deed, which stated that they could be redeemed early if a Capital Disqualification Event ("CDE") occurred. A CDE was said to occur if "as a result of any changes to the Regulatory Capital Requirements or any change in the interpretation thereof by the FSA, the ECNs shall cease 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".

The PRA carried out a stress test in December 2014 (the "December Stress Test"). In doing so, it did not take into account the ECNs. LBG announced that a CDE had occurred and that it intended to redeem the ECNs. On 31 March 2015, BNY Mellon issued proceedings in the High Court for a declaration that LBG was not entitled to do so. The proceedings were expedited due to the on-going expense associated with the ECNs from LBG's point of view, and judgment was handed down on 3 June 2015.

Decision

The High Court held that no CDE had occurred. In doing so, it made an important finding in relation to a "short but critical" argument that had been raised by BNY Mellon. BNY Mellon had argued that no CDE had occurred because the December Stress Test applied to Common Equity Tier 1 Capital, rather than the Consolidated Core Tier 1 Ratio referred to in the definition of a CDE. The Court held that whilst this was a literally correct reading of the CDE definition, it would produce "such an extraordinary commercial result that it cannot have been intended". There was an obvious mistake in the drafting of the CDE definition, which it was appropriate to correct.

Having dealt with the above point, the Court addressed the case put forward by LBG in support of its assertion that there had been a CDE. It had been common ground that the ECNs were not taken into account in the December Stress Test, because the Lloyds Group's capital position was strong enough for it to pass the test without any need to consider the ECNs. The Court held that the definition of CDE in the trust deed was not aimed at that situation. Rather it envisaged a situation where ECNs were no longer taken into account in stress testing in general. The trust deed should be interpreted "in light of its admissible factual content to give effect to its objective commercial purpose". Accordingly, no CDE had occurred and BNY Mellon was granted the declaration it sought.

Comment

This case is a useful reminder of the principles the Court will adopt in interpreting clauses in financial documentation, and the approach it will take to correcting mistakes. The focus is clearly on taking a purposive approach where necessary, so as to give effect to the commercial purpose of the document. Where a drafting error or obvious mistake would lead to a result that was clearly not intended by the parties and would not make commercial sense, that error should be corrected.

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