Shareholders unsuccessful in first class action against directors

January 2020

Judgment was recently given in the first shareholder class action claim in England, Sharp v Blank [2019] EWHC 3078 (Ch).

The claims were brought by 5,803 shareholders in Lloyds Bank against some of its former directors, and Lloyds itself. They stemmed from Lloyds' reverse takeover of HBOS PLC during the financial crisis in 2008.

The judgment concerns the recommendation made by directors to shareholders, and disclosure of information ahead of a shareholder vote approving the acquisition. The judgment demonstrates the difficulty future shareholder class actions of this kind may have (a) establishing a valid claim against directors; and (b) showing loss on the part of the shareholders.

Background

The actions of the directors which formed the basis for the claim took place in 2008, during the financial crisis. HBOS was suffering the effects of the crisis and faced serious liquidity problems. Lloyds had been looking for potential acquisition targets and had previously considered HBOS. However, there were significant competition issues: after the acquisition it was estimated Lloyds would have c. 28 per cent of the UK mortgage market.

The crisis deepened in early September 2008 and, on 15 September, Lehman Brothers filed for bankruptcy. That evening at a function, Gordon Brown, then Prime Minister, implied to Sir Victor Blank (Lloyds' chairman) that the government would step in to handle any competition issues in the interest of certainty regarding the future care of HBOS, but Lloyds would have to move quickly.

Lloyds' acquisition of HBOS was announced three days later, on 18 September.

On 25 September and 2 October 2008, Lloyds made two collateralised interbank facilities available to HBOS with a combined value of £9.9 billion (**Lloyds Repo**). The purpose of these facilities was to help HBOS with its immediate funding requirements in the face of the credit crunch which followed Lehman Brothers' bankruptcy.

On 1 October 2008, the Bank of England gave what later became known as emergency liquidity assistance to HBOS in the form of a collateralised emergency facility (**ELA**).

The Listing Rules required the approval of Lloyds' shareholders for the acquisition. An extraordinary general meeting was called and a shareholder circular was prepared explaining the benefits and risks of the transaction (**Circular**). The Circular recommended that the shareholders approve the acquisition. The Circular did not mention either the Lloyds Repo or the ELA.

The shareholders approved the acquisition on 19 November 2008 and the acquisition was completed on 16 January 2009 by way of a scheme of arrangement. HBOS shareholders received 0.605 Lloyds shares for each HBOS share they held.

The Claim

The judgment summarises the Claimants' case in two parts:

1. *'The Lloyds directors should not have recommended the acquisition because it represented a dangerous and value-destroying strategy which involved unacceptably risky decisions'* (**Recommendation Case**).

2. *'The Lloyds directors should have provided further information about Lloyds and about HBOS, in particular about a funding crisis faced by HBOS and the related vulnerability of HBOS' assets'* (**Disclosure Case**).

It was the Claimants' case that the acquisition would have collapsed or would never have been approved by the shareholders, but for the actions described at 1 and 2 above. The acquisition then caused the Claimants loss because Lloyds had overpaid for the HBOS shares, causing loss of value to the Lloyds shares they held.

The Judgment

The Recommendation Case

To establish the negligence alleged in the Recommendation Case, the shareholders would have had to show that no reasonably competent director would have made the recommendation. It was not sufficient to merely establish that others might have taken a different view.

Advice from investment banker advisors had contributed to the recommendation. The judge concluded that the directors were not expected to replicate the work undertaken by those advisors unless there was some obvious error of analysis or mistake in its factual basis. Further, if the board failed to seriously consider advice given by investment bankers they would almost certainly be negligent.

The judge made clear that claimants could not rely on the benefit of hindsight, and restricted himself to examining the state of affairs at the time the recommendation was made up until the shareholders' vote.

The judge concluded that *'a reasonably competent 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'*, therefore the Recommendation Case was dismissed.

The Disclosure Case

The judgment stated that the duty on directors to disclose sufficient information was to provide shareholders with a fair, candid and reasonable account of the circumstances, so the shareholders could make an informed decision. Directors do not need to provide all the information upon which their recommendation was based; they could select the key points to put across to the shareholders.

The directors were required to assess both positives and negatives, but did not need to emphasise the weaknesses.

The judgment considered whether the directors' direct duties extended to announcements of mergers, statements made during presentations or calls with analysts during the offer period.

It was concluded that directors' duties to disclose sufficient information would not generally apply to announcements of mergers made to the market; to put such a duty on directors would undermine the distinct legal personality of the company. The purpose of these announcements was to fulfil regulatory obligations, not to inform the shareholders in relation to the vote.

The directors were not adjudged to owe duties to the shareholders in this case when they were making statements at presentations to journalists and analysts. The judge commented that personal liability for statements made on behalf of the company required more than merely to be a director and to make a statement. The judge's decision on this point was based on the particular facts of this case but included:

- the statements were not being made directly to the shareholders;
- Lloyds made it clear that shareholders should only rely on the Circular itself;
- the statements could not be taken to be qualifying or adding to the Circular;
- the Claimants had failed to demonstrate that the statements had affected journalists' or analysts' commentary on the acquisition; and
- the Claimants had not shown that any shareholder's decision was influenced by the statements made at that presentation.

Seven aspects of the Circular itself were alleged by the Claimants to constitute negligent misstatements or to fall short of the directors' duty to make sufficient disclosure of information material to the shareholders' decision.

The judge concluded that the directors' duties of sufficient disclosure had been breached by not noting the existence of the ELA on the basis that: *'it showed the funding position of HBOS and presented a funding risk that would have to be absorbed by, and managed by, the Enlarged Group'*.

The judge also concluded that the Lloyds Repo should have been disclosed to provide a fair, candid and reasonable account of the proposed acquisition. The directors treated the Lloyds Repo as just another example of inter-bank lending which Lloyds regularly made in the ordinary course of business and which normally would not constitute a material contract for the purposes of the Circular. However, the directors should have considered the Lloyds Repo differently on the basis that it was much larger (twice as large as any before), it was made during the credit crunch when the market for interbank lending was heavily curtailed, and it was bilateral between the buyer and the target.

To meet the directors' duties of disclosure the Circular should at least have disclosed *'that HBOS was to a degree dependant on bilateral funding'*.

In relation to the ELA, the evidence did not show how the decision not to include the ELA was made, and it was not clear that the directors had considered the issue; further, they had not informed their lawyers about the ELA and they had not sought advice on whether it should be included in the Circular. Likewise with the decision about disclosing the Lloyds Repo, the directors had assumed, without asking, that their lawyers had considered the question of whether it should be disclosed in the course of drafting the Circular. This led the judge to conclude that there had been misstatements in the Circular and that the directors had failed to exercise the requisite level of care in relation to how the Circular dealt with the ELA and Lloyds Repo.

However, the judge felt that sufficient wording to meet the directors' duties would nonetheless have been in *'carefully framed terms'* and, had that wording been included, it would not have caused the transaction to collapse or the majority of the shareholders to vote against the transaction. Therefore, the directors' breaches had not caused any loss to the Claimants, and the Disclosure Case was also dismissed.

Loss

The judge went on to observe that the claimants would have struggled to establish that they had suffered loss, even if either claim had been made out. This is because any loss to the value of shareholders' shares in Lloyds merely reflected the loss suffered by Lloyds itself for paying an inflated price for HBOS. The loss had been properly suffered by Lloyds itself and it would have been for Lloyds to bring any claim it might have in that situation.

This principle is known as *'reflective loss'* and it should be noted that there has historically been some doubt expressed by the judiciary in Guernsey over whether this principle forms part of Guernsey law, and it has yet to be tested.

Conclusion

As well as being an interesting part of the history of the 2008 financial crisis, Sharp v Blank clarifies some important issues relevant for any future actions against directors. Confirmation of directors' ability to rely on their professional advisors without replicating their work is to be welcomed. The breaches which were found to have been committed by the directors came back to key considerations such as how directors' decisions are recorded and how they engage with legal advisors.

The case also re-emphasised that the 'bar' to establishing negligence by directors is a high one – a claimant must establish that no reasonably competent director would have acted as the director in question did; it is not sufficient to establish that a hypothetical, reasonable director would have acted differently. This is the same test that was confirmed by the Royal Court in Carlyle Capital Corporation Limited (In Liquidation) v Conway and others [38/2017].

If you are faced with particularly difficult decisions or potential action by shareholders, please contact Collas Crill's Corporate Disputes team for assistance.

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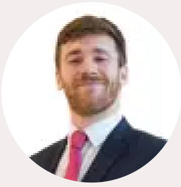

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