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IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 15/11/2019

Before:
SIR ALASTAIR NORRIS

- -

Between:

JOHN MICHAEL SHARP **And the other Claimants listed in the GLO Register**	**Claimants**
- and -	
(1) SIR MAURICE VICTOR BLANK **(2) JOHN ERIC DANIELS** **(3) TIMOTHY TOOKEY** **(4) HELEN WEIR** **(5) GEORGE TRUETT TATE** **(6) LLOYDS BANKING GROUP PLC**	**Defendant**

- -

Richard Hill QC, Sebastian Isaac, Jack Rivett and Lara Hassell-Hart (instructed by **Harcus Sinclair UK Limited**) for the **Claimants**
Helen Davies QC, Tony Singla and Kyle Lawson (instructed by **Herbert Smith Freehills LLP**) for the **Defendants**

Hearing dates: 17-20, 23-27, 30-31 October 2017; 1-2, 6-9, 13-17,20, 22-23, 27, 29-30 November 2017, 1, 11-15, 18-21 December 2017, 12, 16-19, 22-26, 29-31 January 2018, 1-2, 5-6, 8, 28 February 2018, 1-2 and 5 March 2018

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Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

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SIR ALASTAIR NORRIS:

The task in hand

1. This is not the outcome of a public enquiry into the reverse takeover by Lloyds TSB Group plc ("Lloyds") of HBOS plc ("HBOS") at the start of the great credit crunch in 2008. It is a judgment following the trial of specific allegations made by a group of Lloyds shareholders (or former shareholders) who seek to make each of five former directors of Lloyds personally liable to pay some £385 million to that group for alleged carelessness or breach of fiduciary duty (or more accurately "equitable" duty). It has not been my task to investigate or to seek to answer all questions that arise from the takeover.

2. Nor am I required to make an overall assessment of whether in the light of a decade of financial tumult, hesitant recovery and historic claims the takeover was ultimately justified. Some shareholders (especially those who, perhaps because they were members of an employees' share scheme as about 98% of employees were, had put all their eggs in one basket) have emphasised that for them it has been a personal financial catastrophe: and so, it has been. That can only elicit sympathy for the small investor. It has provoked amongst some of those who entrusted their entire nest-egg to an investment in Lloyds a level of distress such that it caused one retired clergymen to write to the Chairman of Lloyds and say in as Christian terms as was possible, that the Chairman was a mountebank and a blaggard. Members of Lloyds' management have, on the other hand, emphasised that what has emerged from the turmoil is the largest and best capitalised bank on the High Street, notwithstanding the enormous challenges subsequently presented by at least £18bn-worth (and continuing) of claims arising from PPI miss-selling and other such activities (which activities themselves had produced the high dividends which made shares in Lloyds so attractive to investors like the Claimants before 2008). But even management must (and does) acknowledge that matters did not turn out as intended because the bank faced "things that were unanticipated but which the real world delivered" (as Mr Truett Tate put it during the trial).

3. Knowing what has happened is, of course, a positive disadvantage when trying to assess activities undertaken and assessments made in 2008: and the legal representatives of the Claimants have done their best to avoid the perils of hindsight. But it is right to articulate what the dangers are, and how different is the process of retrospective forensic examination from that of the actual contemporaneous decision-making in the real world.

4. In the courtroom attention is focused upon one element of a complex picture. Emphasis is placed upon particular voices in what was at the time a cacophony competing for attention. Reliance is placed upon a careful selection from amongst those documents that have survived and from amongst the conversations and debates that are noted or recorded (for the unrecorded maybe forgotten or misremembered). Those documents themselves may not disclose the nuances apparent to the contemporary recipient, and are now read and understood in the light of knowledge that the actual recipient lacked at the time. The mere existence of a document frequently does not establish who saw it and in what circumstances so that one cannot tell whether the scrutiny and analysis to which it is subjected by the Court process bears any relationship to how it would have been received and treated at the time. The case management process identifies the issues

and excludes all that is irrelevant to those issues, whereas real-life is a confusion of competing considerations amongst which the eventually important considerations lie. Recollections are coloured by this process and by the challenges to that process of recall presented by knowing what eventuated: recollection and reconstruction (to the extent that they can ever be separated) become completely undifferentiated. What might have seemed unimportant at the time emerges as significant once the whole narrative is known, and the knowledge of what did in fact occur exerts a subtle pressure to think that at the time it must have been seen as a real possibility. Changes in culture brought about by the response of the market or of the supervisory authorities to the consequences of unfolding events present particular difficulties for retrospective assessments.

5. It is becoming customary, in commercial cases where the events in question lie (as the events with which I am concerned do) perhaps a decade in the past, as part of a judicial self-direction to compare the apparent reliability of the documentary record with the apparent fallibility of human memory. Reference is frequently made to cases such as Onassis v Vergottis [1968] 2 Ll.Rep 403 and Gestmin SGPS [2013] EWHC 3560, and to the extra-judicial observations of Lord Bingham on the role of the judge as juror. I have endeavoured to give proper weight to that guidance; but have seen it as my obligation to base my findings on the impression that the entirety of the evidence has made upon me, without putting a pre-determined value on any particular element of it. Sometimes it is not easy to explain.

6. But the task of making the necessary findings and assessments is one that has routinely to be undertaken. Acknowledging the potential for distortion enables a judge to attempt to compensate appropriately, comforted by the fact that she or he has only to find what probably happened, and only to consider whether the conduct under review was honest according to ordinary standards, or fell within or outside the range of acts or decisions that might have been made or undertaken by reasonable people in the position of the defendants at the time.

7. In this case the process has resulted in an over-long judgment. Even so it represents a distillation of 3000 pages of written submissions, 45 days' cross-examination, 16 lever-arch files of expert evidence, the relevant parts of 343 lever arch files of documentary material (albeit that large parts of this material were undisturbed) and 20 lever-arch files of authorities. I cannot fully express my admiration for the way this material was prepared and presented, analysed and argued by the respective legal teams (Counsel and solicitors).

The landscape in broad strokes

8. The Lloyds TSB Group was formed in 1995 following the merger of Lloyds Bank and TSB Group plc. Strategically it adopted a three phase plan. Phase 1 focused on enhancing the quality of earnings by disposing of or terminating non-core businesses or those which added unnecessary volatility. Phase 2 focussed on accelerating growth by building on customer relationships and improving productivity. Phase 3 was to look for an acquisition that would complement that organic growth.

9. On 18 September 2008 ("the Announcement Date") the boards of Lloyds and HBOS jointly issued an announcement entitled "Recommended acquisition of HBOS plc by Lloyds TSB Group plc" ("the Announcement") in which they told the market that they

had reached agreement on the terms of an acquisition of HBOS by Lloyds which each board intended unanimously to recommend to their respective shareholders ("the Acquisition"). HBOS shareholders were to receive 0.83 of a Lloyds share for 1 HBOS share. At the date of the Announcement HBOS was drawing upon a number of funding sources, including facilities provided by the Bank of England and by the Federal Reserve in the United States.

10. The Claimants are 5803 in number (though there may be a duplication of claims by both the legal and the beneficial owner of some holdings). It is said (though this will require examination at a further hearing) that they were at the Announcement Date (and before the Announcement) collectively the holders of 312,732,812 ordinary shares and 447,392 American Depository Receipts ("ADRs") in Lloyds. Precision in relation to the number of Claimants and in relation to the ordinary shares and ADRs held by the Claimants was not achievable at trial: but that does not matter because a picture painted with broad strokes will suffice for the determination of the issues. That is because the Claimants (however many there are and whatever their precise holdings) hold no more than 5% of the shares (or ADRs) in Lloyds in issue at the Announcement Date.

11. Of the shares held by the Claimants, approximately 13.6% were held by retail investors and 86.4% by institutional shareholders. Of the ADRs held by the Claimants, approximately 20% were held by retail investors and 70% by institutional shareholders. At the trial no distinction was drawn between shareholders and the holders of ADRs and from now on I will simply refer to "shareholders" (though it will be necessary to make a distinction at one point).

12. At the Announcement Date:

    (a) the Chairman of the Lloyds' board was Sir Victor Blank ("Sir Victor"):

    (b) the Group Chief Executive was Mr Eric Daniels (a board member) ("Mr Daniels");

    (c) the Acting Group Finance Director was Mr Tim Tookey (who did not become a board member until 30 October 2008) ("Mr Tookey");

    (d) the Group Executive Director of the UK Retail Banking Division was Ms Helen Weir (a board member) ("Ms Weir"); and

    (e) the Group Executive Director of the Wholesale and International Banking Division was Mr Truett Tate (a board member) ("Mr Tate").

13. These are the Defendants to the present claim. The Board Members at the Announcement Date who are *not* being sued are:

    (a) Archie Kane (the Chief Executive Officer of Scottish Widows Bank) ("Mr Kane");

(b) Dr Wolfgang Berndt (a non-executive director) ("Dr Berndt");

(c) Jan du Plessis (a non-executive director) ("Mr du Plessis");

(d) Sir Ewan Brown (a non-executive director and a former Chairman of TSB Banking Group plc);

(e) Philip Green (a non-executive director);

(f) Sir Julian Horn-Smith (a non-executive director);

(g) Lord Alexander Leitch (a non-executive director);

(h) Sir David Manning (a non-executive director); and

(i) Martin Scicluna (a non-executive director).

They participated in the unanimous recommendation of the Acquisition. Other non-executive directors joined the Board after the Announcement Date and during the acquisition process. Thus, from time to time fresh eyes looked at the Acquisition, but did so without some of the background knowledge and knowing that the existing board had set a particular course.

14. On 25 September 2008 Lloyds made available a £2.4 billion collateralised interbank facility to HBOS to help it with its immediate funding requirements. A week later (on 2 October 2008) it made an additional such facility of up to £7.5 billion available to HBOS. I will call those two facilities "the Lloyds' Repo".

15. On 1 October 2008 the Bank of England made a collateralised emergency facility available to HBOS. In the action this was called "emergency liquidity assistance" although it was not generally so called at the time. I will call this facility "ELA".

16. The context of the Lloyds Repo and of the offer of ELA was the "credit crunch", the great disruption in the funding markets resulting (most immediately) from the collapse of Lehman Brothers that had occurred on 15 September 2008, which brought home to markets that banks might fail and which generated what became unprecedented turbulence in global financial markets. The Bank of England ("BoE" or "the Bank"), HM Treasury ("the Treasury") and the Financial Services Authority ("FSA"), who together tried to maintain the integrity and overall health of UK markets (and were together known as "the Tripartite") determined to restore confidence in the banking sector by providing an unprecedented package of financial support. The announcement came on 8 October 2008. The key elements were (a) measures to provide sufficient short-term liquidity to enable banks to lend in the real economy; and (b) a requirement that banks should strengthen their balance sheets by raising more capital (in which exercise the Treasury would participate) with the object that banks should increase what was known technically as "the Core Tier 1 ratio". This latter element was to be the subject of further discussion with individual banks. The participation of the Government in the recapitalisation process meant that the detailed proposals would need the approval of the European Commission: and that had the potential to require

each participating bank to submit a restructuring plan to address issues arising from the receipt of State aid.

17. There followed (on 12 and 13 October 2008) what was called at trial "the Recapitalisation Weekend". During this weekend (a) the details of the Tripartite recapitalisation scheme emerged (and it appeared that if Lloyds continued as a standalone bank it would be required to raise £7 billion additional capital, and that if the Acquisition proceeded the enlarged Lloyds/HBOS group would be required to raise £17 billion additional capital); and (b) the Lloyds board met to consider whether to proceed with the Acquisition.

18. The outcome of the Recapitalisation Weekend was that the Lloyds board decided unanimously to proceed with the Acquisition, but on revised terms ("the Revised Terms"). First, Lloyds would now raise £5.5 billion of new capital. Of this the Treasury would take £1 billion of preference shares: and the remaining £4.5 billion would be raised by an open offer of new shares at a discount which would be subscribed by the Treasury but with existing Lloyds shareholders having the right to claw-back their proportionate entitlement. The effect of taking Government money was dilutive as regards existing shareholders, and was acknowledged to be so. Second, the effective price paid for each HBOS share was reduced. HBOS shareholders would now receive only 0.605 of a Lloyds share for each 1 HBOS share.

19. Whilst these events were occurring Lloyds was undertaking a due diligence exercise in relation to HBOS's affairs. Part of this work involved assessing what impairments there might be of the HBOS loan book. "Impairment" is the term used to describe current expectations about future events, namely, what lesser performance, then the face of the loan book might suggest, is to be expected because of flaws in the loan quality or because of diminished performance in a recession. (Technically, impairment loss calculations involved the estimation of future cash flows of loans and advances based on (i) observable data at the selected date and (ii) historical loss experience for assets with similar credit risk characteristics, those calculations being undertaken on a portfolio basis). This involved the statistical modelling of the performance of the portfolios on different assumptions (which might or might not eventuate), and then making a judgment about the relevance of the various sets of assumptions in what was anticipated to be "the real world". The principal contributors to this exercise were Patrick Foley (the highly respected Chief Economist at Lloyds) ("Mr Foley"), and Stephen Roughton-Smith (the Deputy Head of Risk and Head of Credit Risk at Lloyds) ("Mr Roughton-Smith").

20. On 29 October 2008, having considered (amongst many other things) the views advanced by Mr Foley and Mr Roughton-Smith the Lloyds board decided unanimously to recommend the Acquisition to Lloyds shareholders on the Revised Terms.

21. On 3 November 2008 Lloyds issued a Shareholder Circular ("the Circular") for the Acquisition, giving notice of a General Meeting on 19 November 2008. The Chairman's letter (signed by Sir Victor) spoke of the compelling opportunity presented by the turbulence in the then-current markets to accelerate Lloyds' strategy and to create the UK's leading financial services group. He encouraged shareholders to compare the proposed enlarged group not with Lloyds as it currently stood, but with a standalone Lloyds as it was likely to be in the future. His letter noted:

> "Whilst HBOS has been significantly affected by recent challenging marketing conditions, including the deteriorating economic environment which has negatively impacted its funding model, the Lloyds TSB Directors believe that HBOS remains an excellent franchise with the potential to contribute substantial value to the Enlarged Group."

The letter went on to elaborate upon this view, and to provide a level of detail in relation to the anticipated capital position as a result of the Acquisition. It said:

> "Based on a review of non-public information provided by HBOS, Lloyds TSB has made a preliminary assessment that net negative capital adjustments of no more than £10 billion after tax would need to be made to HBOS's financial position for Core Tier 1 capital purposes as a result of the Acquisition. The amount of the capital adjustments takes into account the elimination of the HBOS available for sale ("AFS") reserve at 30 November 2008 and includes the effect of the application of market-based credit spreads at September 2008 to HBOS's portfolio. A comprehensive assessment of the fair values of HBOS's assets will be undertaken following completion of the acquisition, the provisional results of which will be published in Lloyds TSB's 2009 interim report. The actual capital adjustments will reflect the conditions that exist at the Effective Date of the Acquisition."

22. The letter concluded with the unanimous recommendation of the Lloyds board that Lloyds shareholders should vote in favour of the resolutions to give effect to the Acquisition, and with the information that the Lloyds directors themselves intended so to vote in relation to their own individual holdings (which together amounted to some 1.316 million shares representing 0.02% of the existing issued ordinary shares). Amongst the principal direct holders of shares were Mr Daniels, Sir Victor, Mr Kane, and Dr Berndt.

23. The Circular described Lloyds' capital ratios as "robust" and its liquidity position as "strong", saying that its wholesale funding maturity profile remained much as it had been 12 months previously and that there were improved signs of stabilisation in global money markets. But it did not contain a "working capital statement". Having referred to the period of unprecedented upheaval and contraction in the global markets for sources of funding, the Circular explained:

> "Due to the severity of this dislocation which has catalysed unprecedented levels of government intervention around the world and extraordinary uncertainty facing the banking industry in the medium term, and the availability of the UK government facilities described above being conditional upon, *inter alia*, the passing of various resolutions including those relating to the Acquisition, the United Kingdom Listing Authority has agreed that a statement regarding the adequacy of working capital for at least the next 12 months should not be required in this document."

24. The Circular contained a section dealing, as regards Lloyds, with “Material Contracts” and a section dealing with “Significant Change”. In neither section was the Lloyds’ Repo mentioned.

25. The Circular contained (as it was required to do) (i) an interim management statement (“IMS”) from HBOS, (ii) certain financial information (including unaudited financial information for the six months ended 30 June 2008 which had been published by HBOS on 31 July 2008) and (iii) a section dealing with “Significant Change” in relation to HBOS. In this last section the Circular stated:

> “…there has been no significant change in the financial or trading position of the HBOS Group since 30 June 2008 the date to which HBOS’s last published interim financial information… was prepared.”

Neither the Lloyds Repo nor ELA was mentioned.

26. Between the Announcement and the Circular Lloyds had held press conferences or briefings (in particular on the 18 September 2008, 13 October 2008 and 3 November 2008) (“the Presentations”). Outline responses were prepared by Lloyds’ staff for anticipated enquiries from attendees; but in essence the Presentations were explanatory or commentary sessions followed by a time for questions.

27. On 19 November 2008 the Lloyds shareholders approved the acquisition of HBOS. In general terms (that are sufficient for this case) 52.2% of Lloyds shareholders by value attended the meeting in person or by proxy. Of the votes cast, 96% by value voted in accordance with the directors’ recommendation in favour of the Acquisition, and the remaining 4% against the Acquisition. Some of the Claimants voted in accordance with the directors’ recommendation and say either that the Lloyds directors should not have recommended as they did, or that the Lloyds directors should have disclosed matters that would have led these Claimants to have voted differently. Other Claimants in fact voted against the recommendation (and against the Acquisition) anyway: and their complaint is that if the directors’ recommendation had been different or their disclosure sufficient then other people would have joined these Claimants in voting the Acquisition down (if the EGM would have been held at all in those circumstances).

28. On 12 December 2008 the HBOS shareholders approved being taken over by Lloyds at an extraordinary general meeting: and on 12 January 2009 the Court of Session in Scotland gave its sanction to the scheme of arrangement under section 899 of the Companies Act 2006 in relation to HBOS by which the HBOS scheme shares were to be cancelled in consideration of the allotment of new Lloyds shares, and the reverse takeover thereby achieved. On 16 January 2009 Lloyds acquired 100% of the HBOS share capital (the scheme shares) and in return issued 7.76 billion new shares in Lloyds. On 19 January the HBOS shares were then delisted and shares in the enlarged group commenced trading.

The claim in outline.

29. By the time of trial a considerable number of issues raised in the statements of case had faded away, and the claim focused on two key claims which (broadly stated) were:

(a) The Lloyds directors should not have recommended the Acquisition because it represented a dangerous and value-destroying strategy which involved unacceptably risky decisions ("the recommendation case"):

(b) 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's assets ("the disclosure case").

If the directors had either not recommended the Acquisition or had made further disclosures about Lloyds and about HBOS it was said that the shareholders of Lloyds and the market in general would not have been misled as to the true financial circumstances of HBOS or as to the merits of the Acquisition, and the Claimants would have avoided the recapitalisation of the merged entity and the consequential loss in value by dilution of their shareholding. This case was set out in the Re-Amended Particulars of Claim dated 21 December 2016 ("the Claim").

30. As to the recommendation case the main allegations are that the Lloyds directors could not properly recommend the Acquisition because of the following:

(a) HBOS shares were overvalued because the market did not know that HBOS was supported by the Federal Reserve and/or ELA, and offering 0.605 Lloyds share for each 1 HBOS share was disproportionately dilutive (paragraph 71(5) of the Claim);

(b) Lloyds only had to participate in the Tripartite recapitalisation scheme because of its potential exposure to impairments of HBOS's loan portfolios, and the dilution of capital involved was not in the best interests of Lloyds shareholders (paragraph 71(6) of the Claim);

(c) The Acquisition would mean that Lloyds (even if it participated in the Tripartite recapitalisation scheme) would have to raise more capital in 2009 which would further dilute the holdings of Lloyds' shareholders (paragraph 71(6A) of the Claim);

(d) Participating in the Tripartite recapitalisation scheme required Lloyds to submit a restructuring plan to address "state aid" concerns, which entailed divestment of assets (paragraph 71(8) of the Claim);

(e) The FSA's requirement that a standalone Lloyds required additional capital of £7 billion was not justifiable (paragraph 71(6C) and (6D) of the Claim).

31. As to the disclosure case the main allegations are:

(a) Neither the Announcement nor the announcement of the Revised Terms disclosed that HBOS was in part supported by the Federal Reserve (paragraphs 60 and 71 of the Claim);

(b) The Lloyds Repo was not a transaction in the ordinary course of business and ought to have been disclosed in the Circular, if not before (paragraphs 32 to 32E, and 71 of the Claim);

(c) The ELA provided to HBOS ought to have been disclosed in the Circular, if not before (paragraphs 61 and 71 of the Claim);

(d) The Revised Announcement and the Circular ought to have disclosed that, without the support provided by the Federal Reserve, ELA and the Lloyds repo, HBOS would have been forced to cease trading so that the price of HBOS shares was artificially inflated (paragraph 71 of the Claim);

(e) It should have been stated in the Circular that the losses suffered by HBOS (and to be suffered by the enlarged group) would mean that further capital would need to be raised in 2009 (resulting in further dilution of the interests of current shareholders (paragraph 71 of the Claim));

(f) It should have been stated in the Revised Announcement or the Circular that if in the recapitalisation scheme the enlarged group was being required to raised £17bn then a requirement that Lloyds alone was being required to raise £7bn could not be justified (paragraph 71 of the Claim);

(g) The Circular should not have said that there had been no significant change in the financial or trading position of HBOS since June 2008 (paragraph 78 of the Claim);

(h) Insofar as disclosures relating to these matters were made they were deliberately ambiguous and "tricky" (paragraph 117 of the Claim);

(i) At investor presentations on 18 September 2008, 13 October 2008 and 3 November 2008 the Defendants failed to disclose the above matters or made representations about the extent of due diligence (paragraph 95 of the Claim), the robustness of HBOS's capital position (paragraph 98) and about competition issues (paragraphs 101 following) which were untrue.

32. I must make clear that this is not a complete account of the pleaded case (which, excluding annexures, extends over some 120 pages and 149 paragraphs). But it is

sufficient for the purposes of this judgment in dealing with the matters argued at trial. I should also make plain that although these were the complaints of breach of duty, not all of them were said to be causative of the loss claimed by the Claimants.

33. The Defendants are charged with negligence (paragraphs 38, 40 and 119 of the Claim) and with breach of "fiduciary duty" (paragraphs 39 and 120 of the Claim). It is not said that any of the Defendants acted in bad faith: although there is a plea that the Defendants "actively misled" the Claimants into believing that Lloyds (if a "standalone" bank) would have to raise £7bn (paragraph 120(6) of the Claim) and the plea that some statements in the Circular were "tricky".

34. In view of the course of the trial I must note what is said in the Claim about what it is alleged the Defendants should have done. Paragraph 122 of the Claim says that the Defendants should have disclosed to the Lloyds shareholders

(a) the existence of the Lloyds Repo and the provision to HBOS of ELA and Federal Reserve support;

(b) a fair and accurate description of the level of impairments that Lloyds was projecting for HBOS;

(c) the "fact" that all of the new capital to be raised by Lloyds under the recapitalisation scheme was required to absorb the HBOS projected losses;

(d) the "fact" that the £7bn required by the Tripartite to be raised by a "standalone" Lloyds was unjustified;

(e) that the Acquisition was not in their best interests.

35. Paragraph 123 then pleads that had this level of disclosure been made then it would have been obvious to the financial press, the market and to Lloyds shareholders that to proceed with the Acquisition would result in a grossly disproportionate dilution of the share capital of existing Lloyds shareholders. This realisation would then have had one of two consequences.

36. The first possibility is that it would have forced the Lloyds' board to pull out of the Acquisition (and from participation in the recapitalisation scheme) either (a) because the transaction would have collapsed as a result of market reaction or (b) because the directors would have had it brought home to them that their own analysis was flawed and they would have cancelled the EGM.

37. The second possibility is that the disclosure which it is said ought to have been made would have caused the requisite majority by number and value of the Lloyds shareholders to vote against the Acquisition (even if it was still recommended by the board).

38. In either event, the argument runs, the Acquisition would not have proceeded and the Claimants would not have suffered the losses that they seek to recover in this action.

39. Those losses are identified in paragraph 147 of the Claim. The Claimants seek as alternatives:

(a) The loss per share occasioned by the dilution of their pre-Acquisition holdings through (i) over-valuation of the HBOS shares and (ii) participation in the recapitalisation scheme promulgated during the Recapitalisation Weekend: or

(b) The difference between the value of their pre-Acquisition shareholding and the value of their post-Acquisition shareholding after eliminating any reduction attributable to a general decline in the value of bank shares and any sum which is irrecoverable because of the “reflective loss” principle

40. The claims therefore focus on the date upon which the Acquisition completed. Whereas the focus on liability questions is upon what did happen and what ought to have happened, whether the claimed losses can be made good involves the creation of counterfactual scenarios i.e. deciding what probably would have happened.

The legal basis for the claim

41. The legal case advanced by the Claimants may be summarised in this way:

(a) in making recommendations and providing disclosure of information the defendant directors voluntarily undertook (in relation to each Claimant) responsibility for (i) correctness of the advice and recommendations; and (ii) the accuracy of all material information provided in respect of the proposed transaction (paragraph 37 of the Claim):

(b) in advising the Claimants as to the merits of the Acquisition and in providing them with information to make an informed decision, and in permitting transactions to go before the Claimants for approval, the Lloyds directors owed the Claimants a “fiduciary duty” not to mislead them or to conceal material information from them, and to advise them in clear and readily comprehensible terms (paragraph 39 of the Claim):

(c) in advising the Claimants as to the merits of the Acquisition and in providing them with information to make an informed decision, and in permitting transactions to go before the Claimants for approval, the Lloyds directors owed the Claimants duties in tort (i) to use reasonable care and skill (ii) to ensure that information was complete and did not contain any material omissions (iii) to ensure that any advice would be reasoned and supported by information and (iv) not to mislead the Claimants or to conceal information from them (paragraph 40 of the Claim):

(d) in providing information to shareholders to enable them to make an informed decision the Lloyds directors owed a fiduciary duty (i) not to mislead the Claimants or to conceal information and (ii) to inform shareholders in clear and readily comprehensible terms.

42. The Claim contains (in paragraph 44) the plea that the Defendants acted at all times as directors, and therefore as Lloyds agents: and that Lloyds is thus vicariously liable for their acts and omissions. Two points may be made: (i) this is not a direct claim against Lloyds, e.g. because its employees failed properly to investigate the Acquisition and failed to put the necessary materials before the Lloyds board for consideration by them, but a secondary claim dependent on proof that the Defendants are liable *as directors*; and (ii) if the Claimants succeed and Lloyds is vicariously liable the effect will be to transfer value from the present shareholders in Lloyds to a group of shareholders who held shares a decade earlier.

The factual witnesses.

43. It is a remarkable feature of the case how little evidence the Claimants adduced. The very nature of their case means that it was difficult for them to produce positive evidence of the breaches they alleged (without calling former members of Lloyds' staff, some of whom were critical of the Acquisition) and they were in that regard heavily reliant on cross-examining the Defendants on the basis of disclosed documents. But those parts of their case that did require positive proof (what a Claimant knew, where he or she got the information from (including from sources other than Lloyds), in what way and to what extent reliance was placed on that information, what the decision made actually was and how it had been reached, what the witness would have done if things had been different) were touched upon to varying extents in evidence from only 7 retail investors and 6 institutional investors out of the 5800+ claimants. Of those the retail investor statements of Stembridge, Owen and Scott stand out as models. (I should make clear that a lack of detail in the recollection is absolutely not a matter for criticism).

44. The Defendants accepted the evidence of the individual retail investors without challenge. But Ms Davies QC cross-examined witnesses representing institutional investors to some considerable effect.

45. The evidence adduced on behalf of the Defendants was much more extensive. I am seduced neither by its length nor by its dependence upon a documentary structure. I begin with three general observations. The first is that with the passage of 9 years the grasp on detail concerning a fast-moving and intense activity has inevitably slackened. The fact that in the witness box an individual might seem somewhat hapless in the face of detailed questions about particular emails or specific figures in a report, and resort to the (entirely honest) answer that they cannot remember, does not mean that they were not completely on top of the detail during the crucial events themselves: nor does it mean that at trial they are being evasive and slippery. On the other hand, the ability of a witness to answer matters of detail may simply reflect a mastery of the documentary structure.

46. The second observation is that the times themselves were so extraordinary, and the events themselves so unprecedented, that the broad sense of what happened and the occurrence of individual events are quite likely to be remembered. Moreover, the

consequences of the transaction emerged within a matter of weeks as the economy plunged into the deepest recession for centuries: and those involved began immediately to review the decisions they had just taken, and how and why they had reached the decisions they did. Whilst this may well lead to a retention of the main thrust of an argument I am sceptical that it could lead to an accurate recollection of a precise thought process (unless this is recorded somewhere). This process has continued as the controversy surrounding those decisions has rumbled on. The evidence tendered in the witness box has been shaped by that process of review and justification: and the evidence tendered in the witness statements is in some cases further shaped by knowledge of and interpretation of key contemporaneous documents (though plainly there were many documents that witnesses had not viewed for 9 years). This observation casts no imputation upon the honesty of any witness. No witness concocted anything or told me anything they did not truly believe. Nor does it mean that I regard the evidence of these witnesses as mere commentary upon selected documents which is of itself without value. Certainly not. It fills in undocumented gaps and provides a necessary corrective to applying a 2017/18 understanding to documents generated in 2008.

47. The third observation is that what can be excluded is any question of collusion in the preparation of evidence, for the respective witness statements of the Defendants (although "lawyered") were prepared in isolation; and moreover, each factual witness called by the defence did not read the statements of other witnesses before tendering their own evidence. Each witness was therefore unprepared for challenges based upon inconsistency or difference in expression between statements.

48. Sir Victor must, I think, have been a pale shadow of the man who co-authored *Weinberg & Blank on Takeovers and Mergers* whilst a partner in Clifford Turner. Before becoming chairman of Lloyds in May 2006 he had (in consequence of his expertise as a solicitor in public offerings and acquisitions) headed the corporate finance department of the merchant bank Charterhouse Japhet, and in due time had become Chief Executive and Chairman of the Charterhouse Group. When Charterhouse was acquired by the Royal Bank of Scotland he served on the board of RBS (whilst remaining at the Charterhouse Group). He had subsequently become Chairman of the Mirror Group Newspapers and chairman of The Great Universal Stores plc. He was the Chairman of Lloyds from May 2006 until September 2009, when he resigned in view of the decline in the Lloyds share price. But in the witness box he displayed none of the vigour or authority that his expertise and experience would have commanded at the time. Whilst his recollection of detail failed him he retained a clear understanding of the roles of the relevant personnel, and of how he supervised the proper discharge of those roles by exercising oversight, testing and questioning the proposals of the chief executive officer (Mr Daniels) and his team.

49. Mr Daniels was the Group Chief Executive at the time of the Acquisition, having been appointed in 2003 after a long career at Citibank. He led the formulation and implementation of the strategy of which the Acquisition ultimately formed part. He therefore naturally was an advocate for it, both at the time and in the witness box: this meant that he was at times unnecessarily defensive about some criticism (e.g. his resistance to the idea that the Acquisition was *in any sense* a "rescue package"). But I thought he withstood the challenge presented in cross-examination (that he was "blinkered" and drove through the Acquisition oblivious to or regardless of any element

of risk) well: and I do not dismiss his evidence as on that account one-dimensional. But it must necessarily be approached critically: for example, where he says that he did see a particular financial model which is not to be found amongst the surviving documents.

50. Mr Tookey had been Lloyds' Deputy Group Finance Director since 2006 and was the Acting Group Finance Director at the time of the Acquisition, but was not a board member. He was centrally involved in events, sometimes working long hours under high pressure. Unsurprisingly, sometimes events coalesced in his recollection. He was an extremely well prepared witness who engaged completely with the process of giving evidence (though he tired somewhat towards the end of his seven day cross-examination). I do not confuse confidence in delivery with accuracy of recollection: but I found that his answers provided an insightful, if on occasion defensive, narrative and an instructive commentary on the recorded events, demonstrating that the documents on their own did not present a wholly reliable picture. The very nature of his thorough cross-examination over those days meant that on many occasions he was not telling me what he recollected of events at the time, but in answering those challenges he was advancing arguments justifying positions that were taken at the time using material that was still available. The process of rationalising decisions could not be separated from telling me what he remembered: and if he had purported to tell me that his evidence was based solely upon accurate recollection what was actually in his mind in the seconds after he saw (say) a figure in a briefing paper in October 2008 I would have found that hard to accept. When deciding whether to accept or reject particular points by assessing the coherence of the justification now advanced I have therefore had to bear in mind the very different circumstances in which I am making that assessment.

51. Mr Tate was at the time of the transaction the Group Executive Director of the Wholesale & International Bank at Lloyds. He had joined Lloyds in 2003 with a depth of experience in corporate banking (including work on the corporate side of investment banking). The wholesale bank at Lloyds included corporate business, the bank's overseas retail business, and the bank's day-to-day liquidity and funding requirements: and Mr Tate had oversight over the various teams which conducted the operations. He was therefore in tune with market conditions and able to assess potential funding difficulties. He was thoroughly cross-examined over three days, during which he gave some confident and clear passages of evidence. He was accused at one point of giving "totally unrealistic" answers: but I thought that the charge was unjustified, and that Mr Tate was an impressive witness who gave considered and nuanced answers and often made sensible acknowledgements and concessions.

52. Ms Weir held a first class degree in mathematics from Oxford University and an MBA from Stanford Graduate School of Business. She had joined Lloyds in April 2004 from Kingfisher plc (where she had been Group Finance Director): and in April 2008 had been appointed Lloyds Group Executive Director of UK Retail Banking Division. In consequence, given the stressed market conditions pertaining and the market events that were occurring during the course of 2008 her focus was upon Lloyds' retail banking operations (in particular its retail loan portfolios and its deposit base): and her principal concern in any merger would have been to consider the integration of the Lloyds and HBOS retail businesses. So that was the nature of her participation in the negotiations. But she was a full board member, and subject to the obligations of that office. In her position this meant that to the extent that she was not party to the more general aspects of the negotiations her obligation was to report to the full board accurately and frankly

those matters touching her area of executive responsibility and to consider carefully the board papers on other matters. She was totally frank as to her inability to recall which documents went to which meeting and as to her inability (when presented with a document she had not seen for nine years) to explain figures in the witness box: the latter inability was occasioned to a significant degree by the fact that throughout her time in the witness box she was evidently tense and discomfited by the process. I thought her acknowledged limitations for the most part to be genuine, and not a stratagem to avoid difficult questions (save that I did not find her inability to remember much about the Northern Rock affair to be credible).

53. Mr Kane was at the material time the CEO of Scottish Widows Bank plc (a subsidiary of Lloyds) and the Executive Director of Insurance and Investments for the Lloyds group. His focus was naturally in that sphere of the bank's business and, being based in Edinburgh, he sometimes participated in board meetings by telephone in the course of which he would make notes (some of which survived). These notes were not a verbatim record of what was said, nor were they intended to be a record of the meeting: they were simply matters which Mr Kane considered at that time to be worth jotting down as the discussion flowed. Some care must therefore be taken in interpreting the literal words on the page: having seen him, I felt that I could trust him fairly to assist me in that task. It is unsurprising that whilst he had a recollection of the general shape of events (such as the time pressure to do a deal rather than waiting for everything to fall apart) he no longer recalled much of the detail. He was a reliable witness.

54. Both Mr du Plessis and Dr Berndt were excellent witnesses: I found the analytical parts of their evidence sharp and insightful, the clarity no doubt deriving from their status as non-executive directors who were at a distance from the mass of operational detail. Mr du Plessis was a chartered accountant and formerly the Group Finance Director of a Swiss-based luxury goods company. He joined the Lloyds' board in 2005 (being at that time the Chairman of British American Tobacco) and became chairman of the Audit Committee. Dr Berndt joined the Lloyds' board in March 2003 having previously held senior executive roles with Proctor and Gamble and being then a non-executive director of Cadbury Ltd and of GfK AG. Because of their roles as non-executive directors of Lloyds they retained a grasp of the strategy behind the Acquisition and the rationale for various of the decisions made, but they have a patchy recollection of matters of detail (even though each had sought to refresh his memory from a selection of contemporaneous documents).

55. Mr Alexander Pietruska was at the material time Head of Group Strategy and Corporate Development at Lloyds. His attitude in relation to his professional responsibilities was one of caution: and he displayed the same characteristic in relation to his evidence. He was careful and measured, ready to concede possible interpretations of his work rather than immediately to build defensive positions, and to acknowledge that on occasion his memory was at fault (either by way of mis-recollection or by way of a failure to recall why a particular phrase occurred in a document). I thought he was entirely trustworthy.

56. Mr Jeremy Parr was the corporate partner in Linklaters primarily responsible for the looking after the interest of Lloyds in relation to the Aquisition as its senior relationship partner. He had considerable experience in dealing with high profile M&A work. He provided advice and oversaw the preparation of all relevant documentation. He was reliant for matters of detail on Linklaters' documentary records though in many cases he had not himself drafted the documents themselves but given direction as to their

form and content and then delegated the performance of the task to associates. Amongst those with whom he worked were Mr Barber and Mr Cutting, from both of whom I heard. Mr Parr was a thoughtful and careful witness, and gave a good account of what actually happened and spoke out of a depth of experience as to why matters had happened as they did, in particular in relation to the genesis and contents of the Circular. Mr Cutting gave straightforward evidence, but I felt Mr Barber was unduly defensive, and could have conceded matters relating to the Lloyds Repo more readily. That said, I am clear that he was entirely right to resist the notion that a note of advice prepared within hours of his being instructed was intended to convey his settled and immutable views.

57. I also received evidence from Mr Short, the Head of Liquidity and Funding Management at Lloyds. He was from that perspective able to give evidence as to the markets in which Lloyds and HBOS actually transacted business, as well as direct evidence about the funding and liquidity workstream which looked at the funding requirements of the Enlarged Group (led by Mr Tate).

58. Sir Hector Sants ("Mr Sants" as he was at the time) was another who was not the man he must have been when the events themselves were occurring. He had in 2008 been the Chief Executive of the Financial Services Agency, and at the centre of the maelstrom around the Lehman collapse. Before trial there was an issue about whether his state of health would permit him to attend trial for cross examination. An application was made on his behalf that his written evidence be accepted on a "hearsay" basis: one of the grounds of that application was that the relevant events occur occurred nine years ago, that Sir Hector's recollection was not assisted by any contemporaneous notes of his own or any FSA records, that all he could reference were those documents exhibited to the witness statements of other parties, and he did not believe that he had any material recollection over and above the events they recorded. In the event Sir Hector attended the trial and was cross-examined in public on detailed matters. Shortly before he gave his evidence he served a supplemental witness statement, apparently addressing issues that had arisen during the cross-examination of other witnesses. This belied the evidence of his solicitors that Mr Sants was not thought to have any recollection above what was to be found in the documents: but having weighed it carefully at the time and scrutinised it on review I do not consider that this additional material was either fabricated or the product of suggestion, but rather that learning what others said had prompted remembrance.

The expert witnesses

59. Mr Christopher Ellerton shouldered a most enormous burden in this case on behalf of the Claimants: he was in some respects at the limits of his expertise. He was an equity analyst, a banking specialist with experience in company and bank sector related equity research, asset management and corporate finance. When he prepared his reports he was a Senior Equity Research Analyst with Turing Experts Limited. His CV revealed experience in banking research for investment houses and banks from 1985 to 2007 and some (unspecified) involvement *as an analyst* in the flotation of TSB and Abbey National and in the sale of Midland Bank to HSBC. But his CV revealed no main board experience with an enterprise of any size: he had never worked as an investment banker (and his role as an analyst would have kept him isolated from all investment banking and corporate advisory work i.e. from the decision making process). Thus he had not

advised on potential transactions or prepared advice for the board on an intended transaction or modelled an intended transaction or participated in board deliberations.

60. Mr Ellerton's instructions were to deal with banking and/or central banking practice; with the capital raising abilities and Lloyds and of the Enlarged Group, the materiality to shareholders of the details of the Lloyds and HBOS disclosed capital positions and the probable market reaction if other disclosures had been made. But these areas were not his "bread and butter". Indeed, he was not an expert in the Listing Rules, the Disclosure and Transparency Rules, the Takeover Code or central banking. So he made mistakes. His first report made a crucial error about what is called "the Core Tier 1 ratio" (which I expand upon later). Once the error had been pointed out, his second report corrected it: but it did not revisit the conclusions expressed in the first report to see whether the error affected the conclusions expressed: and he still had not done so when he gave oral evidence, although he did say that he did not believe that his error had affected his fundamental analysis. He then made a further error about what is included in Core Tier 1 capital during the course of the trial.

61. Mr Ellerton had, in fact, been interviewed by the solicitors for the Defendants on 23 November 2015 as a potential expert witness. The preliminary views he then expressed did not align with the views expressed in his report for the Claimants. For example in relation to market reaction to the disclosure that HBOS was in receipt of ELA (to which I will come) (i) in his interview with the Defendants' solicitors Mr Ellerton expressed the view that had the market known it may have had little impact upon the HBOS share price, being viewed as another funding source for banks suffering difficulties with funding; whereas (ii) in his report for the Claimants Mr Ellerton said (First Report para.6.34) that had there been disclosure of ELA then HBOS's share price would have collapsed. In his oral evidence Mr Ellerton said that it was difficult to have any confidence in estimating how the market would react. I am not accusing Mr Ellerton of "trimming". I am simply pointing out that Mr Ellerton had to face enormously difficult questions at the limits of his (or anyone's) expertise where a slight change in perspective can have a significant impact upon assessment, and that Mr Ellerton's ultimate answer (that one can have little confidence in these assessments) is one with which I have much sympathy. Likewise I have great sympathy for him on those occasions when, under cross-examination, he felt unable to maintain views expressed in his report or where a change in perspective lead to a change in opinion.

62. Mr Ellerton's key evidence (concerning capital adequacy) was not in fact set out in his reports of 21 March or 3 July 2017 but in a supplementary letter dated 15 September 2017, which arose from the debate he had had with the Defendants' experts. In general I think Mr Ellerton benefitted from a process of challenge to his views and that his oral evidence was in general more reliable than those in his written reports.

63. Mr Gervase MacGregor was the Claimants' forensic accounting expert and Head of Advisory Services at BDO LLP. He had been a forensic accounting expert since 1994, specialising in damages quantification in "loss of profits" cases. Thus he had never sat on the board of a company taking over another, though he had some familiarity with the Takeover Code. Like Mr Ellerton, he made an error (failing to take into account the proceeds of an HBOS rights issue after 30 June 2008) but did not work through the consequences of correcting it, though he asserted that it made no difference to his opinions.

64. One of the matters upon which he had been instructed to express an opinion was as to the value of HBOS (a matter that went to both liability and to the assessment of damages). He acknowledged that his reports did not contain any valuation of HBOS: he expressed the opinion that HBOS was "valueless" but made clear that he was not saying that it was worth "zero". That was because he felt unable to put a value on (for example) the synergies arising from the Acquisition even though he thought that the high degree of rigour demanded by the Takeover Code as appropriate to the development of benefit statements had been met: and the reason for that appeared to be that there was a risk that divestment might be required. But it did not strike me as a balanced view to say that a reasonable board of a predator company must treat the target as valueless because there is a doubt over whether the full value of extensive synergies will be obtained.

65. In terms of technical accounting issues, however, I thought he was sound.

66. Mr Benkert was instructed by the Claimants to give opinion evidence upon the interaction of Lloyds and of HBOS with various banks and their standard and emergency liquidity provision regimes ("Central Banking Practice"). He was not a central banker but was during 2007 and 2008 Head of Money Markets and Global Funding for Goldman Sachs in which capacity he sat on money market committees at BoE and the ECB. His experience therefore lay in the debt markets, and in particular the short-term (overnight to 1 year) secured and unsecured end; and he had no experience of the Listing Rules. He was a good and reliable witness as to the views of the debt market in relation to a market participant who used SLS or ELA (though I thought unnecessarily resistant to the idea that SLS might be used as a LOLR facility by some banks unable to raise urgently needed funds elsewhere). Although a fair witness (willing to concede where appropriate) I thought him less reliable away from his central expertise.

67. Mr Torchio was an adjunct professor of finance at the Simon School of Business in the University of Rochester, had authored or co-authored three articles, and for 25 years had been a valuation consultant. He was evidently a very experienced expert witness. He was a purely critical witness: his sole function was to find flaws in the report of Dr Unni (especially in relation to the Lloyds "standalone" valuation) without having to advance any coherent alternative account of his own, which meant that he felt able in making his criticisms to contradict the evidence of other of the *Claimant's* witnesses (e.g. as to the extent of trading in Lloyds shares after the Announcement, or the acceptability of RBS as a comparable). He presented his critique with vigour, principally directed at quantum questions: but his evidence suffered from the limitation that he proceeded (so far as I could see) entirely on the premise that the Acquisition had never been announced ("the unaffected share price"), and upon the assumption that no market events of significance to Lloyds (other than the announcement of the Acquisition) had occurred since 17 September 2008. Thus it seemed to me that in his insistence that if the Acquisition had been abandoned the Lloyds share price would revert to the "undisturbed share price" he did not give sufficient weight to the fact that in the meantime the world had changed for Lloyds.

68. Prof Schifferes was Professor of Financial Journalism at City University: at the time of the financial crisis he was economics correspondent for BBC News On-line, and he led a BBC team producing a week of programmes on the anniversary of the Lehman collapse. His function was to prepare a report on the probable reaction of the financial

press/media to the disclosure of (i) ELA, (ii) Federal Reserve funding and (iii) the Lloyds Repo; but his report ranged significantly wider. He was not a satisfactory witness. As I shall explain, his methodology was very strange. But of equal significance was his reliability. According to the record of interviews, none of the interviewed journalists had been asked if they knew of a contemporaneous story that Lloyds had lent HBOS £10bn. Prof Schifferes said that each interviewee had been asked that question but it was simply not recorded, because none of them knew about it (even though one interviewee had himself written up the story). He was pressed with the oddity of this but repeatedly stood by his answer. When he returned after the short adjournment he told me that all of that part of the morning evidence had been wrong, and he provided an entirely unconvincing new explanation for the admitted omission to ask the question. I could not be confident about the accuracy of his other answers.

69. The Defendants' expert Mr Paul Sharma was instructed to consider two questions; (i) whether it was reasonable for the Lloyds' directors to consider that a "standalone" Lloyds would have to raise £7bn; and (ii) whether it was reasonable for the Lloyds' directors to think that £17bn of additional capital would enable the Enlarged Group to trade for 12 months without raising additional capital. He addressed these questions from the standpoint of an experienced regulator who had been a director of the FSA (serving as director of Prudential Policy from April 2008- March 2013), and as such had been responsible for formulating the FSA guidance on capital adequacy, liquidity, stress-testing and risk management- though he had no role in the calculation of either the Lloyds or the HBOS capital requirements over the Recapitalisation Weekend. I found him to be a precise, accurate and authoritative witness, though I thought unduly defensive in his reluctance to accept the evident vulnerabilities of HBOS. He was careful to confine himself to considering whether the outcome of the FSA stress-test was plausible (in the context of ascertaining additional capital requirements for Lloyds), and not to attempt to build a model as a basis for the sum required (as to which there was insufficient material). I can rely on his evidence.

70. Mr Trippitt was a sell-side analyst covering UK banks during the period 1994-2015 for a succession of investment houses. In 2008 he was at Oriel Securities, and was actually involved in the events with which this action is concerned. He was instructed to give opinions on the probable market reaction to various hypothetical disclosures assumed to have been made by the Lloyds board in the Circular. His personal involvement did not, he acknowledged, give him any better insight into those events than that of any other publishing analyst (whose reports I have in several volumes); but it did give him a sense of where the balance of views lay. It was instructive to compare the views which he published contemporaneously (in particular he did a "buy" note on 5 December 2008) with the terms of his report. He had a tendency in his evidence to keep repeating the content of that report: the more exotic the alternative assumptions being put to him in cross-examination the more difficult he found it to undertake instant analysis, and the more he resorted to repetition of the considered view expressed in his report. On reflection I think this had more to do with a sense of caution than with a refusal to engage because of a lack of confidence in the views being tested. I am in general able to rely on his views.

71. Prof. Persaud gave opinion evidence on Liquidity and Central Bank Practice. He was during the events in question the Chairman of Intelligence Capital Limited (a leading financial advisory and research firm) and Professor of Commerce at Gresham College,

London. He achieved a position of considerable eminence during and after the financial crisis. His evidence was clear, firm and analytical and well referenced. A key part of it was that emergency liquidity assistance is not dependent upon whether it is sector-wide or bilateral, covert or transparent; and that SLS was a "sub-set" of ELA so that both SLS and ELA were "lender of last resort" facilities (where the bank was providing liquidity which the market would not provide), ELA simply being a bridge to other support schemes. But it seemed to me that the question I would have to address would involve not only technical analysis but also market perception and common understanding. This constituted a limitation on the value of his evidence.

72. Mr John Williams was an investment banker with some 30 years' experience with leading institutions and who had participated in M&A work for banks (including Abbey National's defence of a bid from Lloyds in 2001). He was asked to opine on what was "ordinary course" business and whether it was reasonable for the Lloyds' board to hold certain views: these are ultimately questions for me, but the background material relied upon by Mr Williams as to practice, information and expectation was very useful. Under cross-examination he gave measured responses, and was willing to acknowledge the limitations on his expertise.

73. Mr Deetz was the forensic accountant called by the Defendants. He was the Managing Director of Navigant Consulting having formerly been Managing Director of Strategic Valuation Services for Arthur Anderson. He had experience of valuing large financial institutions for regulatory capital and financial reporting purposes (including the evaluation of loans and the determination of impairments). I thought he was a very good witness (although I was not persuaded by his analysis on every point) giving considered and well reasoned answers to points put in cross-examination.

74. The same may be said of Dr Unni, who was the Managing Director of the Berkley Research Group, and leader of its Securities Practice. He produced a well grounded and tightly argued report which in general stood up well under the scrutiny of cross-examination. There were, however, flaws in his quantum analysis identified by Mr Torchio which weakened the impact of that part of his report.

75. This expert evidence covered some 4750 pages, as experts in one discipline commented upon the evidence of other experts in other disciplines and small market events were subjected to the minutest scrutiny. It is impossible to rule upon every point of difference: nor do I think it necessary to do so. I have focussed on those areas where there is a measure of common ground, and moved from there into those areas where discernible principle might guide me, seeking to avoid those areas where (what I thought) wasm speculation was prominent. Of course, all counterfactuals are "speculative" to some degree: but it is possible to sense (if not always to explain) when the feet leave the ground. In key areas there was no expert evidence.

The facts: the emerging financial crisis before the summer of 2008

76. Although punctuated by the bursting of the dot-com bubble in 2000 and the Enron debacle in 2001, the two decades before the financial crisis of 2008 were relatively benign periods of stability and low volatility. There were 60 quarters of continuous expansion, a steady rise in property prices (the Halifax House Price Index rose 2.3 times between 2000 and 2007) and strong growth in financial services, all underpinned by stable inflation and low interest rates. In particular the banking sector grew both in

nominal terms and also relative to the size of the UK economy as a whole. As the demand for loans (especially for property-based activities) outstripped the supply of retail deposits the banking sector turned increasingly to the wholesale money markets, offering those markets asset-backed and mortgage-backed securities, holding such securities on their balance sheets, and using such holdings as collateral in repurchase lending ("repos"). In so doing the sector became highly exposed to commercial and residential property. There is little doubt that policymakers, banks and other market participants became increasingly confident about the assumed continuation of this new paradigm, and increasingly complacent in their assessment of risk.

77. But during the course of 2006 and 2007 the financial markets began to tighten and their health began to deteriorate. A decline in US property values (prompted by 16 consecutive quarter-point interest rate rises) undermined confidence in mortgage-backed and asset-backed securities, with the result that "bid-offer" spreads increased, values reduced and market participants began to question the creditworthiness of other participants. This led to an eventual tightening of the wholesale markets. Failures began to emerge.

78. In July 2007 two Bear Stearns sub-prime mortgage funds failed; and on 9 August 2007 BNP suspended three investment funds.

79. Then at 8.30pm on 13 September 2007 the journalist Robert Peston reported on the BBC news website that Northern Rock plc had sought and had received assistance from the Bank of England acting as "lender of last resort". The news item in fact pre-empted an intended formal announcement by Northern Rock as soon as it had concluded such arrangements at 7.00am on 14 September 2007. The formal announcement said that the Chancellor of the Exchequer had authorised the Bank of England "to provide liquidity support against appropriate collateral and at an interest rate premium" in order to address the difficulties that Northern Rock had encountered in accessing longer term funding and the mortgage securitization market.

80. Northern Rock was an efficient and prudent lender with a good quality asset book. But its retail base (depositors with Northern Rock) did not grow at the same pace as its loan book. So, it adopted a business model which was given the label "originate to distribute" (in contrast to the "originate to hold" model). The loans which it made were not held to maturity ("originate to hold"), but were parcelled up and sold on ("distributed") to investors who purchased bonds secured on the collateral of the relevant parcel of mortgages: a process called "securitisation". The proceeds of the bond issue then became available to fund further loans (which themselves would then be securitised). This process provided about 50% of Northern Rock's funding requirement: and another 25% was raised on the wholesale market on a short (<1 year) or medium (1> year) term basis. Retail deposits supplied most of the remaining funding requirement.

81. The events of 9 August 2007 caused a sudden shock which dislocated the markets both for Northern Rock's securitised offerings and for its wholesale money needs. "Bid-offer" spreads increased. Interest rates rose. Maturity terms shortened. Northern Rock's liquidity came under pressure (although it was still funding its operations). Accordingly, it sought to make "backstop" arrangements to address the contingency of illiquidity. It was the leak of these intended "backstop" liquidity arrangements that led to a "run": and the impending "run" that in turn led to the necessity of implementing the proposed arrangements immediately. So the "leak" became self-fulfilling.

82. Eventually in order to stop the run the UK Government announced on 17 September 2007 that it was guaranteeing Northern Rock's deposits.

83. What followed was continued tightening of the financial markets and attempts by regulators, governments and central banks around the world to stem the crisis. A brief account of the key individual events up to April 2008 (necessary to provide the context for the transaction with which I am concerned) would include the following:

i) Since 2006 the Bank as central bank had operated under a Sterling Monetary Framework which reflected its historically developed twofold role. First, to implement monetary policy (controlling interest rates and inflation): and as part of this function to participate in open market money operations. This participation might take the form of lending to UK banks that were eligible to hold reserves at the Bank against gilts; or of operating what was called “the standing facility” by taking deposits of excess cash from those banks and permitting depositors to borrow cash if there had been a miscalculation of their funding requirement. The second (and separate) function was to ensure the stability of the financial system by ultimately acting as a lender of last resort. The Bank’s lending facilities through its open market operations were not frequently used: and on 13 August 2007 BoE had issued a market notice reminding UK banks that these standing facilities were available throughout the day.

ii) In response to the events to which I have just referred and in recognition that the existing model was not in fact addressing the need, the Bank (along with central banks globally) began to move from this historic role towards becoming a provider of liquidity, aiming to provide to the market generally liquidity that was sufficient to stabilise the market but not so generous as to undermine the element of “moral hazard” that was an integral part of the global financial model.

iii) On 19 September 2007 the Bank of England introduced a "Term Auction" facility (“TAF”) to assist with liquidity issues in the financial markets by offering to provide funds at longer maturities and against a wider range of collateral than it had hitherto done at a bid rate of 100 basis points over bank rate.

iv) Coming as they did alongside the Government guarantee of Northern Rock, the initial auctions were not a success (there were no bids at all in the first four) because of the fear in the sector that any bank using the facility would be “stigmatised” i.e. regarded by the market as “weak” simply because it was using central bank funds.

v) Although taking steps to increase liquidity in the market, the Bank did not in Q3 2007 in fact consider that there was a significant risk of any large financial institution failing. As was pointed out in the Plenderleith Report (*“A Review of the Bank of England’s Provision of Emergency Liquidity Assistance 2008-2009”* published in October 2012), in the Bank of England Financial Stability Report issue number 22 it considered that the probability and impact of large complex financial institution distress had increased only slightly over its original

assessments in July 2006 and April 2007 (when it regarded severe stress in the medium term as being "remote" with a likelihood close to zero).

vi) In November 2007 the BoE offered £10bn of liquidity for 5 weeks via open market operations to inject liquidity into the market as the year end approached.

vii) On 12 December 2007 five central banks around the world (including the BoE and the US Federal Reserve) took coordinated action to inject further liquidity into the global banking system. The Bank increased the funds available under its TAF and enlarged the range of collateral that it would accept.

viii) On 18 December 2007 the Bank of England introduced the new Extended Collateral Long Term Repo operations ("ELTR") extending the range of collateral it would lend against under its three-month long-term repo open market operations. Drawdown here was by way of auction, where banks could bid to borrow cash. Because of the adoption of an auction structure the perception of ELTR as being some sort of emergency funding was eliminated: a bank could bid, but it was not guaranteed to secure the "lot" and so could not rely on it as a last resort.

ix) Northern Rock was nationalised on 17 February 2008, its shareholders ultimately getting nothing (though that did not become apparent until December 2009, nearly two years later). Parliament passed the Banking (Special Provisions) Act of 2008 to give the Treasury powers to facilitate the orderly resolution of a potentially failing bank.

x) On 27 February 2008 HBOS announced its 2007 results. In terms of assets the balance sheet disclosed a significant exposure of the order of £41bn to asset-backed commercial paper ("ABCPs") including (a) an exposure of £430 million to sub-prime lending and (b) an exposure of £7bn to what were called "ALT-A" loans (sometimes called "near prime"). As the latter terms suggests, these lay between prime and sub-prime lending. In terms of funding, the balance sheet disclosed (a) that the impact of the events at Northern Rock had led to a flight *to* HBOS which increased its retail deposits by some 10% (b) that there was an increased dependence on wholesale funding and (c) that because of market conditions the maturity profile had shortened, so that 59% of the total wholesale funding requirement of HBOS (or £164bn) was due within one year.

xi) On 11 March 2008 central banks announced further coordinated action to tackle the crisis, including the Bank of England extending its existing liquidity support operations and extending repo operations, and the US Federal Reserve announcing the Term Securities Lending Facility (under which it would make longer dated loans against a broad range of eligible collateral).

xii) On 14 March 2008, in response to rumours that Bear Stearns was experiencing liquidity problems, the Federal Reserve Bank of New York announced it was providing liquidity supplies to Bear Stearns and on 16 March 2008 JP Morgan agreed to acquire Bear Stearns.

xiii) The US Federal Reserve ran a programme to enable banks facing liquidity issues to access short term money: originally the term was overnight. The programme

was called “the Discount Window”. On the same day that JP Morgan announced it would acquire Bear Stearns, the US Federal Reserve extended the maximum Discount Window term to 90 days and announced the establishment of “the Primary Dealer Credit Facility” (which provided US broker dealers access to overnight liquidity for the first time since The Great Depression).

xiv) On 19 March 2008 the HBOS intra-day share price dropped by 17% (and its market close price by 7%) and its credit default swap (“CDS”) spreads widened (both in absolute terms and relative to its peer group). These movements were caused by unsubstantiated rumours that it had asked the Bank of England for emergency funding. The rumours were false. But they (and the reaction to them, even allowing for the influence of algorithmic trading strategies) evidence a perception in the market that HBOS had potential vulnerabilities. It had an above-average dependence on wholesale markets to provide short-term funding for a medium-term loan portfolio. That loan portfolio itself had a concentration on commercial property lending, on “self-certification” mortgages and on “buy-to-let” mortgages: and the market could see that any increase in funding costs would squeeze the net interest margin. That perception led to an increase in the proportion of sell recommendations from analysts. The Claimants’ expert Mr Ellerton (relying on a report prepared by Citigroup Global Markets Limited (“Citi”) for Lloyds in October 2009) says that the percentage of HBOS “sell” recommendations amongst analysts surveyed rose from 32% in March to 42% in April, and then to 46% in May.

84. These events demonstrate an increased willingness on the part of central banks to depart from their previous role as “lender of last resort” and to facilitate the provision of liquidity within the financial system generally. They also show an initial reluctance on the part of banks to avail themselves of what was on offer for fear of being “stigmatised”, leading to a real endeavour on the part of the BoE to persuade that market that the existence and use of these facilities was part of the “new normal”; but also, a failure on the part of the Bank fully to comprehend what the risks in that “new normal” were. They also show that the steps being taken to facilitate the provision of liquidity were not satisfying the demand created by the tightening of the wholesale markets: and that the debt and equity markets remained nervous on that account.

85. So as part its policy of increased support measures for the financial system the Bank of England introduced the Special Liquidity Scheme ("SLS") to provide further liquidity to banks, in particular, access to term funding. The SLS was approved by the Bank of England Committee of Non-Executive Directors on 16 April 2008 and by 20 April 2008 all major UK banks had committed to participating in the SLS. The SLS was publicly announced by the Bank of England on 21 April 2008. In establishing it the Committee recorded that it was not intended as a “lender of last resort” facility: its purpose was to prevent a sudden crisis of confidence leading to the interbank market freezing up. What SLS was “intended” to be would not, of course, determine what it became.

86. I should at this point explain the key features of SLS. It operated as a collateral swap: for a fee bank could swap high-quality mortgage-backed securitised assets created before 31 December 2007 and other high-grade bonds and securities (on which the market had turned its back) for nine-month UK Treasury bills (in which the market would still deal). The swap was for a term of one year, renewable up to 3 years: and this was anticipated to give the markets time to recover or the funded bank time to

diversify its asset base. There was a specified drawdown window: the first lasting until 21 October 2008 (though this was later extended until January 2009). This was to permit the securitisation of eligible *legacy* loans. A bank that availed itself of drawdown by swapping securitised assets for Treasury bills could then use such high-quality sovereign collateral either (i) as part of its regulatory liquidity buffer or (ii) for raising finance in the active repo markets. The reluctance of the wholesale markets to accept mortgage-backed securities was thereby overcome.

87. The potential for "stigma" through use of the SLS facility was overcome (i) by the fact that all major banks committed to participate in the scheme (whether or not they actually needed to avail themselves of it, as opposed to available alternatives): and (ii) by the fact that the extent to which any particular bank used the facility was concealed from the market. The use of the "swap" mechanism meant that the Bank was not obliged to report the transaction on its balance sheet (as would have been the case with a cash transaction). The Bank did not disclose individual uptake in any of its Reports or Bulletins, and it imposed upon participating banks strict confidentiality clauses preventing the giving of any indication whatsoever about any utilisation. It was the recollection of the Claimants' expert Mr Benkert that

> "…the Bank of England was very aware of the demands by the market for transparency but equally aware of the risk of disclosing too much too soon in relation to which banks had accessed the SLS and to what extent, which it believed could cause disturbances in the market for individual banks. "

So the market was to be kept in the dark (and to that extent distorted). But in fact there were educated guesses about the main users. However, (as was noted in the "*Review of the Bank of England's Framework for Providing Liquidity to the Banking System*" by Bill Winters published in 2012) the suspects did not appear to suffer stigma as a result.

88. There was a limit set for usage by each bank based on the total value of its eligible assets: and the higher the level of usage relative to the size of the institutional balance sheet the higher the fees charged for the SLS facility. To that extent the terms of a given transaction were particular to that bank on that drawdown.

89. But SLS could not provide a complete solution to the funding shortage for every bank: and longer term solutions had to be found. HBOS had already embarked upon (and on 29 April 2008 announced) a £4bn rights issue at a 45% discount to the market price. A fortnight later on 14 May 2008 Bradford & Bingley did the same with its £300m rights issue: and six weeks after that on 25 June 2008 Barclays announced its own £4.5bn capital raising exercise.

90. Elsewhere in the market consolidation was seen as an appropriate response. On 14 July 2008 Santander announced its purchase of Alliance & Leicester for £13bn. By 8 September 2008 Nationwide Building Society would have acquired the Cheshire Building Society and the Derbyshire Building Society.

Initial discussions on an acquisition in Summer 2008

91. It was in the context of challenges generated by this emerging financial crisis and the varying responses to it that in July 2008 contact was made between Lloyds and HBOS regarding a possible acquisition.

92. Lloyds had long been looking at potential acquisitions as part of its Phase 3 strategy. Foreign acquisitions proved unattractive because of the difficulty in generating synergies with Lloyd's existing business. Domestic takeovers or mergers of entities with the right "fit" would likely be frustrated by competition issues. A potential merger with Abbey National plc in 2001 had foundered upon that very obstacle, following a reference to the Competition Commission. Shortly after Sir Victor had become chairman in May 2006 he had an informal conversation with Mr Hornby of HBOS (instigated by the latter) which led to some very preliminary exploratory talks at a high level about the potential for a merger. In many respects a combination with HBOS was the most attractive goal for Lloyds: but the very reason that made it attractive also raised the most difficult competition questions. So these talks did not develop on account of the perceived competition obstacle. But the idea remained on the table.

93. The events of the first half of 2008 afforded a fresh opportunity to approach a takeover or merger between the two entities once again. Lloyds continued to see the desirability of non-organic growth by acquisition to enhance shareholder value. Whilst some shareholders valued the stolidity of Lloyds the Board was aware of pressure from other shareholders to grow the business (as the bank's peers were doing). Some 200 possible targets were considered, and 20 shortlisted for potential further consideration. During June 2008 Lloyds actively investigated acquiring both Dresdner Bank and also Deutsche Postbank: but neither provided sufficient synergy benefits. On the otherhand Lloyds regarded the HBOS brands (Halifax, Bank of Scotland, Clerical Medical) and areas of market penetration (HBOS was overweight in areas where Lloyds was underweight) favourably. Noting that by July 2008 HBOS's share price was on a downward trend and stood some 60% lower than at the beginning of the year Sir Victor asked Mr Daniels to approach Mr Hornby again. This chimed with an emerging view in the market, for Mr Daniels himself had been approached by a number of investment bankers (Mr Costa of Lazards amongst others from Rothschilds, UBS, Citi and Merrill Lynch) suggesting such a move. It resulted in some new high-level preliminary meetings during July, in which Mr Daniels, Ms Weir, Mr Tookey and Mr Tate took part, with each side agreeing to instruct their respective legal advisers to prepare a paper on how the competition issues might be addressed.

94. On 21 July 2008 HBOS announced a 8.29% subscription rate for its £4 billion rights issue announced on 29 April 2008. This was due to a significant degree to the fact that HBOS had the biggest non-institutional shareholder base in the UK, to whom the rights issue was unattractive. So the issue was a "flop" and (after a placing of a further 29.53%) nearly two-thirds of the new shares were left with the underwriters, creating a huge market overhang. That day Sir Victor was sharing a flight back to the UK with the Prime Minister. During a discussion about the economy Sir Victor raised with Gordon Brown Lloyds' interest in acquiring HBOS but observed that such a deal would not realistically be viable if there was to be a reference to the competition authorities. In the then current climate no bank could have lived with 9 months' uncertainty about its future. Gordon Brown said he would discuss the matter with colleagues in government.

95. On 31 July 2008 HBOS published its interim results for 2008. These announced a profit of £0.8 billion for the first half of 2008, a fall of 72% on the equivalent period in 2007, but ahead of market expectations. Addressing this fall in profits Mr Hornby told analysts that it had been impacted by valuation adjustments and the first sign of increasing impairments largely as a result of asset price deflation in both residential and commercial property (and significant "write-downs" were taken in addition to some that had been disclosed at the time of the rights issue). But he said the underlying performance of the business "remained extremely robust".

96. Dealing with liquidity, the announcement said:

> "The assets in the liquidity portfolio are treated in two forms. Firstly, assets which we know to be eligible under normal arrangements with the Bank of England, the European Central Bank and the Federal Reserve, which for internal purposes we describe as primary liquidity. Secondly, a substantial pool of high-quality (secondary) liquidity assets that allow us to manage through periods of stress taking into account the likely behaviours of depositors and wholesale markets. The Group routinely uses the repo market as a liquidity management tool and has well established relationships with a wide range of market participants. The Group also has access to the standing facilities at a number of central banks."

The statement also noted the launch during the reporting period of SLS and said: –

> "HBOS has used this facility to provide high-quality liquidity assets".

But in this (and in its use of central bank facilities provided by the BoE, the ECB and the Federal Reserve generally) it was no different from many other banks.

97. The market reacted by marking HBOS shares 7% *up*. Analysts were split. Some saw the large mortgage book and the concentration of the corporate loan book on property and construction lending as leading to higher levels of default and higher average loss per default, generating impairments that constituted a significant threat to the bank's value. Some saw the bank's structured credit exposure and the large wholesale funding needs as generating serious risk and warranting an underweight position. Others thought that the then-current share price offered a compelling investment case with current and prospective risks already priced into the discount to book value and recommended an overweight position. One put a target price of 430p (as against the then current 290-300p). Some were neutral. For example Deutsche Bank analysts, looking at a current share price of 291p and estimating that to be 0.7x book value, considered the HBOS shares a "hold" and put a target price of 325p notwithstanding the deterioration in credit quality which they observed and the higher levels of default which they anticipated.

98. These figures and comments would, of course, be available to the Lloyds negotiating team: however, Mr Daniels recalls that Mr Hornby was frank in the course of discussion and confirmed that HBOS was facing funding difficulties i.e. that whilst the present

was as depicted in the Interim Announcement the future was not assured. This did not come as a surprise to Mr Daniels, who knew that the growth in the HBOS loan book far outstripped its savings account base, and had made HBOS particularly dependent upon the wholesale markets for funds. His concerns remain dominated by the competition issues which (even in the light of legal advice he received) seemed insurmountable.

99. On 5 August 2008 Sir Callum McCarthy (then chairman of the FSA) called Sir Victor to enquire (according to the file note of the conversation)

> ".. What [Lloyds'] position would be either in terms of [its] own inorganic development plans or in terms of what [it] might be prepared to do should there be an emergency."

The question did not identify (but clearly referenced) HBOS. Sir Victor indicated that there were good reasons why Lloyds would look at HBOS. Sir Callum indicated that if Lloyds and HBOS wanted to get together then the FSA would be very supportive and would do all it could to help with regard to competition issues. He went on to say that if there was a further financial crisis then Lloyds was one of the two banks to whom the FSA would turn for help (though he expressed satisfaction with the current funding position of HBOS).

100. This conversation I think captures the nuanced position of the main players. Lloyds was interested in HBOS for its own good reasons but recognised the reality of the competition obstacle. The Tripartite was satisfied about the present but concerned for the future of HBOS, and would do what was necessary to enable Lloyds to attain its goals (and would if necessary turn to Lloyds for assistance in an emergency, knowing of Lloyds' interest). HBOS could be satisfied with its present position, but knew that its forecasts were vulnerable to further deterioration in the markets, and could see a merger with Lloyds as a solution.

Initial discussions: emerging themes

101. On 6 August 2008 there was a conversation between Mr Pietruska (the Global Head of Group Strategy & Corporate Development at Lloyds) and his opposite number at HBOS to identify areas of particular interest for discussion. They covered a broad range: the impact of the implementation of Basel II upon capital requirements; the impact upon "bancassurance" businesses of impending regulatory changes to the capitalisation of insurance businesses; the combined entity market shares in current and small business accounts, the competition issues likely to arise and the development of mitigating actions; commercial property and construction finance growth; the treasury portfolio and its prospects; litigation (including the potential impact of PPI); where the corporate business was successful, and what impact a downturn might have; strategic questions about the shape of an enlarged group; a high-level look at synergies; a granular look at the P&L account, the balance sheet and impairments; a review of the capital position; a review of the funding position; and regulatory issues. It is not necessary for the purposes of this judgment to elaborate on these. I record them simply to illustrate the number and range of high-level and detailed issues that had to be thought about even in the early stages.

102. Mr Pietruska had been appointed to his role at Lloyds by Mr Daniels in April 2008, as part of Mr Daniels' strategy to improve Lloyds' growth prospects and to take advantage of any opportunities for strategic buyers created by the financial environment. Mr Pietruska himself had performed a similar role at ABN Amro before joining Lloyds: and in that capacity, he had looked at Lloyds itself as a potential takeover target, and had rejected it because of its limited opportunities for organic growth. It might therefore be thought that Mr Pietruska would be predisposed to favour exploiting the opportunity that was now presenting itself. But he characterised his approach as "naturally conservative" (by which he meant that his tendency was to seek first to identify the problems and see if they could be solved, rather than to jump at an opportunity): and when he drafted a presentation for the board (identifying HBOS as "Dover" and Lloyds as "Lion") it was to the effect that, on the basis of what was currently known, a merger between HBOS and Lloyds should not be undertaken.

103. The basis for that provisional view was twofold. First, there were problematic uncertainties about the competition environment. He considered that the circumstances in which a merger might receive clearance did not then exist and regarded the prospect of clearing the competition hurdles as "remote": and he also noted that in any event the cost of actions to remedy competition issues (e.g. disposals) might reduce the apparent headline value creation.

104. Secondly, he considered that the context in which the transaction had to take place involved addressing three separate elements, each of which was a source of significant uncertainty. They were:-

a) the need for Lloyds to raise possibly £3.7bn of additional capital because of impending changes in the regulatory treatment of "bancassurance" businesses:

b) the need for HBOS to raise £3.1bn additional capital for the same reason, and an amount (between £0 and £8bn) to offset any write-down of HBOS's assets arising from the fact of the accounting treatment of HBOS assets on a merger under IFRS3 "Fair Value" rules (I will come to these) or from the necessity to make "write-downs" arising in the very circumstances in which the transaction was most likely to obtain competition clearance (viz. HBOS' collapse as a competitive force):

c) the need significantly to reduce the Lloyds' dividend in order to rebuild capital ratios and maintain support for further growth.

Mr Pietruska thought that these simultaneous requirements made the deal economics "marginal" when viewed from an EPS perspective (notwithstanding anticipated cost synergies of the order of £1.2 billion and anticipated revenue synergies of approximately £0.8bn); and he considered that no company had tried to accomplish the three identified objectives simultaneously.

105. Having noted the key points in Mr Pietruska's August draft, it worth noting some points of detail.

106. First, Mr Pietruska's core workings assumed an "all share" offer pricing the HBOS shares at approximately 295p. At that level he thought the transaction would be EPS

dilutive until 2012, but noted that the return on investment (on the basis of consensus earnings) would be 13% by 2009 and 20% by 2012. He was concerned not so much with the immediate dilutive effect of the proposed transaction, but rather that any adverse reaction by analysts might provoke a decline in the Lloyds' share price which itself might render the completion of any announced transaction impossible. He felt that if analysts understood that a capital raise of some sort was inevitable because of the "bancassurance" issue then market reaction to a dilutive deal might be moderated. (In relation to this concern Mr Pietruska was later to be assisted by Merrill Lynch whose view, in essence, was that the market would be more receptive than Mr Pietruska feared). The period for which a transaction is forecast to be "dilutive" and how the market might react to a transaction with an immediate dilutive effect were, I think, important insights.

107. Second, as part of his underlying analysis Mr Pietruska commented upon the exposure of HBOS to several areas of potential asset quality risk (in particular commercial property): as well as noting (see above) the potential impact on capital requirements, Mr Pietruska foresaw a problem in addressing analysts concerns in this area as well.

108. Third, the provisional view recorded in his draft was that the capital issues (arising from the matters summarised at 104(b) above) might mean that the transaction could not be financed. He suggested

> "Capital is a major problem and paying less does not help materially. Depending on the outcome of the "Fair value" adjustments under IFRS3 there is a possible need to raise substantially above the consideration level to repair ratios and hit target levels of 6%+ Core Tier 1"

109. It is convenient at this point to provide a commentary on these technical terms relating to capital. The commentary outlines (in sufficient detail for the purposes of this judgment) the essential features of a highly complex system: accuracy is sacrificed in the interests of concision.

110. Under the Basel Capital Accord published by the Basel Committee on Banking Supervision in 2004 ("Basel II") (and implemented by Lloyds and by HBOS from 1 January 2008) a bank was required to maintain a minimum capital requirement calculated as a proportion of its "risk weighted assets" (or "RWAs"). The "assets" in question were the loans which the bank had made. The "risk" in question was the "credit risk" (i.e. the risk of loss due to the failure of the borrower to meet its obligations). This credit risk for each borrower could either be assessed by an external ratings agency (such as Moody or Standard and Poor's) (which was dubbed the "standardised" approach) or by the bank itself using internal models (which was dubbed the "Internal Ratings Based" or "IRB" approach). In general the standardised approach was more conservative than the IRB approach. The assessed risk was not fixed, but could vary over the life of each loan as available information emerged or the economic environment changed. The raw "weighting" was achieved by multiplying the amount of the loan by the risk-percentage. I describe this as the "raw" weighting because in addition to credit risk a bank had to assess its RWAs overall taking into account (a) "market risk" (the risk of loss due to a change in market prices such as interest rates, which risk could be assessed either on a standardised or an IRB approach) and (b)

"operational risk" (the risk of loss resulting from inadequate internal process or systems or from external events). In this way the RWAs were calculated.

111. A function of a bank's capital (share capital, disclosed reserves, asset revaluation reserves, general provisions, subordinated debt etc) is to absorb losses. Basel II divides capital into two categories. Tier 1 (which has the greater loss-absorbing capacity) is the primary capital and consists of issued and fully paid ordinary shares, perpetual non-cumulative preference shares, perpetual subordinated debt, other innovative capital of a similar nature and disclosed reserves. All these types of capital are available to the bank for unrestricted and immediate use to cover risks and losses as soon as they appear, and they rank low in the waterfall on a winding-up. Within Tier 1 was a category of "Core Tier 1 capital" viz. that which displayed to the greatest extent the characteristics of permanency, absence of servicing costs and exposure to loss. In essence Core Tier 1 consists of permanent ordinary share capital and disclosed reserves, and excludes all non-perpetual subordinated debt. Tier 2 is the supplementary capital and consists of all other capital, revaluation and similar reserves and provisions (including other subordinated debt). Tier 1 and Tier 2 together constituted the "eligible capital".

112. Basel II as implemented in the United Kingdom required a bank to have a ratio of eligible capital to RWAs of 8%, and to ensure that at least half of that 8% should be Tier 1 capital (and at least half of that 4% to be Core Tier 1). So 4% Tier 1 capital (and 2% Core Tier 1) was the theoretical absolute minimum. This was referred to as "Pillar 1".

113. In addition to this minimum, a bank could be required by its regulator as part of that regulator's Supervisory Review Evaluation Process (and also as a result of the internal assessments the bank itself was required to undertake) to maintain additional capital identified in "Individual Capital Guidance". This additional tranche was called "Pillar 2". Its objective was to provide additional resilience in response to stress testing Pillar 1. At the beginning of 2008 the FSA had required Lloyds to have a Tier 1 capital ratio of 4.4% and a Core tier 1 capital ratio of 2.2%. In mid-2008 the FSA used this process to communicate to all large UK retail banks that their expected Core Tier 1 ratio was to rise to 5% (but the FSA had not explained in detail how that ratio was to be calculated).

114. In addition to the Pillar 1 and Pillar 2 requirements, a bank could set its own internal targets for capital adequacy: and under Basel II a bank was required to disclose how it assessed its risks and determined its ratios (so that comparisons could be drawn in the market). This market discipline was referred to as "Pillar 3". Lloyds did not initially have a formal internal target ratio: but the market expectation in mid-2008 was that the Core Tier 1 ratio would be around 6%.

115. I think that the first point Mr Pietruska was making in the passage I have quoted above was that any difference between Lloyds and HBOS as regards (i) the profiles of their respective loan portfolios and (ii) the models they adopted in applying the IRB approach might (because of a recalculation of the RWAs) have an impact on the capital requirements under Basel II quite separate from (as was then thought) the impact of the impending "bancassurance" adjustments.

116. The second point he was making was that acquisition accounting adjustments that fell to be made on a takeover might also have an impact on capital requirements. International Financial Reporting Standard 3 on "Business Combinations" ("IFRS3")

would require Lloyd's to recognise HBOS's identifiable assets, liabilities and contingent liabilities at their "fair value" as at the acquisition date. "Fair value" is the amount for which the asset could be exchanged (or the liability settled) between knowledgeable, willing parties in an arm's length transaction (as opposed to the value at which they were being carried in HBOS's books): any difference between "fair value" and "book value" will require a fair value adjustment ("FVA") to be made.

117. If the fair value of HBOS's net assets were to be *less* than the price that Lloyds was to pay for them, then the excess value would be treated as "goodwill" (the present value of some future income stream from those assets over and above the value of the assets itself). That "goodwill" would have to be left out of account in calculating capital ratios. If the fair value of HBOS's net assets were to be *more* than the price that Lloyds was to pay for them (so that Lloyds was getting something of a bargain) then that element of bargain was frequently called "negative goodwill". But because vendors do not generally sell assets at below the price upon which knowledgeable parties dealing at arm's length would agree, before booking "negative goodwill" the fair value of the assets in question must be scrutinised and reassessed. But even after that re-assessment it may still be possible to "capture" any remaining element of that negative goodwill.

118. The point that Mr Pietruska was making was that if it was possible to capture some negative goodwill through acquisition accounting then that would to some extent relieve the pressure to raise new capital to maintain the necessary capital ratios. But his provisional view (as an experienced corporate strategist and not as an accountant who would actually apply the standards to given facts) was that the prospect of capturing all of any "negative goodwill" was remote. So he built a scenario in which if Lloyds acquired HBOS at below book value it was assumed that only half of any negative goodwill would be captured (by which he meant that the "negative goodwill" would be half of the postulated maximum, all of which reduced "negative goodwill" would be captured).

119. I have simply used Mr Pietruska's draft report as a vehicle for introducing some key concepts and major themes: and having done so I return to the chronology. The report is clearly a draft: and it proceeded on the assumption (never a reality) that Lloyds would pay £14.75bn for HBOS. The evidence does not establish how widely the draft was shared. Mr Tookey and Mr Tate acknowledge seeing it at some point: Mr Daniels denied doing so. But in my view the very broad issues identified by Mr Pietruska (if not the detail or his underlying argument) are likely to have been known to the small team undertaking discussions with their HBOS opposite numbers as they prepared for their meetings. But two qualifications are needed. First, those undertaking the discussions would equally have known of the general views of others as to the opportunities and obstacles that might present themselves: Mr Pietruska's was not the only voice in the room. Second, Mr Pietruska's draft addressed one aspect of the transaction: he himself knew that there were many other aspects – from valuation methodologies to the potential impact of PPI to the market shares of the combined entities to the shape of the future business model - which he had summarised in an email copied to the core team on 6 August 2008 (to which I have already made reference).

120. Nor was Mr Pietruska alone in having an eye on capital ratios. Mr Tookey as part of his routine work prepared a survey of "Current Capital Considerations" in preparation for a meeting with Mr Daniels on 21 August 2008, reviewing whether the Lloyds' capital position was adequate up to the year end and in the medium term irrespective of any

potential acquisition. He noted that the market expected a Core Tier 1 target of 6%, and that the group needed to be confident that it could deliver that ratio at the year-end during a deteriorating economic environment in which there might be reduced business volumes and increased impairments (and also following any capital adjustments arising out of the impending "bancassurance" insurance consolidation rules). He identified Lloyds' high dividend policy as a potential obstacle to repairing the balance sheet, and posited a "significant cut" in the dividend and a programme of disposals as potential solutions. (A dividend cut was already anticipated by some in the market as soon as Lloyds had published its 2008 half-year results, Merrill Lynch in an analyst's note published in July 2008 anticipating a 46% reduction).

121. On 1 September 2008 there was a meeting of the Group Executive Committee of Lloyds. This noted amongst other things some confusion in the market perception of Lloyds' capital position. Lloyds had generally appeared better capitalised than its peers. In its half-year figures as at 30 June 2008 Lloyds had reported its Core Tier 1 capital ratio as standing at 6.2%: this was above what the FSA required, but now placed Lloyds firmly "in the pack". I note this because it further demonstrates that capital ratios were constantly under review, and as an illustration of the facts that (although Lloyds did not at that time have a formal internal Core Tier 1 target ratio) the market expectation was that it should be about 6%, and that Lloyds was concerned to manage and address that expectation: this reflected the work Mr Tookey had undertaken in preparation for his meeting with Mr Daniels in the latter part of August.

122. On 2 September 2008 there was a further preliminary meeting between Lloyds and HBOS to explore a possible acquisition. Mr Daniels had instructed Mr Pietruska to prepare a set of questions for HBOS directing him to the need to hit the right balance between being rigorous on the big risks and accepting that Lloyds would not be able to be as thorough as it would wish on all risks. Those attending for Lloyds were Mr Tookey, Mr Tate, Mr Daniels and Ms Weir. They and their trusted lieutenants had also prepared lists of questions to be put to their opposite numbers. The enquiries were based on publicly available information about HBOS: those attending knew that the amount of non-publicly available information which a competitor bank like HBOS was prepared to disclose about its business and affairs might well be limited. During this meeting Mr Hornby of HBOS shared with Mr Daniels the thought that any deal between Lloyds and HBOS would have to be done "within weeks". Mr Daniels interpreted this as an indication that HBOS was anticipating facing near-term funding pressures.

123. After this meeting Mr Pietruska prepared a further draft presentation for the board. This presented a more positive investment case (omitting the recommendation against the transaction). It noted that the combined entity would have about 35% of all UK current accounts and 29% of mortgages and a significant market share in virtually all product areas. The draft presentation continued to identify material issues. The first of these remained "competition issues", the commentary now including the observation that

> "… the best prospects for competition clearance would be driven by a regulatory view that a transaction was desirable on national interest grounds …"

124. The capital issues remained those which Mr Pietruska had earlier identified though in his draft he now described them in these terms:

"? Capital

- the potential need to raise more than the consideration level due to the need to rebuild ratios as a result of

  -fair value accounting under IFRS3

  -the impending CP [*sc. the "bancassurance" adjustments*]

  -Basel II [*sc. the focus on the nature of Core Tier 1 capital*]

? Valuation

- issues around the value of our offer driven by uncertainty around market pricing of Lion [*i.e. Lloyds*] paper against the background of the capital position

? Day-to-day funding where there is a tension between the need to reduce the size of the asset book to maximise funding flexibility and the potential to realise capital losses given current market valuations"

125. The detailed workings in this draft also show that it had been discovered that some of the provisions anticipated in the August draft had already been provided for in HBOS's 2008 half-year figures: but the implications of this reduction in the write-downs potentially required were not worked through in the draft.

126. Meanwhile Merrill Lynch were undertaking similar work (and providing it to Mr Daniels). Their work suggested that HBOS had a value of some £19bn on the assumption that the write-downs and fair value adjustments to be taken into account would be about £4.8bn.

The sudden turn of events

127. The financial crisis began to deepen in early September 2008. On 7 September 2008 "Fannie Mae" and "Freddie Mac" were taken into "conservatorship" by the US Federal Housing Finance Agency. This affected US markets, but was not globally disruptive. Then on 10 September 2008 Lehman Brothers announced losses of $3.9 billion in the 3 months to August 2008. There were crisis talks in New York over the weekend.

128. On Monday 15 September 2008 Lehman Brothers filed for Chapter 11 Bankruptcy in the USA: and Merrill Lynch (widely perceived to be the next potential casualty) was taken over by Bank of America. The former event was hugely disruptive across the globe because it brought home that perhaps there were no institutions that were "too big to fail", and that it could not be assumed that governments would always provide a "bail-out". The "Daily Telegraph" described it as "another heart attack for the money markets incapacitating them for who knows how long this time": and it is right to note that the true extent of the disruption and its aftershocks was not to become apparent for many, many months. The instant reaction was that the wholesale funding markets virtually closed as each market participant viewed each other market participant with deepening suspicion. Term loans would continue relentlessly to mature: but they would only be replaced in the market with "overnight" money that required daily refinancing. Banks, such as HBOS, that were heavily reliant upon the wholesale markets could see

a looming liquidity (not solvency) crisis as the SLS, and similar schemes run by other central banks, became the key providers of term funding. Conscious of this, the Federal Reserve immediately enlarged the range of collateral it would accept within its funding programme bid and provided a massive injection of liquidity. The BoE immediately injected £5bn into the system to provide liquidity and on 17 September 2008 announced an extension of the SLS scheme from its intended close on 21 October 2008 to January 2009 (a remarkable reversal of the position it had adopted when giving evidence to the Treasury Select Committee only days before). The market reacted by marking down HBOS shares by 36% at one point, wiping £5bn off its value: though the shares recovered to end the day at 232.5p (down 18% in a market that had declined 4% overall).

129. On the following day the turmoil continued. Standard & Poors downgraded HBOS' credit rating (because of fears of losses on its mortgage book) to AA-. The FSA issued a statement to say that it was satisfied that HBOS had a strong capital base and confirmed that it considered that HBOS continued to fund itself satisfactorily. But the "short sellers" moved in and HBOS closed the day at 182p (down another 17.5%).

130. This deepening of the financial crisis led to an intensification of discussions between Lloyds and HBOS. Upon the collapse of Lehman Brothers Mr Hornby (of HBOS) and Mr Daniels (of Lloyds) spoke on the phone and agreed that their respective teams should meet again immediately.

131. The board of Citigroup had arranged for a function to be held on the evening of 15 September 2008. Sir Victor was one of the guests, along with Mr Daniels. The Prime Minister, Gordon Brown, was another guest. During the course of the evening Mr Brown informed Sir Victor that the Government would "assist" (by which Sir Victor understood "handle any potential competition issues") if Lloyds wanted to move forwards with a deal to acquire HBOS, but that if Lloyds did wish to purchase HBOS then it would have to do soon because the Government wanted certainty as regards the future care of HBOS. In Sir Victor's words:

> "I did not feel that he was trying to place any pressure upon Lloyds to proceed with the acquisition if it did not wish to."

132. Later in the evening Sir Victor told Mr Daniels about the conversation. In Mr Daniels's words:

> "This was the moment at which the deal became a realistic possibility."

Mr Daniels left the function and telephoned Mr Hornby to update him on the developments prior to the meeting scheduled for the following day.

133. Early on 16 September 2008 the Lloyds Group Executive Committee (the "Lloyds GEC") was briefed by Mr Daniels on the recent events and the proposed discussions with HBOS; and it gave its support to those discussions. It was the prelude to numerous meetings between Lloyds and HBOS on the 16 and 17 September 2008 (both as teams and in break-out groups examining specific workstreams) seeking to agree terms for a deal and to allow Lloyds to carry out some initial high level due diligence. The Lloyds

team consisted of Mr Daniels, Mr Tookey, Mr Tate, Ms Weir and Mr Kane (advised by Mr Greenburgh, a senior investment banker from Merrill Lynch).

134. According to Mr Daniels

> "… While at the earlier meeting on 2 September Mr Hornby had been indicating that a deal would have to be done within weeks, there was now a sense that it was an hour-by-hour proposition. While at earlier meetings there had been a sense that the tightening funding markets were placing pressure on HBOS to seek a deal, Mr Hornby indicated, and everyone at the meeting understood, that obtaining funding had a become even more difficult after Lehman Bros went into bankruptcy, creating a more immediate sense of urgency for HBOS to do a deal. Accordingly at this point Mr Hornby was asking us what it would take Lloyds to get the deal done."

But there was also pressure upon Lloyds to act quickly. Further falls in the HBOS share price might generate such a concern about the viability of HBOS such that the HBOS franchise might be permanently damaged to a point where it was no longer worth acquiring, and where it might have a knock-on effect on all banks (including Lloyds). The Prime Minister had also set a fairly tight timeframe within which Government assistance for a takeover by Lloyds might be provided.

Assessing the proposed transaction following the Lehman's collapse

135. The competition issue was still seen as a key consideration. On 16 September 2008 Sir Nicholas Macpherson (a senior Treasury civil servant) attended Lloyds and was pressed to give a commitment that the transaction would not be referred to the Competition Commission. He would not give that promise in so many words: but he did say that the Prime Minister's assurance from the previous evening stood, without committing the Government to any particular course of action. The competition issue was to that extent covered.

136. A further key consideration was the question of liquidity. This was addressed in two contexts. First, there were discussions with the FSA and with the Bank of England as part of an attempt by Lloyds to obtain assurances from the Tripartite that they would provide funding support for HBOS until the completion of any takeover, and for the enlarged group following completion. Discussions were led by Mr Tate (as the Group Executive Director, Wholesale and International Bank since August 2004). He met with Mr Sants (CEO of the FSA) who expressed support for a merger: and he met with Mr Bailey of the BoE (who indicated that HBOS and the enlarged group would have access to Bank-sourced liquidity, but without providing any details of exactly how). The liquidity issue was to that extent covered.

137. Second, Mr Tate created a small team under the leadership of Mr Ian Firth (Managing Director, Treasury and Financial Markets Trading Division) specifically to address funding issues. This small team would engage with the HBOS team, using both publicly available information and Lloyds' own insights into HBOS's assets and funding requirements (derived from (i) syndicated loans in which both HBOS and Lloyds participated (ii) propositions which Lloyds had rejected but HBOS had accepted (iii)

competitive bids in which Lloyds had lost out to HBOS, and (iv) positions which Lloyds had decided to sell and HBOS had bought). This material would provide a basis for interrogating the HBOS liquidity needs prior to any acquisition and thereafter, and for seeking the provision of such further information as HBOS (as a continuing competitor bank) was prepared to disclose. HBOS was much the larger of the two institutions and its funding needs exceeded £680 billion (as against the £370 billion required by Lloyds). This team began work on 16 September 2008.

138. Amongst Mr Firth's early thoughts on HBOS was the question of funding after an acquisition. He pointed out that funding counterparties generally (in order not to exceed their own internal limits of lending to individual institutions) would probably mark a lower limit for a combined entity than the sum of the limits marked for separate entities. This, he thought, might present Lloyds with a difficulty: but, on the other hand, he thought that new management might well improve the market's perception of the combined bank above its current perception of HBOS as excessively dependent on the short-term market and as an entity in which the market had lost confidence. The funding issue was thus identified.

139. A further update was provided to the Lloyds Group Executive Committee early on 17 September 2008 at a meeting attended by Mr Pietruska. The tone of the minute indicates a cautious desire to exploit a window of opportunity:

> "A further fall in the Dover share price that morning underlined the urgency of the situation so far as Dover were concerned. However competition issues and liquidity issues would need to be addressed for an acquisition to proceed."

140. That meeting was followed by a meeting of the Board of Lloyds (also attended by Mr Pietruska and by Mr Greenburgh of Merrill Lynch). This was the first board meeting to address the potential transaction, and Mr Daniels provided a briefing as to the current position. There was a strand of cross-examination at trial which suggested that the executive team went out of its way "to sell a proposition" to the non-executive members of the board i.e. for the executive team to go beyond presenting a reasoned recommendation for adopting a particular course of action considered to be advantageous to the company, and, through an excess of exuberance, to suppress information relevant to a proper consideration of the proposal. So it is well to let the Minute of this initial meeting speak for itself. After some introductory remarks

> "Mr Daniels then briefed the Board on the background to the current position. Since the beginning of the week, discussions with Dover had taken on a more urgent tone. The chairman had also spoken with the Prime Minister about the possible transaction.
>
> Mr Daniels briefed the Board on the outcome of the high level due diligence on Dover that had been carried out so far, including liquidity, the Treasury portfolio and Dover's capital position. Mr Daniels commented on the factors which were being taken into account in the price negotiation with Dover, in particular Dover's initial wish to secure a price equal to the rights issue price. This discussion was ongoing. The Dover share price had

been subject to extreme volatility over the past few days so to use the current price is the reference point for a merger negotiation was not considered to be appropriate.

Clarification was required on three principal issues before an acquisition could be announced, namely

(1) Competition issues. The Government is of the view that the merger should proceed in the light of the financial stability issues and was planning to use legislation to bring this about. It remains to be clarified precisely which legislative route would be followed.

(2) Liquidity/funding: comfort would be required about availability the future liquidity from the Bank of England.

(3) Terms: the terms of the transaction required finalisation.

There was also urgency for a transaction to be announced by the following day in order to avoid undue market speculation about the position of a Dover with the risk of a damaging impact on its business; it remains to be seen whether this could be achieved.

The board noted that these were fundamental issues which require satisfactory resolution before a transaction could be supported.

The board also discussed a number of other issues in connection with the proposed acquisition. As regards branding, this requires further discussion but it would be important to maintain many of the existing brands, with a common group holding name…

The board was also briefed on potential negative aspects of the transaction.

As regards capital, the current cost of raising capital made a capital raising plan unattractive for the group. Accordingly, the current plan was to improve the combined group's capital base through divestments and through an adjustment of the dividend although there was regulatory pressure to consider raising new capital."

141. What emerges from this minute is a weighing of the pros and cons. But fairness requires that I should record the strongly positive note struck by Mr Greenburgh, whose views were sought on "investor perception". He said that shareholders would be supportive, given that combination would create value and that UK expansion (as opposed to overseas expansion) would be favourably regarded. His view was that "subject to the short-term market uncertainties" the transaction was a "highly attractive" one for the group to undertake. He said later in the meeting that the transaction "represented a most extraordinary opportunity for the group".

142. The Claimants adduced no expert investment banking evidence to suggest that this advice was so far outside the parameters of competent investment banking advice that any recipient of it was bound to appreciate that it was nonsense. But Mr Hill QC did suggest to various of Lloyds' witnesses that the views of Mr Greenburgh should have been discounted by competent directors because they were the views of an investment banker, and investment bankers are only paid (and are handsomely paid) if transactions proceed: so "He would give that advice, wouldn't he?". Of course Mr Greenburgh was not "independent" in the sense that there was absolutely no overlap of interests. But that does not necessarily mean that professional objectivity was absent. Barristers seem to have no difficulty in viewing the advice they tender on the merits of a case as "objective" even though they will only earn fees if the case proceeds. Whilst the ethical training of investment bankers before the credit crunch may not have been nearly as rigorous as that of the Bar it is altogether too cynical to regard investment bankers as being so devoid of integrity as to warrant a discounting of their views. Investment bankers also have personal and corporate reputations to protect. Indeed a board that did *not* seriously consider the advice of an investment banker on a significant takeover (given that it would be required under the Listing Rules to appoint a sponsor in relation to the ensuing circular) would almost certainly be negligent. But that said, Mr Greenburgh's view was only *advice* and it was the responsibility of the board to scrutinize it and weigh it and to make up their own minds.

143. During the course of the meeting Mr Daniels received a telephone call from Mr Sants of the FSA. He was informed (and duly told the Board) that the Government had decided that in the event of a transaction it would issue "a public intervention notice" under the Enterprise Act enabling the Secretary of State to adjudge the competition questions (avoiding a reference to the Competition Commission).

144. Like any "minute" of a meeting the Board Minute contains an outline of the information provided and a record of the decisions made, but does not seek to reproduce the debate that led to those decisions being made on that information. There is no reference, for example, to any contribution from Mr Pietruska: yet he attended and had prepared a Discussion Paper (based on the two earlier drafts to which I have referred).

145. This Discussion Paper is significantly more positive in tone than either of the earlier drafts, highlighting the possibility of creating the U.K.'s leading retail and commercial franchise with diversified funding for the new world of financial services, identifying "a small window of opportunity to pull off this deal, given likely political support and potential interlopers", but emphasising the need during the course of that day "to address the key risks (write-downs and liquidity) and lock-in the key dependencies".

146. Mr Hill QC identified (and put to some of Lloyds' witnesses) at least eight examples of where more positive notes were struck:

(a) I have recorded above the way in which in earlier drafts the very positive aspects to the investment case had been balanced by the identification of issues relating to competition, capital, valuation and day-to-day funding. In the paper for the board aspects of the investment case are enlarged upon, but the risks are not placed alongside that positive case. They are there, but in a different context. Sometimes they are included in the general commentary:

as in “market volatility makes political support likely to address competition, capital and funding with the tripartite authorities”. But most significantly there is a page headed “Key risks & dependencies” (to which I will revert).

(b) The section in the draft referring to the probable need for a rights issue to maintain a Core Tier 1 capital ratio of 5.75% is replaced with a section in which on stated assumptions (about postponement of the “bancassurance” capital adjustments, when synergies would be influential, limiting write-downs to £3.5 billion and allocating them to eligible capital rather than Core Tier 1 capital, and cutting the dividend) there would be no need to raise capital to rebuild ratios. The evidence does not establish that these revised assumptions were imprudent. The postponement of the “bancassurance” capital adjustments was emerging as a possibility. Preliminary work had been undertaken on synergies. As I have noted, it came to be realised that HBOS had already taken some “writedowns” in its interim statement.

(c) Whereas the draft considered maintaining a Core Tier 1 ratio of 5.75% to be “challenging” the paper presented to the board expressed the view that it would be possible to maintain a Core Tier 1 ratio of 5.9%, a change achieved by making adjustments as to when synergies would be influential and by limiting write-downs to £3.5 billion.

(d) The draft used a working figure for “write-downs” of £3.8 billion (being 50% of a potential maximum of £7.6 billion): the paper presented to the board assumed an asset fair value adjustment of £3.5 billion. The HBOS interim statement had already included some write-downs.

(e) The draft suggested that the transaction would be EPS dilutive until 2012: the paper presented to the board suggested that the transaction would be EPS dilutive only in 2009 and 2010. That would follow from the revised synergy and writedown figures.

(f) The draft had contained impairment figures and a narrative suggesting that in relation to HBOS’ corporate lending it was to be expected that there would be a significant deterioration in the short term of impaired loans mainly due to asset quality (particularly commercial property and leveraged loans). The paper presented to the board *increased* the impairment figures over the lowest shown in the drafts, clearly demonstrated a significant deterioration of the position in 2008 and 2009, but did not contain the narrative commentary. But it did elsewhere

warn of potential asset quality risk, of exposure to commercial real estate, and of exposure to self-certified mortgages.

(g) The draft had contained an estimate of the profit before tax from the corporate lending operations of HBOS for 2008 and 2009, providing maximum, minimum and median figures. The paper presented to the board provided a single figure for each year that was somewhat above the median given in the draft, but noted that those estimates were "significantly below consensus" whilst at the same time warning that profitability was under pressure.

(h) The draft contained an estimate of the profit before tax from international operations of HBOS in 2008 and 2009, again providing maximum, minimum and median figures. It was accompanied by a narrative which commented upon the stagnant or deteriorating profitability in international operations due to expected general market declines in key regions and increased impairment losses. The paper presented to the board provided a single figure for each year that was either around or markedly below the median figures in the draft (thereby emphasising the deteriorating profitability) but replacing the commentary with detailed observations about market participation (consistent with the format used throughout the board paper for each area of business).

147. Mr Hill QC's questions suggested to the witnesses that these changes were the product of a desire on the part of the executive team to "sell a proposition" to the board. He put to them that by comparison with the very first draft produced by Mr Pietruska (that was not widely circulated) the paper presented to the board was lacking a balanced and objective description of the negative sides of the deal.

148. There is, of course, no doubt that the executive team was seeking to solicit approval for a bid. The executive team opined that the deal (i) would create the UK's leading retail and commercial franchise; (ii) create the biggest and best financial institution focussed on retail, commercial and corporate customers in the UK; and (iii) put the enlarged group 11th by market capitalisation in Europe and providing the opportunity for future international growth. It argued that there was a small window of opportunity to pull off the deal, given political support and few potential interlopers, and of avoiding erosion of the franchise value of HBOS.

149. This solicitation of approval does not mean that every change from draft to presentation is to be viewed as a suppression of legitimate doubt. In my view the evolution of a draft in the light of continuing analysis and comment is not in itself surprising: and it was, of course, difficult for any witness to recall at a distance of 9 years what new information, argument or analysis underlay a change in language or layout between a draft produced for internal executive use and a paper prepared for consideration by the board. But Mr

Pietruska (who took responsibility for the work of his team) in my judgment answered the (unpleaded) challenge to his integrity when he said:

> "…..as head of corporate development, my professional obligation is to, in the end, present facts and assessments as I see -- how shall I say? -- justified, because my name is behind it, and, you know, there were -- I can recall at least one instance where Eric Daniels wanted me to present a particular position to the board where I said, "No, that's not what I can put in this piece of paper" -- so not in this one, but another one -- and at that point in time, that paper wasn't discussed in this way. So the bottom line is: if Eric Daniels would have said, "I would like to present the following", and I had disagreed that this was a position that I can defend, I wouldn't have done that."

He fairly assessed the developing position reached by the morning of 17 September 2008 in this way:-

> "This is positioning the acquisition as an attractive opportunity for Lloyds to create shareholder value, with risks around funding and write downs that have been -- and particularly the write downs -- have been incorporated in the model that says: this is in the interests of shareholders because it's going to be accretive."

150. Mr Pietruska had identified in the paper prepared for the board the unattractive features of the deal (that it was at a significant premium, that write-downs and liquidity represented key risks, that HBOS' assets included high LTV ratio lending, and that the Core Tier 1 ratio would drop to 5.9%)- ; and he included a separate page headed "Key risks & dependencies" (enlarged upon in appendices). It was to these that the Board Minute had referred. The key risks included "liquidity funding risk" (set out in an appendix) "write-downs" (also set out in an appendix) and market reaction affecting the relative share price development of Lloyds and HBOS (which would impact upon the attractiveness of a Lloyds all-share offer). The funding paper clearly warned that although Lloyds was (at the date of the paper) significantly more dependent than HBOS on "overnight" money, over the term of 1 to 12 months HBOS was (even allowing for its much larger balance sheet) very significantly more dependent upon the wholesale markets than Lloyds. The paper specifically advised

> "Highly dependent on wholesale market funding - loan to deposit ratio of 177%; 55% wholesale funded (£266bn 1H08) and 45% retail funded (£219.4bn 1H08). "

The paper commented that capacity existed under the current SLS arrangements and that a modified form of SLS may increase capacity.

151. The commentary on the Financial Performance noted the risk that HBOS's business model might be value-destroying in the immediate future, that profitability and growth were under pressure and were significantly affected by fair value adjustments on its Treasury assets, and that HBOS was exposed to several areas of potential asset quality risk (identifying commercial real estate, leveraged loans and private equity)

152. The "Key Dependencies" were identified as being government management of the competition question, the date of implementation of the "bancassurance" capital requirement adjustments, and funding availability through SLS (and any "SLS2"). In that connection, the Tripartite had given assurances to assist on the competition question, and it was becoming apparent that the implementation of the "bancassurance" capital requirements was likely to be postponed (easing short and medium term capital pressures).

153. I am satisfied that these key risks and key dependencies were discussed by the board. Not only does the decision reflect such a discussion, but the minute itself separately records a discussion (the content of which is not noted) about potential negative aspects of the transaction, and about plans to improve the combined group's capital ratios by divestment and dividend reduction. I am satisfied that the Defendants did not themselves (nor did they procure others to) overstate the opportunities or understate the risks and thereby "sell a proposition" to a gullible board.

154. Having considered the paper the board resolved that talks should continue and according to Mr Daniels (though the minute does not reflect this) authorised him to continue negotiations for an "all-share" acquisition at a share -equivalent price of up to 275p per HBOS share. This was above the closing price on 17 September 2008, but below what the price had been immediately before the Lehman's collapse.

155. Meanwhile rumours began to circulate in the market. They are well captured in a note circulated at noon on 17 September 2008 by the team at New Star Asset Management:

> "The FSA stated this morning that it was satisfied that HBOS was a well capitalised bank. However, if the merger stories turn out to be true it is likely that HBOS would have been forced into it as they feared that they could not adequately refinance wholesale funding when they needed to. If the merger does go through without any government money (and this is conjecture – the merger stories are still only stories) this may actually be a positive sign that the market can behave as it is supposed i.e. if a bank gets into trouble it is taken over by a stronger bank. The problem will be if Lloyds walks away or has to be offered tens of billions of pounds of public support to do it (Northern Rock was tiny in comparison to HBOS). In the normal course of business there would also be significant competition issues as well. If the merger is progressed, together the two banks would have 28% of the UK mortgage market, though it is highly likely that for the sake of market stability these problems would be ignored or deferred until later."

156. It is now known (though could not be known at the time) that the BoE wrote to the Treasury expressing the view that

> "..there is an immediate need to secure the future of HBOS in order to preserve the stability of the financial system in the UK and to avoid contagion spreading to other banks and building societies. The best available solution is for the proposed takeover to go ahead with minimum delay….the merger is highly desirable to allay the immediate and substantial risks to the stability of the financial system."

I have no doubt that that perception drove every move which the Government made over the following days in fixing timeframes and in facilitating some outcomes and inhibiting others.

The settlement of terms

157. The eventual terms negotiated by Mr Daniel's with Mr Hornby were for an "all-share" offer with an exchange ratio of 0.83 Lloyds share per HBOS share (equivalent to 232p per HBOS share, a 60% premium on the HBOS share price at that day's close, but below pre-Lehman levels). No case was run that Lloyds shareholders have lost out because they could have obtained HBOS more cheaply. Their whole case has been that HBOS should not have been acquired at all because it was valueless. Rather, the settlement of the price was used (i) as an illustration of a suggested approach that the Board was simply determined to acquire HBOS irrespective of the price required and equally irrespective of the risks involved; and (ii) to a lesser extent as a magnifier of economic risk in the transaction (because of its impact on EPS and capital). In that context I ought to comment briefly on the price.

158. A premium over the undisturbed price on a takeover is an absolutely routine (though certainly not inevitable) occurrence. The value of an entire business to a predator will almost as a matter of course exceed the aggregate of the values at which those individual investors who choose to sell are prepared to deal in their respective parcels of shares. The fact that Mr Daniels was probably given the informal "nod" to negotiate up to the 275p indicative price used in Mr Pietruska's presentation (beyond which a transaction would clearly be ruled out) does not mean that the board would necessarily have approved a transaction at that level: the board gave no such indication. The level of premium remained to be examined. The extent of any premium will in part reflect the strength of the desire of the predator to acquire the target (including offering a price that will discourage interlopers): and in part will reflect the strength of the target board's view that the market is fundamentally undervaluing its business. Mr Daniels proposed (and stuck to) 232p per HBOS share. In terms of asset value HBOS was much the bigger bank: but its market capitalisation was about half that of Lloyds. So, even at the premium proposed and eventually negotiated, Lloyds was acquiring the HBOS business at a significant discount to book value (giving considerable margin for impairments and write-downs). It is unsurprising that HBOS should seek a significant premium over the highly volatile daily spot price before agreeing to a transaction that could be recommended to *its* shareholders: but it is equally unsurprising that Mr Daniels should be unwilling to agree to pay the 275p per share which HBOS sought (given that pricing at that level was rejected by HBOS shareholders themselves in the failed rights issue). Nor is it surprising that the view might be taken that a reference point for the "undisturbed" share price was an averaged price prior to the Lehman's collapse (and the speculation which it generated), as to which both the pre-crisis market price of

around 285p and analysts' target prices following the release of HBOS' half year figures provide an indicator.

159. Mr Hill QC suggested that even at the 17 September 2008 spot price the pricing was wholly excessive given that if Lloyds had not made an offer then the Government would probably have nationalised HBOS. But I think all that can be fairly said (viewing matters *as at the time of the meeting*) is that if Lloyds had not made an offer within the timeframe indicated by the Government then it was known that the Government would have had to consider "alternatives". Those alternatives might have included an approach to another suitor: Lloyds was one of two banks that the Tripartite might have approached. They might have included a break-up. They might have included the taking of a majority stake or some other form of nationalisation (but not necessarily one that wiped out the entire equity value of HBOS). But even if nationalisation on "wipeout" terms was a real possibility it is clear that Lloyds was not seeking to compete with others to salvage planks from the wreckage of HBOS. Lloyds wanted the entire ship, even if it was storm tossed and veering towards the rocks, because Lloyds thought the ship could be saved and, with somebody fresh at the helm, could be brought to a safe harbour as a great prize.

160. In short, I do not consider that the price level is an indicator that Mr Daniels, the executive team supporting him or the board which approved a transaction at that level, was determined to effect the acquisition come what may and so did not give full and fair consideration to its viability. I find some support for that view in the evidence of the Claimant's expert Mr Ellerton who, in cross-examination, acknowledged that 232p per share was (at that stage) a not unreasonable price to offer.

Due diligence continues

161. Whilst those negotiations were underway due diligence meetings continued. Some of these took place at the office of Linklaters. In his written evidence Mr Parr expressed the view that Lloyds had not been able to conduct pre-announcement due diligence at a typical level (though in his oral evidence he said there was no absolute norm as to what was an acceptable level and that disclosure can be very limited in the case of listed companies, essentially being confined to confirming that there was nothing material that was not in the public domain). Mr Pietruska in his evidence expressed the view that the due diligence prior to the announcement was satisfactory and was comparable to pre-announcement due diligence that had occurred in other transactions in which he had been involved (in particular referencing the sale of La Salle Bank to Bank of America for $21 billion where the due diligence had been undertaken in 36 hours for a transaction completing two days later).

162. Neither Mr Parr nor Mr Pietruska was giving expert evidence as to the customary level of due diligence prior to the announcement of a bank merger: so their personal experience serves only to illuminate the question whether the due diligence exercise undertaken was so obviously deficient (as would have been apparent to any competent director) as to undermine any decision which took its results into account. On the basis of their personal experience, it was not.

163. Mr Pietruska had prepared and circulated a 9-page due diligence outline directing the attention of the relevant teams to the key questions to be answered. (Mr Tookey had also identified what work needed to be undertaken and the 9-page document seems to

reflect his work also). It was not suggested to Mr Pietruska in cross-examination that this outline was not adequate or had not been adopted. I am satisfied that pursuant to it Lloyds' risk team had engaged with their counterparts to consider both asset quality and potential impairments in relation to HBOS's largest exposures. The general tenor of their report according to Mr Pietruska's unassisted recollection is that in general HBOS had adopted much the same approach as Lloyds in the assessment of asset quality and of impairments but it that it might have been necessary to make further impairment adjustments of "a billion or two here or there". (If that seems somewhat casual it must be recollected that the relevant HBOS assets after existing writedowns exceeded £533bn). Documentary records of this due diligence (not established by the evidence as being available to any meeting on 17 September 2008) provide a more detailed report: I will come back to them.

The offer

164. This activity culminated in a second Lloyds board meeting on the afternoon of 17 September 2008. It was a meeting of the full board with Sir Victor in the chair (save for Dr Berndt, who was on a plane bound for London, and Sir David Manning). In attendance were Mr Tookey, Mr Pietruska and Mrs Coltman (the company secretary): and the investment bankers (Mr Greenburgh of Merrill Lynch and Mr James from Citi). Again, it is simplest to begin by letting the record speak for itself.

165. The meeting began with an update from Mr Daniels. The executive directors were then invited to comment on the results of the due diligence meetings held that day.

> "Mrs Weir confirmed that as far as the retail banking division was concerned the acquisition represented in her view a significant value creation opportunity. [HBOS] has a good franchise and position in the market. Mortgage asset quality has been thoroughly explored and impairments were expected to rise, which would consume more capital.
>
> Mr Kane reported on his meeting with the head of [HBOS's] insurance and investments division and confirmed that nothing had been found to give him cause for significant concern. In his view, this was an excellent transaction for the insurance and investments division.
>
> Mr Tate commented on funding and on the wholesale banking division. His meeting had confirmed that there were opportunities for both cost and revenue synergies, although further work was required on impairments. As regards funding, the information received during the course of the day had improved the level of the group's confidence that HBOS could manage its funding. In addition, clarity had been received from the Financial Services Authority and the Bank of England on support for liquidity.
>
> Mr Pietruska was asked to give his views to the board. In his view, the transaction represented the right opportunity for the bank at this time. The group was in a good position to deal with

> funding issues, in difficult markets. Concerns about the price and the combined group's capital strength would need to be carefully managed.
>
> Mr Tookey reported on the information from the financial due diligence discussion. Particular areas for concern were the large amount of growth in risk-weighted assets, which needed to be reduced, and capital. On a pro forma basis, the enlarged group would have a 5.5% core tier 1 capital whereas the target at completion should be 6%. Accordingly, a plan would need to be developed to bring the core tier 1 capital within that range.
>
> Mr Daniels explained to the board the need to give certain assurances regarding future availability of loan funding and read the text of an undertaking which it was intended should be included in the offer announcement. The board also noted the position in relation to the competition position and noted that the offer would be conditional on there not being a reference to the Competition Commission and if there were such a reference then the offer will lapse. The Secretary of State was expected to issue a public intervention notice and it had been indicated that the Office of Fair Trading had agreed to a fast track process. "

166. The views of the investment bankers were also sought. Mr Greenburgh confirmed his view that the chance to acquire HBOS "represented a tremendous opportunity for the group to enter into a transformational deal": but he warned that given the market's volatility there was likely to be a variety of views on the transaction. Mr James endorsed that view but stressed that it was important for the market be given (i) a clear message that the management of Lloyds would run the enlarged group (ii) clarity about what was to be done to remedy the capital position and (iii) clarity about any continued dependency on wholesale funding.

167. There followed a discussion which Mr Tate described (I consider probably accurately) as "robust and thorough", and in relation to which Sir Victor observed (again, I consider probably accurately) that each member of the executive team was listened to and questioned. This was a high quality non-executive board addressing a hugely significant transaction in turbulent times. Sir Victor's description of them as "sophisticated and able" and as "men of great strength, great independence and great wisdom….not a "pushover" board…" is in my judgment warranted. The likelihood is that they each brought to bear their respective skills and experience: it is unlikely that to a man their critical faculties deserted them to the extent that they did not even test the executive case at all. (This is, of course, not to prejudge whether, having tested the case, the answer was an obvious "No": nor would it be an answer to any charge that on this occasion the executives misrepresented the true position to the whole board).

168. The recorded view of the non-executive directors is that they "expressed their strong support for the transaction", but expressed concern about the capital position and the need to address this. I will consider further the views of the non-executive directors' (other than Sir Victor) at a later stage in the transaction. For the present I will confine consideration to the views of Sir Victor and of the executive directors (and Lloyds' staff

in attendance who were not board members). What is it likely that they said in discussion? and why did they say it?

169. In his written evidence Sir Victor explained that in addition to the obvious synergy benefits that the acquisition of HBOS would bring, he considered that there were a number of attractive intangibles – the power of the HBOS brands, the creative and proactive approach of HBOS, its customer spread and the quality of key employees. Whilst I accept this evidence, in my judgment one has to be careful not to overstate the weight that can properly be attributed to these features when weighed in the scale with hard numbers. As to the disadvantages (in particular arising from the HBOS exposure to the commercial property market) Sir Victor considered those to be manageable in the economic climate as it was anticipated at the time. It was put to him (as part of a challenge to his integrity) that he would have found it "awkward" to express any other view in the light of his earlier conversations with the Prime Minister. Sir Victor replied that he would not have found the slightest bit of embarrassment declining the transaction if it had been his view that it should be declined. I accept that answer.

170. It was put to him that considering the disadvantages to be "manageable" was simply "a leap in the dark", and that had he focused upon the key issue of "impairments" and tested the suggestion that they would amount to only £5bn (£3.5bn of impairments strictly so called and £1.5bn of fair value adjustments on treasury assets) then the real risks of a capital raise as a result of the acquisition (undermining the case for the acquisition being positive for earnings per share) would have been apparent. Sir Victor's answer to these charges was that the acquisition proceeded (as do all acquisitions) on the basis of published information, information that was published to a regulated standard: on the basis of that the board had identified areas of concern (including impairments and the risks to capital noted in the Board Minute) which, at that stage, did not appear to be "highly troubling". He explained:

> "… when you have impairments… they are not losses at the moment you identify them as impairments: they are what you anticipate may be losses over a period of time. And with a quality team, you can often make the position much better than your worst assessment impairment."

According to Sir Victor, "impairments" assumed a greater dimension when the extent of the economic downturn (what he called "the most gigantic financial collapse seen in my lifetime") became apparent in late 2008 or early 2009 when there was a serious decline in commercial real estate prices.

171. The written evidence of Ms Weir made clear that she was attuned to the obvious attractions of combining the Lloyds and HBOS retail banks with the potential of a merger to deliver significant cost synergies and to generate considerable value. She was supported in her view by a small team led by Mr Kenyon, a senior member of the retail banking team, which assessed the specific retail synergies and benefits of a merger. In addition, over the days preceding 17 September 2008 due diligence work had been undertaken by Mr Dale, the Head of Risk in the retail banking team, aimed at assessing HBOS' mortgage asset quality (in order to determine the potential risks involved in acquiring the retail bank). It was this that informed Ms Weir's comment to the board that there was a risk of rising impairments which could consume more capital. (It is fair to point out that Lloyds itself was facing the same risk in relation to its

business, though the degree of risk was different because of the difference in the nature and quality of the HBOS mortgage book). Nothing in Ms Weir's cross-examination undermined this, or suggested that the positive views she advanced were unsustainably overstated or the identified risks were grossly understated. There was no attack on her integrity.

172. The written evidence of Mr Kane made clear that he understood that a merger between Lloyds and HBOS would bring about substantial cost synergies, principally in the retail and commercial banking area: and within his own area that HBOS seemed to offer certain savings and investment products that appeared to be more successful than those offered by Lloyds. He was therefore supportive of a merger proposal, but aware of the risk that HBOS's assets were concentrated in areas that were more likely to be exposed to and affected by any economic downturn. On 17 September 2008 he had met with his counterpart at HBOS to discuss with her at a high level the key issues in HBOS insurance and investment business; and in particular to satisfy himself that the merger presented an opportunity to create value. Whilst lacking exact recall of what those discussions produced, Mr Kane was confident "that no red flags had been raised". His cross-examination did not undermine the strength of his evidence: it did not suggest that there was anything of concern in the insurance and investment business. Nor did it suggest that (on the basis of material known to Mr Kane) there were questions which ought to have been asked of other executive directors which would have demonstrated deficiencies in their report.

173. I have already examined the evolution of the views of Mr Pietruska in relation to the acquisition. It is necessary to note only two matters in connection with the views he expressed to the board at its second meeting on 17 September 2008. First, he personally felt that the agreed price was "full" and that a lower price might have been achieved. But he correctly identified the real question for the board at that stage as being whether the transaction stacked up at the price that *had* been agreed: so he confined his observations to informing the board that concerns about the price would have to be managed. Secondly, he was cross-examined as to the adequacy of the explanation to this meeting of the due diligence exercise and its outcome. I find that it is likely that he explained to the meeting in outline the process than had been undertaken, communicated his view that it was satisfactory for the purpose of considering whether to announce an acquisition, but warned that further work would need to be undertaken. I find that it is likely that impairments were discussed, that Mr Pietruska is likely to have contributed to that discussion, and that he would have conveyed the view that some further impairments were likely to be required but that they were of a manageable magnitude (even if above the levels discussed at the previous board meeting earlier on 17 September 2008). This would be consistent with his earlier views and their evolution, with the minute of the meeting and with his approach in general.

174. In his written evidence Mr Tate recorded his view that on balance the transaction represented an opportunity for Lloyds to create value for its shareholders: and that the risks of proceeding, in terms of (i) the size of the balance sheet that would need to be funded in difficult market conditions and (ii) the exposure to the economic cycle, were outweighed by the potential rewards. He thought there was a steep discount to book value which would cover all sorts of potential write-downs and impairments. In cross-examination he acknowledged that at the second board meeting of 17 September 2008 there had been no quantification of impairments, nor had there been any updated

analysis which looked again at the underlying economics in the light of the emerging due diligence information: but he stressed that all of this was a work in progress, and underlined his recommendation that more work was required.

175. Mr Tookey's awareness of Lloyds' own capital position (and his provisional view that disposals and a dividend cut would be required even in the absence of an acquisition) I have noted above. It is therefore no surprise that he should have reported to the board at the second meeting on 17 September 2008 that both the growth in RWAs, and capital, were particular areas of concern, and that a plan would be required to bring Core Tier 1 capital to 6% at completion. That plan might be influenced by the level of impairments: and Mr Tookey was cross-examined as to the information provided to the board. His evidence was to the same effect as that later given by Mr Daniels, Mr Pietruska and Mr Tate.

176. Mr Daniels was the CEO who was putting the proposal before the board. It was he who had negotiated the price. There is little doubt that he would have been an advocate for the transaction he had negotiated. But even he commented upon future funding issues (notwithstanding that HBOS had in fact managed to fund itself satisfactorily up to that point, as the FSA had confirmed to the market): and he gave free rein to others to express their own cautionary views. Neither Mr Daniels nor any other member of the executive team presented the opportunity as risk-free or as involving negligible risk. It is clear that this experienced board knew that advocacy of the deal was Mr Daniels' role and that testing his proposition and considering the support for it was their role.

177. At the conclusion of this second meeting the board decided to announce an acquisition, though it wanted additional clarification about liquidity and funding and understood that the executive team would seek to continue the due diligence process. Because of that, the associated Implementation Agreement gave Lloyds a unilateral and penalty-free right to withdraw the offer if in the light of the continuing due diligence material emerged which caused the board to decide that the Acquisition could not be recommended to the shareholders.

178. Picking up on firm market rumours of a merger between Lloyds and HBOS Mr Tadhg Flood of Deutsche Bank contacted Mr Daniels and Mr Pietruska late in the evening of 17 September 2008. He commented that a merger was "a unique strategic opportunity for [Lloyds] with very clear and significant value creation opportunities". But he commented on the deal price ("your shareholders will ask why any value should be paid for an institution that is effectively being rescued") and he struck this cautionary note:

> "The market will focus immediately on the enlarged group's pro forma tier 1 ratio. A likely cut in the dividend, the future emergence of synergies, and plans for potential disposal/RWA reduction are all positives, however the market will want to understand what immediate buffer you will have against future losses (and existing marks that are required in HBOS's book) as we enter a downturn in the UK economy… Shareholders will want to see a clear liquidity plan in place to ensure the enlarged bank can access sufficient liquidity at economic margins to fund existing and future business. While government support will aid liquidity, this is not a permanent solution to liquidity and your

> shareholders will want to know how this will be addressed over time without central bank support…"

I do not think that these insights alerted the executive team to anything of which they were previously unaware or would have recast the discussion that had occurred at board level. But equally I do not think this market view was ignored by the Lloyds team as matters developed.

179. Also on that evening Mr Daniels attended a meeting with Sir Callum McCarthy and (as he then was) Mr Mervyn King (then Governor of the Bank of England). Mr King emphasised the urgency of the HBOS acquisition. Sir Callum and Mr King were (because of the intense scrutiny of HBOS then being brought to bear by the Tripartite) probably aware that at the same time as this intense activity around a possible acquisition, HBOS was borrowing a further $5 billion through the US Federal Reserve Discount Window. The Claimants have characterised this as "the Government putting pressure on the Lloyds board to acquire HBOS" and in an eye-catching phrase in opening described the Lloyds shareholders as having been "mugged". But this is a caricature of a much more complicated picture.

180. (As will appear from the letters to which I refer next) the Government desperately wanted to stabilise the market and to avoid any bank failing in a disorderly fashion; and it undoubtedly wanted to use market mechanisms (not intervention) to do so if possible. It was prepared to invite market participants to assess opportunities. It was prepared to lend every assistance to a market participant who wished to exploit an opportunity. That was what Lloyds had done. Government assistance (in smoothing away competition obstacles or in giving comfort as to available funding) enabled Lloyds to do what it otherwise could not have done (and had conspicuously failed to do over the preceding 5 years and more), namely, expand through inorganic growth. But both the Government and Lloyds knew in mid-September 2008 that their influence in a panicky global market was limited, and potential movements in the equity and debt markets imposed severe time constraints. The Lloyds board knew that it had to operate within those limitations, and that this might entail taking decisions on available information and within a timeframe that was less than optimal. In my judgment that is not succumbing to pressure. The Lloyds board did what it thought best for its shareholders; not what the Government wanted even though the Lloyds board did not think it for the best. It bears, and has throughout this case acknowledged, that responsibility.

181. During the course of the day two letters were written by members of the Tripartite to the Treasury justifying not referring the proposed bid to the Competition Commission (a condition of the Lloyds offer). The first was from Mr Sants and said:-

> "The Financial Services Authority considers that the failure to allow the proposed merger between [HBOS] and [Lloyds] would drastically undermine market confidence and cause significant harm to consumers and the UK economy. This harm would, in our view, greatly outweigh any adverse competition effects. Credit, jobs and output would contract, and there would be knock-on effects in financial markets that would weaken the capital position of other banks…. [It] would in our view be imprudent not to take the necessary measures to allow a soundly structured merger to proceed"

182. The second letter was from Sir John Gieve, the Deputy Governor of the BoE and said:-

> “The current situation in financial markets is one of extreme fragility…. The dramatic fall in HBOS share price and adverse movements in other financial market prices for HBOS create an immediate danger to financial stability. There has been heightened deposit activity (both retail and in wholesale financial markets that provide major funding to UK banks) over the last day or so. This activity is increasing further in the light of growing media speculation on the future of HBOS in the view of the bank of England, there is an immediate need to secure the future of HBOS in order to preserve the stability of the financial system in the UK and to avoid contagion spreading to other banks and building societies. The best available solution is for the proposed takeover to go ahead with minimum delay…. Given its size and profile an abrupt failure of HBOS would have a big direct and indirect effect on the wider financial sector and the economy generally at any time. In the current conjuncture it would be very severe and destabilising….. The merger of HBOS with [Lloyds] is the best available means of preventing such contagion in a very limited time available.”

183. The Lloyds executives and board were unaware of this confidential exchange, which had immediately preceded their second meeting. But I have no doubt that the executives were aware of the strength of the Tripartite support.

The Announcement

184. On the morning of 18 September 2008 the Lloyds board and the HBOS board jointly issued the Announcement about the takeover of HBOS by Lloyds (the "Acquisition") saying that both boards intended to unanimously recommend the Acquisition to their respective shareholders. The Announcement said that the boards believed that the Acquisition presented a compelling business combination offering substantial benefits to shareholders and to customers. It recited that the board of Lloyds had received financial advice from Merrill Lynch (though the body of the Announcement made clear that that financial advice had itself incorporated the commercial assessment of the Lloyds board) and considered the Acquisition to be in the best interests of Lloyds shareholders. At the same time Lloyds and HBOS entered into an implementation agreement in which they undertook to use reasonable endeavours to implement the Acquisition. Mr Daniels was at pains to tell the market that the merger had been struck on commercial terms and was not merely a government-brokered rescue of HBOS. So was the Chancellor of the Exchequer, Alistair Darling when denying in a Radio 4 interview that day that he had “pushed” Lloyds into the Acquisition whilst acknowledging that he had “helped in every possible way”. Whilst some might be cynical about such statements, they are in my view an accurate summary of the respective objectives.

185. The 38-page Announcement explained the terms of the Acquisition and informed shareholders that existing Lloyds shareholders would own approximately 56% of the enlarged group, which it described as “a compelling business combination”. It explained that the final Lloyds dividend would be by way of a scrip issue (not cash)

and that the 2009 dividend would be reduced. It projected cost synergies of £1 billion a year by 2011 by which time there was an anticipated accretion to earnings of 20% per annum. The Announcement said that the pro forma capital ratio of the enlarged group based on the half year figures published on 30 June 2008 would be a Core Tier 1 ratio of 5.9%: but that the target was 6% to 7% which Lloyds expected to achieve during 2010 (but would seek to accelerate by the disposal of non-core assets). The Acquisition was expressed to be conditional upon the transaction not being referred to the Competition Commission. It informed Lloyds shareholders that they would receive the Circular and contained the following paragraph (repeated twice):-

> "[Lloyds] and HBOS strongly advise [Lloyds shareholders] and HBOS Shareholders to read the formal documentation relating to the Acquisition when it becomes available because it will contain important information relating to the Acquisition. Any response in relation to the Acquisition should be made only on the basis of the information contained in the formal documentation relating to the Acquisition."

186. In addition, the digital version of the Announcement said that it was provided for information purposes only and that

> "[Lloyds] shareholders should seek advice from an independent financial adviser as to the suitability of any action for the individual concerned. Any shareholder action required in connection with the Acquisition will only be set out in documents sent to or made available to shareholders and any decision made by such shareholders should be made solely and only on the basis of information provided in those documents."

187. Following the Announcement Lloyds and HBOS together held an investor presentation. Sir Victor, of course, extolled the Acquisition as "a unique opportunity to create the largest and best financial services business in the United Kingdom", whilst Mr Daniels trumpeted it as "a fantastic deal". Mr Daniels commented upon the robustness of the capital position, upon the strength of the liquidity position and upon the ability of the combined entity to access wholesale markets (where the strength of Lloyds rating would assist). He expressed the opinion that the transaction would be EPS accretive from mid-2011. Mr Tookey told the meeting that he anticipated being within the target Core Tier 1 capital ratio of 6 to 7% during 2010. It is important to note that both EPS accretion and the attainment of the target Core Tier 1 ratio were from the outset presented as forecast events and not immediate consequences.

188. There was less positivity about the transaction from HBOS. Challenged as to why HBOS should fall into the hands of Lloyds at a substantial discount to book value in the face of temporary turmoil, Mr Hornby expressed the view that the dislocation in the funding markets was something that was long-term and that given the immense disturbance and competition issues in the current market the acquisition "seemed a decision we had to take". The questioner commented that the merger had not "changed the fundamental underlying dynamics of the funding market" i.e. that the combined entity would still have to address the problems that troubled HBOS. The message received in the room was that HBOS's funding pressures meant that it had no other real option than to be acquired by Lloyds. That was the evidence of Mr Mike Trippitt, one

of the Defendants' experts (who was able to give factual evidence since he attended the presentation and himself asked a question), on which he was cross-examined: that evidence I accept. It is also the tenor of much of the press coverage and analyst comment. It was the broadcast view of the Chancellor of the Exchequer: in a radio interview at just after 8.00am that morning Alistair Darling said "there wasn't much choice in the matter" and "if we hadn't done it the future was very bleak indeed".

189. From that point onwards the market understood that, because of the increasing difficulty of finding wholesale funds to bridge the "funding gap" between deposits taken and loans made, HBOS had no long-term standalone future. That was also the public position taken by Lloyds. So on 15 October 2008 Mr Daniels was reported as telling the "Financial Times" that the dependence of HBOS on wholesale markets meant that "it had no long term future as an independent bank". But what nobody knew was the time horizon: for how long could HBOS have lasted as a functioning independent bank? As a writer put it in the "Daily Telegraph" on 19 September 2008:

> "In the short term HBOS had a bit of wriggle room. But with the money markets shut and no guarantee it would be able to access funding, in the long term it faced administration."

190. The market reaction to the Announcement from the Lloyds perspective may be broadly described in this way:

(a) The reaction of analysts was mixed, review notes with a negative tone being as numerous as those with a neutral or positive tone.

(b) For some the Acquisition was viewed as a strong operational transaction which would deliver considerable shareholder value for Lloyds through cost synergies (which the market predicted would be twice what Lloyds was estimating) and the establishment of market leading positions. But whilst it might be the "deal of the decade" (or as one of the Claimants' own witnesses opined to his clients at the time "the deal of the century") the coming economic downturn posed near-term and medium-term risks.

(c) There were concerns over whether competition issues would remove some of the operational benefits of the transaction.

(d) The price level was questioned by some, given that the Acquisition was seen as a rescue deal. But others assessed it against the HBOS rights issue price and were "outraged" at the price at which HBOS had been sold.

(e) There was concern that the Acquisition of itself did not address the funding issues associated with HBOS (absent any government guarantee about funding) and simply

transferred the problem to Lloyds. But the combined entity would clearly be "too big to fail".

(f) There was concern whether Lloyds itself had deep enough pockets to save HBOS.

(g) There was some concern about how the Core Tier 1 ratio of 5.9% could be strengthened by disposals in a difficult market, and a possible capital raise was anticipated.

(h) There was a mixed reaction to the dividend proposals, some investors being unhappy at the combination of a "scrip" dividend and a cut dividend, but others understanding the realism of that approach.

(i) There was in some quarters regret that the proposed deal was "transformational" in the sense that Lloyds would cease to be a relatively liquid, well-capitalised bank with a defensive loan-book and a high dividend yield: and in others the view that the transformation presented a growth opportunity into which investors should buy.

(j) One commentator said that the Government appeared to have learned its lesson from Northern Rock and that if a deal was to be done than it had better be done quickly.

(k) The Lloyds share price itself dropped by 15% at the close of trading (though it rebounded the next day).

191. Of the views to which my attention was drawn I thought the most pithy summation was that expressed by Andrew Thompson of Citigroup to Mr Daniels when commenting on the Announcement:-

> " If you have the nerve or foresight to see that the enlarged group can navigate its immediate issues [HBOS] is a highly attractive option…."

Key external events following the Announcement

192. It is best to comment on the key external events following the Announcement under a number of headings.

193. On the competition front, on 18 September, following the Announcement, Mr John Hutton (then Secretary of State for Business and Enterprise) issued a "public intervention notice" requiring the Office of Fair Trading (the "OFT") to investigate and report on the Acquisition by 24 October 2008, and in doing so to take into account the stability of the UK financial system. The letters from the FSA and the BoE (combined with the Treasury view) had done their work: a reference to the Competition Commission could be ruled out.

194. On the capital front, Lloyds used the opportunity created by the Announcement to raise £760 million through a rights issue. On 19 September 2008 it announced a placing of 284.4 million new ordinary shares at a price of 270p per share (representing an increase of about 5% in its current issued share capital) - a discount of 13.9% to its close-of-market price. The offer was heavily over-subscribed.

195. On the liquidity front the BoE continued to pump liquidity into the system in a variety of innovative ways. I have already drawn attention to its extension on 17 September 2008 of SLS as a mainstream source of funding: a total of £185bn was to be drawn by banks under this scheme. On 18 September 2008 BoE took part in coordinated global measures to relieve pressures in the US dollar funding markets by embarking upon direct US dollar repo operations (i.e. itself providing dollar funding to UK banks against eligible collateral) backed by a reciprocal swap arranged with the Federal Reserve. The terms of the US dollar repos were individually settled under a variable rate auction process. Initially this provided overnight money (because, as a later review by the Bank of England was to record, at this stage money was not being distributed between banks even in the overnight market). Within days the facility was enlarged and was expanded to offer one-week money. Days later the classes of eligible collateral were widened. The enlargement of the classes of eligible collateral was applied also to the Bank's existing Extended Collateral Long Term Repo scheme. The Bank consulted on further extending the range of collateral acceptable in its money market operations, and also upon accepting pledges against asset pools of highly rated corporate loans in unsecuritised form. In short, the Bank was taking unprecedented steps to support the market. It was assuming the role of a mainstream provider of liquidity (operating in effect an alternative wholesale market) and beginning radically to alter the role of a central bank.

196. On the 7 October 2008 the Chancellor of the Exchequer informed Parliament that the Treasury was willing "to make further resources as necessary" available to maintain financial stability. Then on 8 October 2008 the Treasury informed the world that "the Bank of England [would] take all actions necessary to ensure that the banking system [had] access to sufficient liquidity" and "[would] extend and widen its facilities in whatever way [was] necessary to ensure the stability of the system". It announced the provision of additional liquidity under the SLS scheme (doubling the amount available). It said it would review the size and frequency of its current open market operations "as necessary". It disclosed that it would announce plans for a permanent regime underpinning bank liquidity. It announced bank capital support measures (to which I will come in greater detail) which made available additional Tier 1 capital amounting in the first place to £25bn and stood ready to double it: and alongside this it announced a Credit Guarantee Scheme under which there was a Government guarantee provided for medium-term senior unsecured debt issued by banks (which would itself be eligible collateral for all support schemes). These were extraordinary, momentous steps and amounted now to a radical redefining of the Bank's role.

197. Mr Henderson, one of the Claimants' witnesses, commented on the government recapitalisation scheme in a contemporaneous letter to his clients in these terms:-

> "The financial package put forward by the Government is one of the most intelligent schemes that I have seen. The offer to invest £50 billion in the banks' share capital (via preference interest-bearing shares ….) essentially guarantees all the major banks. To

> put this figure into context the current market value of HBOS, RBS Lloyds TSB and Barclays combined is £57.1 billion. In addition they have committed to guarantee £350 billion worth of loans between banks."

198. On the global financial front there was a rapid deterioration. In the USA Washington Mutual foundered on 25 September 2008 and was acquired by JPMorgan. On 29 September 2008 Bradford & Bingley was nationalised by the Government. In Europe on 30 September 2008 Fortis Bank was rescued by the Belgian, Dutch and Luxemburg governments and Dexia Bank was rescued by the French and Belgian governments. On 3 October 2008 Wachovia Bank was rescued by Wells Fargo in the USA. On 7 October 2008 the Icelandic banking system collapsed and was bailed out by the Icelandic government. On 10 October 2008 the central banks of the G7 nations issued a joint statement in which they recorded their agreement to take decisive action and to use all available tools to support systemically important financial institutions and to prevent their failure. These were clear global messages from central banks that the financial system was secure.

Key internal events following the Announcement and preceding the recapitalisation

199. It will aid clarity if I also consider the key internal events thematically rather than purely chronologically, looking at (i) interbank dealings between predator and target (ii) the progress of due diligence (iii) the support of the Tripartite for HBOS and Lloyds and (iv) reviewing the Acquisition. Inevitably the themes intertwine: and I would again make the point that these themes in no way represent the full range (nor even, perhaps, the most substantial part) of the issues being examined in relation to the Acquisition. These themes are simply those that are material to the case presented in this action: there was a multiplicity of other workstreams and areas of attention and action.

Interbank dealings

200. First, interbank dealings between Lloyds and HBOS. On 18 September 2008 HBOS approached Lloyds seeking additional access to Lloyds' interbank overnight funding facility. Lloyds agreed to increase the existing unsecured overnight lending facility to HBOS by £1.5 billion to more than £3.0 billion. (To put this in context, according to Mr Short Lloyds itself took up to £35bn from the overnight markets, and had drawings on the overnight market supplied by other banks and central banks of over £12bn on 25 September 2008). A "roll-over" of the HBOS overnight facility was reviewed each day through a process which involved Mr Firth (Managing Director of Trading within Lloyds Corporate Markets) liaising with his counterpart at HBOS, and then submitting the proposed transaction for approval by Mr Cumming (Senior Sanctioning Director), Ms Sergeant (Chief Risk Officer) and Mr Tate. On 19 September 2008 Mr Tate had sought from the FSA approval for the way that Lloyds and HBOS intended to communicate, plan and execute the management of their respective funding positions, and was told (though the FSA declined to record it in writing) that the FSA heartily encouraged such exchanges.

201. The "roll-over" continued until the time of the Shareholders' Circular. From the outset the decision to entertain the transaction had both commercial ("Lloyds can profit from this counterparty's proposal") and strategic ("We should support HBOS because we are proposing to acquire it") elements. At trial it was not suggested that in relation to the

overnight funding the successive transactions were "skewed" by the proposed Acquisition.

202. On 22 September 2008 HBOS approached Lloyds with a request for a *secured term* facility. In tight wholesale markets it is entirely understandable that HBOS should look to its intended acquirer as the market participant most likely to look favourably upon a proposed transaction: and the more understandable given that the Announcement itself had had the effect of cutting HBOS' credit lines as funders began to look at their exposure to the enlarged entity (rather than to each of its component parts). Recognising this reality, the FSA supported and encouraged Lloyds to take an engaged role in the joint management of the funding issues. In relation to any such proposal for a secured term facility the Lloyds executive team and board might, as regards the interests of the company, be expected to have in mind both commercial and strategic considerations: but they would need to have clearly in view possibility that the Acquisition might not proceed.

203. The original proposal by HBOS was that Lloyds should provide it with a facility of £25bn secured by the assignment £25bn-worth of corporate loans made by HBOS (adopting the model that was under consideration by the bank). This was unsurprisingly viewed by the Lloyds team as "a complete non-starter". But what emerged from that request were discussions which were ultimately to lead to the Lloyds Repo.

204. The discussions had two strands: (i) an overall facility of £10bn for 6 months, and (ii) an immediate advance of £2.8bn for one month. The discussions were neatly captured in an email which Mr Short sent to Mr Parr of Linklaters. He first outlined a prospective facility of £10 billion with a six month tenor secured on marketable debt securities or corporate loan assets valued subject to a 20% "haircut" (i.e. the discount applied to the value of the collateral) and at an interest rate of a then-undetermined premium over LIBOR. Mr Short then explained

> "The transaction is being considered on an arm's length basis, as a market transaction. The final form is not agreed yet, and I believe that [Mr Tate]/[Mr Daniels] will be asked to approve the final version. With respect to timing, [HBOS] have asked if we can be in a position to lend c. £2.8 bn on this basis (or something similar) tomorrow the 24th ."

In cross-examination Mr Short confirmed that from his perspective what was being proposed was an arm's length commercially priced transaction, with obvious implications for Lloyd's own liquidity position.

205. Part of the context of this request was an outflow of about £20bn in retail and corporate depositors' funds from HBOS during August and September, which had continued after the Announcement. The interconnectedness of the level of retail funding, the availability of wholesale funding and terms on which funding was available was well explained in a letter which one of the Claimants' witnesses (Mr Henderson) wrote to his clients on 10 October 2008 when commenting on the above-mentioned BoE and Treasury support announcements of 8 October 2008 (but to which it is convenient to make reference now). Mr Henderson first explained the significance of the access to government funds that had just been announced, and then continued:-

> "It is this latter point that is so important as if we take HBOS as an example for every £1 of deposits they have lent out £1.70. The difference i.e. 70p they borrowed in the market… All was well until interest rates rose… This put pressure on margins then the short sellers appeared and started selling shares they didn't even own, as the share price fell worries over HBOS grew and the market said that this implied more risk and HBOS would have to pay above LIBOR. This further deflated earnings and therefore the share price which then began to make depositors nervous – so they started withdrawing funds, and the £1 deposits became 80p, and the cost of borrowing the extra new 90p (original 70p plus new 20p) rose from 5½% to 9%. This happened not in the space of years, months or weeks but in days, if not hours. So the crisis became tangible. Confidence had gone, and the banks would not lend to each other, let alone us. The government's £350 billion bailout puts the American government's half baked attempts to shame…."

So the outflow of corporate and consumer deposits (short of a "run") had both increased the need for and the cost of replacement funding, and the Announcement had itself reduced what was available to HBOS in the market. Hence the HBOS request to Lloyds.

206. Satisfying the HBOS request (even partially) would have the usual liquidity implications for Lloyds itself, which was (according to Mr Short) providing liquidity to quite a lot of other institutions at this time through interbank transactions similar to that requested by HBOS. What is not clear is whether those other similar transactions shared a particular feature of the full HBOS proposal, namely, that some of the collateral to be offered was not generally pledgeable and could not be "posted out" or proactively used by Lloyds i.e. it could not be match funded. This meant that Lloyds' own funding resources would have to bear the strain of meeting the HBOS request until some other arrangement was put in place.

207. The corporate trading team was alert to the issues which the proposed HBOS transaction raised. Mr Conway communicated to Mr Firth the thought that

> ".. there needs to be a question asked about how intertwined we become with HBOS before the merger is agreed by shareholders et cetera. It does define how committed we feel to the deal and how much risk we want to take on for our future colleagues…"

Ms Grey communicated to Mr Firth the thought that

> "I do not see a level of pricing which would compensate us for adding to the strain of our own funding. HBOS would be nicely "transferring the monkey from there (*sic*) to our shoulders"…"

208. With those thoughts in mind Mr Firth himself identified the questions to be:-

> "Can we stomach the increased liquidity risk here…. Consideration of the desire to protect HBOS value as an acquisition….. Consideration of the loan we may wind up owning if the merger is abandoned…"

Having identified those questions he was nonetheless satisfied that the request stood up as an arm's length transaction, if only quality collateral (e.g. Euro- and US-denominated floating rate notes or asset-backed securities, not assigned corporate loans) was taken, if the collateral was reviewed before each drawdown request was considered, if the valuations were subject to a significant "haircut" in line with comparable market transactions, if each transaction could be structured as a repo, and if the interest rate reflected market conditions. On that basis, the risk-adjusted return on capital for Lloyds was predicted to be 200%. (The eventual transaction ultimately yielded a return of £16.5m for Lloyds).

209. Mr Daniels, Mr Tate and Mr Tookey would have been aware of these views through Mr Firth (even if not copied in on every exchange of e-mail): they were certainly aware of the three questions which Mr Firth had identified. They were not, of course, bound to agree with the views expressed: but they were cognizant of unusual features of the proposal. The transaction immediately agreed (the first part of the Lloyd's Repo) was for an advance (in repo form) of £2.4bn secured by Euro- and US-dollar denominated marketable securities valued at £2.8bn and at a margin of 20bps over one-month LIBOR. (The securities, although marketable, were not eligible collateral under the SLS because of the currency denomination, nor were they eligible collateral under similar schemes operated by the European Central Bank or the Federal Reserve). In the view of Mr Firth at the time this was "in the range of pricing seen elsewhere on other similar style deals", though he acknowledged that his approach had been "to lend in as commercially prudent a manner as possible, not to savage [HBOS] on pricing" in circumstances where there was no directly comparable benchmark.

210. Mr Hill QC cross-examined Mr Tookey, Mr Daniels, Mr Tate and Mr Short on the basis that this was a "sweetheart" deal in which strategic considerations had overwhelmed commercial considerations to a degree that this transaction of itself could not be regarded as having occurred in the ordinary course of Lloyd's business. But the point was not established.

211. I find that the £2.4bn first tranche of the Lloyds' Repo itself was a repurchase transaction done on commercial terms that met Mr Firth's profile. A bank is not required to "savage" a counterparty (whether that counterparty is another bank or a retail customer) on pricing: and the fact that it does not do so does not render a deal uncommercial. The nature of the collateral was unusual (not being eligible for repo at certain sources), but the transaction resembled a repo in that the £2.4bn was made available against securitised assets that were themselves capable of being repo'ed.

212. I hold that the first tranche of the Lloyds Repo was a transaction in the ordinary course of business. It was business conducted on ordinary commercial terms. I have noted above that it was commercial business which also had a strategic objective: enabling HBOS to survive in a form in which Lloyds could acquire it and thereby generate value for Lloyds' shareholders. So its context was certainly unusual (Mr Tate thought it "unique" and acknowledged that in ordinary and normal markets Lloyds would not ordinarily execute such a transaction). But many loan transactions will have unique

features which require adjustment to a standard lending template: that of itself does not take the transaction outside the “ordinary course of business” provided that the eventual transaction is on proper commercial terms. In the instant case it cannot be said that the £2.4bn interbank loan was commercial business that would, in the then-state of the market, have been declined but for the desire to achieve the strategic objective. The Claimant’s expert Mr Benkert approached the Lloyds Repo on the footing that the first tranche was a “business as usual” conventional repo of marketable securities: and in his evidence the Claimants’ expert Mr Ellerton described it as “a £2.4 billion repo facility secured conventionally on securities”. There is nothing in the evidence to suggest that Lloyds would not have entered into such a conventional transaction in the ordinary course of business.

213. As Mr Firth had identified, the desire to preserve HBOS’ value as an acquisition was something that had to be recognised. Mr Tate acknowledged that the aim was to structure something that would be commercial, would address volatility in the marketplace and would help Lloyds to get to a successful acquisition. He said:-

> “… Keeping in mind the fences that need to be there, because we are independent companies and we are in the process of coming together, [bearing] in mind all of that I think there is no doubt…. we are trying to work together.”

From Mr Daniel’s perspective he considered Lloyds

> “… to be part of the solution to see HBOS through to completion, but ….. we had to do it at an arm’s length basis in case the deal did not go through…”.

Mr Tookey thought that

> “.. HBOS funded to the point of acquisition was in our interests in the context of wanting to put a transaction to our shareholders that we believed would enhance shareholder value….”.

Such acknowledgements of the strategic significance of the transaction do not mean that the transaction itself was not made in the ordinary course of business.

214. Notwithstanding the first tranche of the Lloyds Repo (the £2.4bn repo) HBOS' liquidity difficulties intensified, driving forward the discussions on a larger secured facility. The Lloyds team was only prepared to contemplate lending that satisfied its risk criteria (as it assessed them in the then-current market conditions): the Lloyds team was not prepared to advance whatever was required simply to preserve HBOS as its target. There would therefore always be a question whether HBOS had access to other stable funds.

215. On 25 September 2008 the Lloyds corporate credit team approved the first tranche of the Lloyds Repo and worked on the proposed additional facility to HBOS. Ms Sergeant expressed to Mr Daniels her concern at “the bits of the jigsaw” that she was seeing, questioning why Lloyds might, as part of the additional facility, lend against apparently illiquid assets (like assigned corporate loans) when HBOS had, as she understood it, securitised assets that could be used in the SLS scheme: and she was concerned about

HBOS exporting its liquidity problems to Lloyds in extraordinarily difficult markets before completion of the Acquisition. Mr Daniels himself understood the point. In truth the position was that HBOS had used (or was in the course of using) all of its SLS-eligible securitised assets and was now seeking to borrow (as it had done in relation to the first tranche of the Lloyds Repo) against other collateral: but nobody in Lloyds was at that time in a position to know that.

216. Late on 25 September 2008 HBOS indicated to the Lloyds team that it was facing severe difficulty and that there was a concern that HBOS would not be able to continue its operations if further sources of funding were not achieved on an ongoing rolling basis. To that end HBOS and its advisers were preparing a funding plan to show the Bank, embodying an assumed £10bn facility from Lloyds, and making certain assumptions about the ability of HBOS to access the SLS using different collateral from that within the then-current restricted range: but it is apparent from the surviving notes of the contemporary conversations that there was sensitivity about the market knowing of any approach by HBOS to the Bank for support outside the standing facilities and SLS as it then existed, lest this reignite an outflow of corporate and consumer deposits.

217. Mr Tate participated in the putting together of a funding plan (“the HBOS plan”). In outline, the HBOS plan proposed to the Bank an industry-wide solution to the severe difficulties being experienced by all banks (by pumping in extra liquidity and by extending the classes of eligible collateral under the SLS scheme); and in the alternative, it suggested that (i) Lloyds would create a deal-specific facility of £10bn for HBOS (the Lloyds Repo had not at this stage been agreed) whose term would be defined by the closing of the deal; (ii) the Bank would make an additional £25bn available to HBOS under the SLS scheme; and (iii) the Treasury would make available a back-up facility of up to £60bn to be drawn upon if necessary. The first proposal, of an industry-wide solution, was prescient (in that the BoE was in the course of implementing those very measures): the alternative proposal was not taken up by the Bank, though the seed of the idea that Lloyds should provide a specific facility in addition to normal liquidity facilities and that the Tripartite should help Lloyds to get to a successful completion of the Acquisition (because in doing so it would aid financial stability) was sown.

218. Meanwhile work continued on the proposed second tranche of the Lloyds Repo. What HBOS could now offer by way of collateral was not some marketable asset-backed security but the benefit of part of its loan book (“raw loans” as they were called in argument). This was a type of security that was being considered by the Bank as acceptable. The benefit of the raw loans could be given to Lloyds by way of assignment by way of mortgage: this would have the disadvantage both that Lloyds would itself have to manage the loan book and that the assignment by way of mortgage would have to be registered (putting the arrangements into the public domain) or would otherwise become void. So HBOS proposed a trust structure under which legal title to the raw loans would remain with HBOS, but HBOS would declare that the benefit of the loans was held upon trust for Lloyds under a repo arrangement as security for the proposed facility. Such an arrangement could be kept confidential.

219. The condition of the markets was at this time intensely febrile: even coordinated intervention by central banks had not prevented the collapse of another American bank. A desire to avoid the risk of provoking the markets into some uncontrollable action in the light of disclosed funding arrangements of a systemically important bank is entirely

understandable from every perspective. But the executive team at Lloyds still had to judge the merits of the transaction with which they were presented.

220. On that matter Lloyds sought the advice of Linklaters. Their immediate reaction (based on an internal discussion between relevant specialists) was that the HBOS proposal gave rise to "material concerns about the structure and risks for Lloyds". Those concerns were:-

a) the fundamental illiquidity of a trust interest in a pool of loans;

b) the effectiveness of trusts over loans whose terms included a restriction on transfer without the borrower's consent;

c) the difficulty in obtaining legal title to or the cash flow under the loans in the event of the insolvency of HBOS;

d) the possibility that the trust arrangement *would* constitute a registrable charge over book debts in any event;

e) the possible need to get regulatory approval given (i) the size of the proposed transaction (if looked at as a single advance) and (ii) the unusual circumstances.

The Lloyds team needed to address those concerns, to decide whether they or any one of them meant that the proposal had to be rejected, and to consider whether the risks identified in those concerns could be mitigated.

221. This near instant response by Linklaters was elaborated in a telephone call soon afterwards during which Mr Tookey and Ms Coltman from Lloyds were able to fill in some of the background and Linklaters were able to give what a note of the conversation describes as "preliminary thoughts". Linklaters were told that HBOS had a big funding requirement, and that Lloyds as its potential acquirer was willing to help out and to contribute to a rescue package: hence the proposal it had received. Linklaters in turn went through their concerns. Amongst them were regulatory and disclosure issues. In that connection the note of the conversation records the following:-

> "Class 1 transaction - consideration is 25% of market capitalisation.. difficult to argue in ordinary course of business and would need shareholder approval to enter into deal… Would need to discuss with FSA (which they are) and with UKLA …. Obligation to disclose material contracts under the offer circular on HBOS…. Would need to put it to the board- in excess of normal authorities … [GEC] would need to sign off… Board sign off." [I have expanded some shorthand expressions].

Mr Barber of Linklaters was cross-examined by Mr Hill QC on the footing that this represented Linklaters' final and concluded advice to Lloyds. Mr Barber denied that that was so, given that his firm had only been instructed 2 or 3 hours earlier. He insisted he was identifying issues for further consideration, some of which would have to be resolved before others. In this I think he is right: Linklaters did provide a lengthy memorandum of advice later that weekend.

222. There is one point in that preliminary advice that I should draw out, relating to the reference to “Class 1”. Lloyds was a listed company. The Listing Rules required it to observe the principle that it must “act with integrity toward holders and potential holders of its listed equity securities”. As an aspect of that, Chapter 10 of the Listing Rules sets out circumstances in which shareholders have to be notified of transactions to be entered into by a listed company which may change the shareholders’ economic interest in the company. Sometimes the shareholders have to be notified and their approval sought (“Class 1”). Sometimes they simply have to be notified (“Class 2”). But the transaction will not be a notifiable transaction within Class 1 if it is of “a revenue nature [made] in the ordinary course of business”. So the practical point being made by Linklaters was that if the second tranche of the Lloyds Repo was a Class 1 transaction it could not be entered into unconditionally without shareholder approval: and since that approval would take at least four weeks to obtain (requiring the preparation of a circular and the convening of a meeting) if the second tranche of the Lloyds repo was urgent then the transaction could not be entertained.

223. That was the immediate question that had to be addressed. There was also a separate (and later) question: that was whether the Lloyds Repo (if entered) would have to be disclosed in the circular sent to shareholders relating to the Acquisition (which was itself undoubtedly a Class 1 transaction), either as a “material contract” or otherwise. In their preliminary advice Linklaters flagged this future question: and in the event prepared a Circular which did not make such disclosure.

224. It was in the knowledge of these immediate and future questions and with the benefit of that preliminary advice that Lloyds considered the HBOS proposal. On 26 September 2008 the Lloyds team set about mitigating the risks to which Linklaters had referred. Instead of being a single transaction the facility was structured as a line of credit that could be drawn down in tranches each of which had, at the time of drawing, to satisfy the Lloyds risk criteria. There was a review by a team of 25 credit analysts and 2 senior sanctioners of each of the raw loans underlying the collateral that was offered for the initial tranche. A substantial proportion of the offered collateral was rejected. A “haircut” was applied to ensure a substantial valuation margin on the amount advanced (an “over collateralisation” of 133%). The term of each advance was limited to 14 days (not the 6 months sought by HBOS) with no commitment to “rollover”: that period was selected so that if Lloyds decided not to renew and if HBOS defaulted on repayment then Lloyds could register its interest as a registrable charge within the 21 days limited for so doing (thereby protecting itself against the risk of that categorisation of the transaction prevailing in an insolvency). Although legal title remained with HBOS, Lloyds was granted a power of attorney enabling it to take specified actions in the event of default. Amongst these was the ability to establish the default market value of the security by selling the underlying loans (though this could not overcome any illiquidity problem). As so structured this was clearly not an “off the shelf” repo transaction: and Mr Parr of Linklaters thought the structure “not great from Lloyds’ perspective”.

225. That work was continuing when, on the afternoon of Saturday 27 September 2008, Sir Victor was told by Mr Daniels he had been informed by Mr Hornby that HBOS could no longer access the SLS (for reasons that were not clear) and that, "if the situation were to continue, HBOS might not be able to open on Monday 29 September 2008 and would possibly need to be nationalised."

226. In his oral evidence Sir Victor described his response to the news in these terms:-

> "..[HBOS] was having difficulty in accessing the central bank schemes at that time, and that seemed to be the logjam. Given that that was the logjam… I remember well, I walked round the garden three times thinking "What the heck can I do?". It was a bit like looking at two ocean liners about to collide, and you wanted to do something. But I decided on something I'd never done before: just to pick up the phone and see if I could get hold of the Prime Minister and tell him that it looked like a catastrophe was coming.
>
> Q: The catastrophe being that HBOS would run out of funds?
>
> A: That HBOS might not be able to open its doors on Monday morning. And please, you know, let's all bear in mind, the consequences of that for the rest of the UK banking sector would have been colossal. ….
>
> Q: And the gist of that conversation was that you were asking the government to ensure that there was funding available to HBOS?
>
> A: No. I was telling him what the facts were that had been disclosed to me and saying that I thought there was….It seemed to me that there were differences around the terms on… There were concerns, there were delays, there were problems around the terms on which the Bank of England would advance further funds to HBOS. I didn't know the detailed circumstances, but I thought the situation was incredibly serious and he needed to be aware of it."

Sir Victor was pressed with the suggestion that he was effectively asking for ELA to be made available to HBOS. But he denied that saying:-

> "The conversation was not that specific about the type of funding or any detail about the funding. It was simply putting the Prime Minister on notice…. that there was a crisis looming and he needed to be aware of it."

227. The next day on Sunday 28 September there was a Lloyds' board meeting. The course of events and the conclusions reached may be discerned both from the minutes of that meeting and from some handwritten notes made by Mr Kane (subject to the caveat that those notes are not comprehensive, will record those observations made in the course of discussions which interested him or which he thought important from his perspective, and will not necessarily record conclusions).

228. Mr Daniels informed the board that notwithstanding favourable market reaction to central bank proposal of a plan to rescue banks, liquidity had become more of an issue (particularly for HBOS) and had led to a tightening of wholesale funding. From Mr Kane's notes Mr Daniels seems to have linked this tightening to an analysis of liquidity, capital and impairments. HBOS had suffered an outflow of deposits (losing about £17 bn in 10 days). He informed the board that:

> "[HBOS] was working on a funding plan with the Bank of England but had had difficulty in accessing the Bank's special liquidity scheme for reasons which were not entirely clear. In parallel, it had become apparent that HM Treasury were becoming increasingly concerned about issues concerning Bradford & Bingley…. "

Mr Kane's notes suggest that at this point observations were made which he recorded in this way:-

> " 3 alts.
>
> 1. BOE changes collateral requirements
> 2. TR - lines available to all banks
> 3. one line esp.available to HBOS .. to complete transaction."

229. It is possible to interpret this last note as meaning that there was some discussion around the possibility that HBOS would be given funding sufficient to enable Lloyds to complete the Acquisition. In his written evidence Mr Kane simply said he could not remember what item 3 meant. But in his oral evidence in chief he explained that these notes occurred in a section dealing with (i) the collapse of Bradford & Bingley disclosed in a telephone conversation with Shriti Vadera (the Minister for Business) that morning, and (ii) with a potential bid by HBOS for some Bradford & Bingley assets. Then in cross-examination he was asked again about the context of the quoted notes:-

> "Q: were you intending also to be describing what you think you were dealing with [in the quoted notes]?
>
> A: No, I think what I've said in my witness statement about that still stands I'm not entirely sure about that. I mean, if – given the changes that I made to the pre-and post bits of those three alternatives, I can only assume that this is some form of funding in relation to the conversation, or perhaps its general funding in relation to what's happening in the marketplace, funding issues. But what I have in my witness statement I still think is appropriate. "

In answer to a question from me he confirmed that the parts of the document before and after the quoted notes were dealing with Bradford & Bingley. I must, from this evidence and from the document itself, try and work out to what the quoted notes refer.

230. In this part of the meeting two matters were being commented upon. First, HBOS's general funding difficulties. Second, the dire position of Bradford & Bingley, and the Government plan (disclosed in Ms Vadera's conversation) to sell off its branch network to a third party. Mr Kane's surrounding notes indicate that the board was being told that HBOS was being encouraged by the Tripartite to bid for this Bradford & Bingley branch network (probably because the resulting inflow of customer deposits would have eased

HBOS' own difficulties). The board minutes crisply record that Mr Daniels "briefed the board on HBOS's possible participation in this arrangement". So I think the "transaction" in respect of which it was possible HBOS would be granted an especial credit line was its bid for the Bradford & Bingley branch network (not its acquisition by Lloyds). I find that at this board meeting there was probably no discussion relating to the grant of emergency assistance to HBOS in relation to its general funding difficulties in order to preserve it for acquisition by Lloyds: on the other hand there is no doubt that the board was aware that it was anticipated that the BoE would provide, in some form, supportive funding to HBOS to enable it to maintain its position in the market.

231. There was, however, discussion both about Lloyds' participation in a funding plan for HBOS and about whether, and if so in what form, the Acquisition should proceed.

232. Focussing for the time being on the former, Mr Daniels explained to the board the possible extent of Lloyds participation in providing funding to HBOS but noted that

> " this was subject to a number of legal issues being resolved in particular with a view to ensuring that the group's position was properly secured. "

This was a reference to the second tranche of the Lloyds' Repo.

233. As to the latter it is convenient to note that Mr Daniels identified four key issues:-

> "1. Funding and liquidity - [HBOS] needs to resolve its funding difficulties, with assistance from the Bank of England. The bank's funding well but market pressures could eventually have an impact on the bank's own liquidity .
>
> 2. The interplay between the equity and money markets …. the share prices of banks were under pressure which would have implications for the terms on which the [HBOS] transaction been announced
>
> 3. The wider impact of the financial crisis on the economic environment …..
>
> 4. A capital increase required serious consideration. This was what the market expected even though previous announcements by the group had indicated that this was not an immediate requirement ."

I shall return to those topics later. Meanwhile I will focus on the dealings between Lloyds and HBOS.

234. As this consideration by the board was happening the structure and terms of the proposed second tranche of the Lloyds Repo were being settled. Before an advance could be made Lloyds' internal processes and its commercial requirements had to be addressed.

235. As to commercial requirements, it was at this stage the stance of Mr Tate that (beyond the overnight lending and the £2.4bn first tranche) "we WILL NOT make an incremental penny of this secured facility available until we have a permanent solution COMMITTED by the authorities". In other words, from his perspective Lloyds should look for a commitment from the Tripartite to see any funding plan through and not to leave Lloyds in the lurch.

236. As to internal process it is evident that the executive team wished to keep knowledge of the proposed arrangement within a restricted circle. The transaction did not therefore go through the normal governance structures and was not considered by two of the usual lower tier committees (being considered only at a higher level). It was, however, considered by the Wholesale & International Banking Division ("W&IB") and by the Legal, Credit, Operational Risk, Compliance and Finance Departments. At the W&IB meeting on 30 September 2008 the minutes record:-

> " W&IBCC did not consider this to be a bankable proposition in the normal course of business for the following reasons (albeit W&IBCC accepted that they may not be in possession of all the facts)
>
> - Existing exposure already exceeds prudential levels in the current market, absent external support.
> - There is uncertainty concerning the overall quality of HBOS's book.
> - The merger transaction is not consummated and will take months to come to fruition. If it falls away, we could be left in an exposed position.
> - Press reports indicate that HBOS's funding shortfall may be significant and could have been exacerbated by the announcement of a merger which would cause the banks to aggregate [Lloyds] and [HBOS] limits before paring them back.
> - Any new lending exposes the bank to refinancing risk. "

The "refinancing risk" referred to arose from the fact that Lloyds, even with the drastically shortened tenor of the repo, was providing 14-day money but it would itself be unable to raise that 14-day money in the market (because that market was closed). Lloyds itself would have to rely on overnight money: and that mis-match would breach Lloyds' internal liquidity ratios.

237. The views recorded in these minutes were incorporated in a paper prepared for consideration by Mr Daniels, Mr Tate, Mr Tookey and Ms Sergeant in connection with sanctioning the extension of credit. The paper included the information that

> "UKLA have confirmed that the transaction is ordinary course and as such avoids the Class Tests. The Panel have confirmed that they have no objection. [Mr Tate] was speaking to the FSA

> to seek their confirmation that they have no objection. A considered view has been taken that the transaction is not disclosable to the market."

238. The views of the UK Listing Authority had been sought by Mr Ross of Merrill Lynch, and he had communicated the outcome to Mr Barber of Linklaters on 1 October 2008. He in turn conveyed the information to Lloyds in these terms:-

> "I gather UKLA have agreed [the Lloyds Repo] is ordinary course as it is a repo (Derek says they did not get into the details of its unusual features but he is confident that UKLA will not go back on this). "

The conversation appears to have been with Mr Teasdale, the Head of Listing at UKLA. From other material it appears that the UKLA considered that the transaction was a revenue one in the ordinary course of business, and the authority was prepared to waive any disclosure and approval requirements connected with the incidence and size of the Lloyds' Repo.

239. The terms of Mr Barber's report to Lloyds provided a proper basis for Mr Hill QC to suggest to Mr Barber that UKLA may not have been fully apprised of the true nature of the transaction. Mr Barber strongly resisted the suggestion. Given that neither party to the relevant conversation (Ross/Teasdale) was a witness before the court the best I can do is to assess the probabilities.

240. Whether the Lloyds Repo was a Class 1 transaction was a difficult question, the answer to which was fundamental to the whole transaction: if it fell within Class 1 , the transaction could not in practice proceed, and nor could the Acquisition. Under the Listing Rules (in particular Listing Rule 8.3.3) a sponsor to the Acquisition (such as Merrill Lynch) owed a regulatory duty (reflecting in this instance also a legal duty) to exercise due skill and care in giving advice to a client about the interpretation of the Listing Rules. A sponsor would not want to be responsible for getting advice or guidance wrong: there would be every incentive to "lay off" that risk by obtaining a watertight UKLA approval. There would be no incentive to conceal material information from a regulatory authority (particularly one that formed part of a regime that was generally supportive of the transaction and of the Acquisition) if that might produce a challengeable approval. There would be every incentive to tell a generally supportive regulatory authority whatever it said it needed to know before it commented on the guidance that the sponsor intended to give. So the probability is that the UKLA was given as much information as it sought from Lloyds' advisers about the transaction before commenting upon it (which did not descend to the minutiae of the transaction, or the "detail" of the unusual features): so it was not misled as to the circumstances, and so far as the evidence shows the UKLA has never suggested that its categorisation of the Lloyds Repo was given on a mistaken basis. I am glad to reach this conclusion, because I would have been very reluctant to make an implicit finding of deception against a professional man like Mr Ross in his absence and based solely upon inference drawn from the terms of a document he did not write.

241. The evidence of the Defendants was that "the green light" given by the UKLA was not taken to absolve Lloyds from itself considering the class question. The documents suggest that this separate consideration occurred on more than one occasion. But it was

certainly done on the evening of 1 October 2008 in a telephone call involving Mr Tookey, Mr Cumming and Ms Coltman, and the Lloyds advisory team (Linklaters, Merrill Lynch and Citi) which focussed on whether the transaction (both the overall arrangement and the first drawdown) needed to be disclosed to the market generally as "insider information".

242. A note of the conversation records that the following material matters were addressed:

a) The Lloyds Repo would be the largest that Lloyds had done;

b) The transaction was "unorthodox" being characterised as "a very specialised liquidity support for HBOS";

c) The transaction was on satisfactory commercial terms as regards both the balance sheet (were HBOS to default or were the Acquisition abandoned) and the profit and loss account (the return adequately reflecting the risk) such that if undertaken with any other counterparty there would be no issue requiring disclosure;

d) Lloyds had taken into account the fact that the Acquisition might not proceed but remained satisfied with the transaction even in that event;

e) Although the fact that HBOS was the target of an acquisition by Lloyds had reinforced the motivation to enter the transaction "the key point was that the terms of the transaction were the same as would apply with any other counterparty of a similar credit risk" and Lloyds may well have chosen to enter into the present transaction with a third party on the same terms "for genuine commercial reasons including… contributing to maintaining liquidity in the interbank lending market";

f) If disclosed, the repo would be likely to be construed by the market as simply confirming Lloyds commitment to its offer for HBOS.

243. It must be accepted that these were honestly held views. They of course underpinned the conclusions (i) that the Lloyds Repo did not fall within Class1 and so (ii) did not require shareholder approval and so (iii) could proceed within a transactional timetable that would enable HBOS to securely fund its operations in the immediate future and so (iv) thereby enable HBOS to remain a worthwhile acquisition target without overt Government intervention. Furthermore, the arrangement afforded the possibility that HBOS might continue in that state (so long as it could continue to offer acceptable collateral). These were very highly desirable conclusions - both for Lloyds and for the Tripartite. So I can understand why Mr Hill QC should suggest to some of the Defendants' witnesses that the participants were "straining" to reach those conclusions (a charge they denied). But the issue is not whether they were conclusions which it was easy to reach, but whether the conclusions ultimately reached were honestly held and tenable by competent executives and competent board members.

244. The sanctioning decision had to be taken by Mr Daniels, Mr Tate, Mr Tookey and Ms Sergeant in the light of this guidance and knowledge. Mr Daniels was in favour of the transaction and considered it to be "ordinary course" in the context of the market conditions prevailing at the end of September if (i) it was on commercial terms that

were acceptable even if the Acquisition did not proceed (which he considered to be a risk); (ii) the collateral was rigorously assessed on each requested drawdown; and (iii) Lloyds' own funding and capital position was not endangered. Mr Daniels was challenged with the proposition that Lloyds would not have entered into the transaction if it was not for the context of the Acquisition. To this he responded:

> "….that's not necessarily clear… We are an interbank lender and this is something that is a normal part of any clearing bank…. We had interbank lines out to virtually every bank in the UK in virtually every one of the major banks across the world. "

The focus of that answer was not necessarily secured term lending and so Mr Hill QC rightly pressed the point, which was answered:

> "Q: You wouldn't have been lending this amount of money under these terms to this institution in the situation it was if it were not for the acquisition ?
>
> A: That's not completely clear … What we had said is that we wanted this to be completely arm's length, so in other words there was no guarantee that this deal was going to go through, so what we wanted to do was to make sure that we insulated Lloyds from that risk, and we would have done the same with any other institution. So it was priced by us, it went through our credit process, and we felt comfortable that, should there ever be a default, that we will be able to collect against it.
>
> Q: But Lloyds would not have chosen to expose itself to amounts of this size, to an institution in the circumstances, or to enter into a facility on these terms, were it not for the acquisition?
>
> A: Again, that is not clear…. Interbank lending is part of what we do – or …..what Lloyds did, and we had other interbank facilities with… virtually every other bank… The facilities were done for varying reasons, but they were all interbank lines… We were desirous of keeping HBOS funded until completion, there is no question about it, but we priced it at a commercial rate, we set the price and we were very happy with the return and, again, it was done on an arm's length basis …. "

245. Mr Tate also was in favour of the transaction, which he considered "unique" but nonetheless in the "ordinary course", albeit that the Acquisition provided a motivation for entering it. It was interbank lending which could have been extended on those or similar terms to another large financial institution which made a similar request.

246. Mr Tookey was also in favour of the transaction, having considered what he called "all of the ordinary factors" as well as

> "…specific factors such as the benefits in maintaining liquidity in interbank lending markets and a maintaining the supply of

> liquidity to HBOS ahead of the shareholder vote on the acquisition."

His evidence was that improving interbank lending conditions was an important objective of the Tripartite, aimed at reducing pressure on more volatile forms of wholesale market funding: but the fiduciary obligations owed by the board to the company meant that a transaction with HBOS consistent with the Tripartite's objectives had still to proceed on entirely commercial terms which could have been offered to another bank.

247. Ms Sergeant (who until 2003 had been an Executive Director on the Board of the FSA) was the least enamoured with the transaction. She had already expressed disquiet about the first tranche of the Lloyds Repo. She now (on 1 October 2008) informed the other members of the sanctioning committee that she would "probably find it hard to form a positive view about this particular transaction without the wider context" because it seemed to her "to be part of a systemic rescue package". She went on:

> "If this is the case I would want the FSA to explicitly endorse the transaction and all its risks…… If we are under pressure from one part of the tripartite…. to carry out this transaction as part of a wider rescue operation then the FSA should be made fully aware of the risks we are having to take on behalf of [Lloyds] depositors and shareholders and explicitly endorse the transaction. From my reading of the paper they are being asked rather narrow technical questions…. rather than the big question over the appropriateness of the transaction and the risks associated with it both for [Lloyds] and the system as a whole."

I am satisfied that the assumption upon which this request proceeds (that Lloyds was being pressured by the Tripartite to enter the Lloyds Repo or to proceed with the Acquisition) is not well founded. Lloyds was approaching both the Repo and the Acquisition on the footing that each was an opportunity to be exploited for the benefit of the company and in the interests of its shareholders, and in doing so it was exploiting the willingness of the Tripartite to assist with the transactions because they achieved the Tripartite's own stability objectives.

248. But she was in a sense right to think of the Acquisition and the second tranche of the Lloyds Repo as part of "a systemic rescue package". Despite the weekend worries, HBOS had opened its doors on the 29 and on 30 September 2008, *funding itself in the market*. That market knew that HBOS had no independent future; so for how much longer such funding would remain available was very uncertain. The very request being made of Lloyds by HBOS already evidenced the diminishing availability of other market funds. It was to cope with that decline (and to avoid the systemic threat posed by a disorderly collapse) that the Tripartite was embarking on supportive measures to facilitate the Acquisition. The second tranche of the Lloyds Repo had a function as a bridge to that secure funding. But it was not a loan made to "bail out" HBOS having no commercial or strategic benefit for Lloyds.

249. In the light of the further information provided to her by Mr Tate, Ms Sergeant was prepared to sanction the Lloyds Repo provided two matters were clear:-

a) The FSA were fully aware, involved and supportive at the very highest levels-: ("I think we should have a final, very clear conversation with Hector Sants which is about the FSA's full understanding of the risks in the deal and the FSA's strong support for the arrangement").

b) The Lloyds repo would be the maximum contribution with the BoE providing the rest. (In the event the Lloyds Repo facility was not fully utilised).

250. Mr Tate made contact with the FSA. The result was recorded in a contemporaneous email in these terms:-

> "This is to record the fact that during the course of this morning and prior to extending any funds to HBOS… I spoke with Hector Sants, Clive Adamson and Simon Green. The overall purpose of the conversations was to obtain clear confirmation that each one of them, as individuals and as representatives of the FSA, were aware of the transaction and all of the circumstances surrounding it. Further, that they not only supported our extending the credit, but felt that they were encouraging the action and blessed it on every level (including the fact that it would not require disclosure in any respect, nor shareholder approval et cetera). [I]ndividual comments which might differentiate each would include
>
> Simon Green: confirmed that he… had been involved earlier than we had…. In actually designing the overall proposal, running the funding schedule, working up scenarios et cetera. Indeed, he and Mark accompanied me to visit Andrew Bailey at the Bank of England and "sponsored"/"vouched" for the proposal….
>
> Clive Adamson: all of the above, but added that he had been in direct conversations with the BoE after each of our meetings and felt confident that this was a "united" position on the part of "the authorities"…
>
> Hector Sants: Hector wanted it noted, explicitly and word-for-word, that "he was ABSOLUTELY involved, in every aspect of the transactions, and supported it the detail". He added that they were VERY keen to have the deal go through and, indeed, felt that "EVERYONE" was increasing (*sic*) committed past the point of no return.
>
> I would add to the above 3 that I spoke with Tom Huertas and JJ (head of markets), both in relation to Disclosure and liquidity, and each of them reassured me of the involvement as well. "

251. The Lloyds Repo was then signed off: Mr Andy Cumming (one of the authors of the original cautionary briefing note) also concurred in the sign-off. The total credit line was limited to £10bn available for drawdown in tranches. The first Master Repurchase Agreement was in the sum of £2.5 billion. There were 21 further repos, each subject to

its own scrutiny and assessment and to its own agreement. None of them exceeded £3bn. The peak drawdown under the facility never exceeded £6bn. On each occasion an assessment was made as to how far the Bank of England had got in providing a clear plan for funding (to HBOS or to Lloyds) through to completion of the Acquisition: Lloyds continued to have what Mr Tate described as "live and dynamic discussions" with the BoE about the sustainable solution up to completion. Only after completion of the Acquisition was the rigour relaxed and the interbank funding treated as intra-group lending.

252. There is no doubt that all parties concerned (including BoE and FSA) viewed the Lloyds Repo as "ordinary course" lending for the purpose of observing Class 1 requirements: in consequence, it was not disclosed either at the time of the extension of the credit line or when the line was drawn upon.

253. As a footnote (and a point to hold in the back of one's mind during the sections which follow) once the Lloyd's Repo was in place (and in the teeth of Mr Tate's insistence, noted above, that advances under it must be considered in the context of the Bank's commitment to a comprehensive funding plan for HBOS through to the Acquisition completion) the Bank began to link the availability of SLS facilities *to Lloyds* with the availability to HBOS of drawdown under the Lloyds Repo. In particular on the evening of 10 October 2008 (i.e. as the Recapitalisation Weekend opened) the Bank refused to make available SLS facilities to Lloyds, despite Lloyds having "headroom" under its then-current arrangements, unless Lloyds agreed to make funds available to HBOS. Like every other major bank Lloyds depended on the availability of SLS for its own liquidity.

Due diligence

254. Prior to the Announcement some due diligence had been undertaken, based on publicly available information (principally the HBOS interim statement) supplemented by (i) Lloyds' own insights into its competitor and (ii) high level meetings undertaken on 17 September 2008 (which Mr Daniels acknowledged in evidence to be "the beginning of due diligence, not the end of it"). This material the board considered sufficient to justify the Announcement but insufficient to justify a properly founded recommendation to shareholders. For such a recommendation the board needed to assess the quality of HBOS's assets, to judge the risks of a deterioration in the HBOS balance sheet and to consider whether the agreed price for the Acquisition could be recommended to the shareholders. It was therefore anticipated that the due diligence process must continue.

255. I indicated when dealing with the Announcement that the process of conducting detailed due diligence had already begun, but that it was not clear that the product was available to the board on 17 September 2008. The relevant parts of it are likely to have been available to the area specialists for them to take into account in their respective presentations to the board.

256. This initial due diligence work had been undertaken by a team from Merrill Lynch. Amongst the matters upon which they commented were the following:-

a) the HBOS mortgage book had a higher risk profile than the Lloyds mortgage book (with 12% of the mortgages "self certified");

b) the corporate lending was conducted according to a very different model (being “transactional” rather than “relationship-based”);

c) the corporate business included taking equity stakes in businesses (“private equity”) and entering joint ventures through structured equity/senior debt/mezzanine debt packages;

d) there was no information on forecast impairment numbers because enquiry on the subject was “dodged” by HBOS personnel, with the result that accounting policies on impairments, which “always look[ed] low” needed to be checked;

e) there were potential incremental value adjustments on the corporate business of £6.6bn (including fair value adjustments on equity stakes of about £1 billion and on the corporate portfolio of an assumed £2bn).

Although Lloyds had negotiated a price which reflected a substantial discount to book value these remained matters that needed pursuing in the post-Announcement due diligence process. Mr Daniels acknowledged that a “robust due diligence” was important.

257. To that end Lloyds assembled a team of 26 experienced risk and credit specialists to examine what was disclosed concerning HBOS’ mortgage book, corporate book, retail book, treasury assets, international division, private equity and joint ventures (having together a book value as at 30 June 2008 of £533bn and being the assets most exposed to fair value adjustments and impairments).

258. Mr Roughton-Smith described to Sir Victor in December 2008 the nature of the work undertaken in this due diligence process. In relation to the mortgage book the team applied Lloyds’ own methodologies to the £170bn prime book and to the £65bn buy-to-let, self-certified and sub-prime book. In respect of the corporate book it adopted a sampling technique (and in this was assisted by the fact that HBOS had to provide ready access to all of those corporate loans that were being offered as security under the Lloyds Repo): about £30bn out of a total book of £120bn was sampled and the results extrapolated and discussed with the HBOS team. Further work could not be undertaken because of client and commercial confidentiality. In relation to the retail book of consumer loans and overdrafts (current and historic) the work showed that HBOS was performing better than Lloyds itself. In respect of treasury assets, the Lloyds team was provided with detailed asset level data and it reviewed prices on a statistically significant sample of 50% by value. In relation to the international portfolios there was a review of the management information and a series of discussions with local managers to discuss major exposures: this was the limit of what was possible having regard to client and commercial confidentiality. In relation to private equity the team was able to undertake a high-level review of the portfolio and brief reviews of the top six investments (which constituted 54% by value). Again further work was not possible because of client and commercial confidentiality: nor was it considered necessary because the Lloyds team assumed that most of that value would be written off. Work of the same nature was carried out on the joint venture portfolio, concentrating on the most significant packages and all those where Lloyds had its own insight into the joint venture and could therefore compare its work with that undertaken by HBOS.

259. The results of this process emerged unevenly and over time. Initially HBOS was not cooperative in the disclosure process and it took until about 6 October 2008 before real progress could be made. The process was also affected by the global disintegration that occurred in the latter part of September 2008. Thus when the Lloyds board met on the 28 September 2008 it expressed its concern to ensure that any adverse developments in HBOS should not impact adversely on Lloyds' existing business or its shareholders, and decided that further consideration needed to be given to both capital and funding issues in the light of the outcome of the financial due diligence that was then current. This was, I consider, an appropriately cautious approach.

260. Below board level and below the level of those who reported to the board some concerns were being expressed about parts of what was being revealed by this process. On 24 September 2008 Graham Taylor (who was the Deputy Director of Group Strategy and Corporate Development) emailed Mr Pietruska to comment upon what was emerging from W&IB regarding the corporate portfolio in the course of the due diligence process. This material had indicated that HBOS's risk appetite was far greater than that of Lloyds; that there was a very large real estate exposure; that the principal joint ventures were the residential construction, hotel and real estate investment fields (including to customers to whom Lloyds itself also lent); it had disclosed the private equity position; and it had suggested incremental fair value adjustments and additional impairments of some £3bn. Mr Taylor commented:-

> "We've set the context for the Financial Review exercise with our Risk people and they understand the need for a commercial approach and balanced judgement. However, it does appear that we will be looking at material adjustments to the level of negative goodwill we will generate and the prospect of further equity raising is real. Perhaps we could discuss because I can foresee a lot of problems here."

He was not alone in thinking that the W&IB material made sobering reading. Further equity raising is, of course, what ultimately proved to be necessary: and "a lot of problems" is what ultimately came to pass.

261. Because of that there is a temptation to say that this opinion should at the time have been seen as significant and should have been communicated by Mr Pietruska or by someone else directly to the board, and that without the benefit of it the board would receive an inaccurate picture of the outcome of the due diligence. That temptation must be resisted. Mr Taylor's individual view was communicated to Mr Pietruska (on whom the board called for advice) and it no doubt was considered by him and informed the advice that Mr Pietruska gave to the extent he thought right. The material on which Mr Taylor was commenting was itself widely distributed within the core team (including to Mr Roughton-Smith), so other recipients will have evaluated it and taken it into account in their own work and reports to the board. The assessment of fair value losses and impairments was an ongoing work.

262. Before recording my findings about the product of this work it is necessary to emphasise one feature of the process of assessing fair value losses and impairments. The outcome of the process is intended to provide adjustment figures to apply to current book values in order to produce sensible predicted valuations applicable at selected future points (in the instant case, as at the end of 2008 and, to the extent possible, the end of 2009),

for the purpose of using those predicted valuations as an element of planning other actions. Thus an anticipated fair value adjustment or an anticipated impairment may have an impact upon the calculation of RWAs which will in turn have a consequence on the capital required to maintain a regulatory or internal capital ratio. The outcome of the process will therefore reflect both an assessment of the quality of the asset itself and an assumption about the market in which that asset will be performing ("the scenario"). The eventual planned actions will take account both of the estimated fair value adjustments or impairments based on that scenario, and of the probability of the occurrence of the scenario itself.

263. Scenarios and the probability of their occurrence were considered in the context of Lloyds general business risk at a meeting of the Risk Oversight Committee on 6 October 2008. It was chaired in part by Sir Victor and in part by Mr du Plessis, and was attended by Mr Daniels and Ms Sergeant. When considering how things must have appeared at that time it is well to remember that during September 2008 the Treasury's official forecast for GDP *growth* still remained in the range of 1.75% to 2.25% for 2008 and continued to be 2.25%- 2.75% for 2009 (though it was widely expected that these forecasts would be cut.). Neither the length nor the depth of the recession that was to come was anticipated.

264. In contrast to the Treasury, Mr Patrick Foley, the Chief Economist at Lloyds, had already adjusted his planning scenarios. He worked with three economic scenarios.

265. His "base case" assumed that the credit crisis would continue to feed through to the real economy, but would not intensify sharply. Whilst businesses and consumers would react to this slowdown they would not change behaviour sharply enough to cause a recession. House prices would continue to fall through to 2008-2009. GDP growth would fall to 1.6% in 2008 but would grow again in 2009 and by 2010 would be back on its long-term trend.

266. Mr Foley's "credit crunch" (or "1 in 15") scenario assumed that the feed through of the credit crisis into the real economy would intensify sharply with businesses and consumers reacting by becoming increasingly cautious. This would trigger a recession in Q3 2008, though growth would only become negative in 2009. House prices would fall sharply, down 25% during 2008, with a knock-on impact on consumer spending. Business investment would fall by about 5%, and unemployment would rise. Recovery would not begin until 2010.

267. Mr Foley's "1 in 25" scenario assumed that the feed through of the credit crisis into the real economy would intensify sharply with lenders cutting back severely on credit availability in reaction to increasing default rates. Businesses and consumers would become much more cautious GDP would fall by up to 2.5% in 2009 (as compared with 1.4% in 1991). House prices would fall by 30% over 2008-2009, and share prices by a further 30%. Business investment would fall sharply and unemployment would rise to over 7% by 2010. A recovery would not begin until 2012.

268. In his paper for the Risk Committee Mr Foley expressed the view that there was a 40% chance of a "significant downturn" (his "base case"), a 30% chance of a 1990s-style recession (his "1 in 15" or "credit crunch" case), and 10% chance of a deep "1 in 25" recession, though he thought that (depending on market movements) the "base case" and "credit crunch" probabilities might "flip". The Minute of the meeting records that

the Risk Oversight Committee itself considered the current economic turmoil to be a "once in 50 (sic) years event". Having regard to the material that was before the Committee and in view of the events which followed I am not satisfied that this Minute records a considered decision as to the basis for future action which was intended to prevail over the view of the Chief Economist (rather than a non-technical observation as to the perceived seriousness of the position). It is convenient at this point to note that Mr Foley's "1 in 15" scenario was more rigorous than mainstream views and his "1 in 25" scenario was severe: the FSA in fact thought it "too severe" and more like a "1 in 60" scenario (and said so during the Recapitalisation Weekend).

269. Scenarios and the probability of their occurrence were next considered (in the context of Lloyds' general budget and planning assumptions for its banking business) by a meeting of the Group Executive Committee on 7 October 2008. The meeting was chaired by Mr Daniels and included Ms Sergeant (who had both been at the preceding day's Risk Committee meeting). It was attended by Mr Tookey, Mr Pietruska and Mr Foley. Mr Foley had prepared a paper for the meeting setting out the latest iteration of his developing views. He commented that whilst the real economy had developed in line with the "base case", the financial markets had now developed more in line with the "credit crunch" scenario so that there was an increased risk of a recession. He currently (for the purpose of making "deliberately prudent planning assumptions") put the probability of the base case at 35%, that of the "credit crunch" at 35% and that of a "1 in 25" at 15%. The minutes record that

> "The committee agreed in principle to adopt the "credit crunch" scenario, subject to further review should the funding position improve. [Note – the committee received an update from Patrick Foley subsequent to the meeting suggesting changes to the base case scenario to take account of market events]."

270. The "market events" to which the post-meeting note cryptically refers were the momentous Treasury announcements of 8 October 2008. The "update" to which the post-meeting note refers was an email from Mr Foley giving his first reaction to the Treasury announcement. His view was that the government package went a long way to address the issues of capital and funding which had underlain his assessment of an increased probability of the "credit crunch" scenario: so the probability of its occurrence should have fallen somewhat. He continued:-

> "However, my initial reaction is that this doesn't necessarily put us back on track for the base scenario. That will depend on (1) how the market reacts to the package and (2) how it impacts on confidence in the broader economy…. My initial reaction therefore is that whilst the probability of the credit crunch scenario has fallen, the shape of the base case scenario has also changed to be weaker than it was hitherto, and with lower interest rates. "

Shortly put, Mr Foley was now saying that the base case scenario was more likely than the credit crunch scenario (though what the relative probabilities actually were he did not state), but that the base case scenario itself had weaker elements leading to worse outcomes than he had earlier thought.

271. The Group Executive Committee met the following day to consider this post-meeting note. The Minute records that they

> "agreed to adopt these revisions to the base case scenario instead of the credit crunch scenario adopted the previous day."

The revisions were to the economic assumptions (about consumer spending, household disposable income, business investment, unemployment, inflation, house prices, base rates and so forth): these revised base case assumptions were called "the mid-case scenario". They produced outcomes that were more conservative than the then-current consensus view. It is not apparent to me that the probability of the occurrence of the mid-case scenario was adjusted above 35%. (A reduction in the probability of the credit crunch scenario does not necessarily lead to an increase in the probability of the mid-case scenario since the stated probabilities do not have to add up to 100% because of the existence of other possible outcomes over and above those selected for assessment).

272. Mr Foley confirmed in an email at the end of the day his view that a new base scenario (the "mid-case") was "now the highest probability outcome", and recommended that it form the basis for budgeting and planning: but he noted that the credit crunch scenario remained "a significant downside risk" although no longer the most likely outcome. He did not put percentages on the probabilities. Mr Daniels indicated that he understood that the "mid-case" should also be used in forecasts and for the purposes of dealings with HBOS: Mr Foley did not demur. Accordingly, instruction to use the mid-case scenario for forecasting purposes was disseminated, including to Mr Roughton-Smith of Group Credit Risk.

273. The Group Executive Committee next met on 10 October 2008 (the government having announced the recapitalisation). Such a recapitalisation had clear implications for the Acquisition, and these were the focus of the meeting. But in preparation for it Mr Roughton-Smith (on behalf of himself and Mr Graham Taylor) sent to Mr Tookey (having already advised Sir Victor and Mr Daniels late on the preceding day) a draft report from the Group Risk team on the impairments that were required as at 30 September 2008 (i.e. based on what was already known) and the forecast impairments for the remainder of 2008 and for 2009 prepared on the assumption of a "1 in 15 credit crunch" scenario (not the "mid-case" scenario). In addition, they reported on the fair value adjustments required to treasury assets (such as asset-backed securities, the "Alt-A" securitised loans, senior bank paper etc) in the last quarter of 2008 (but not for 2009, such a forecast being regarded as too speculative to be of value). The figures showed impairments for 2008 to lie in a range of £3.5-£5bn; and for 2009 to lie in a range of £6.5-£10.1bn. The FVAs for 2008 lay in a range of £6.2-£10.4bn. So the total adjustments to the HBOS balance sheet of £693bn on an assumed "1 in 15 scenario" were between £16.2bn and £25.5bn. These were (i) the total impairments required (not additional impairments over and above HBOS' own forecasts and provisions) (ii) provisional (because based on limited work) and (iii) stated at the pre-tax level (and so could be reduced by 28%).

274. These figures must have been considered because the minutes note:-

> "The committee considered a number of issues including… the requirements to carry out further due diligence on [HBOS] particularly in more adverse scenarios than currently being

> applied. Particular care would need to be taken to ensure that the acquisition would not expose the group to an unacceptable level of risk, given the anticipated economic downturn. The committee agreed to continue with the acquisition process with a view to establishing whether revised terms could be agreed.. ”

Any revised terms were intended to reflect both what had been disclosed in the due diligence process and also the intended Government support for the banking sector in general and HBOS in particular: and to this support I now turn.

Government support for Lloyds and HBOS

275. On 16 September 2008 Mr Bailey of the BoE had assured Mr Tate that the Bank would provide sufficient liquidity to HBOS to enable the Acquisition to proceed, though he had not descended into any detail. He had also indicated that the enlarged group would be likewise supported. (It was this that lay behind Mr Tate’s comment, noted above, concerning the circumstances in which advances under the second tranche of the Lloyds Repo might be made). So when Lloyds was considering whether to enter the Lloyds Repo Mr Tate prepared in consultation with his counterpart at HBOS a joint funding proposal. Mr Parr said (and I accept) that it was probable that during the course of these discussions the HBOS team indicated the great funding difficulties which HBOS faced, and their understanding as to the potential availability of additional central bank funding should such be necessary.

276. A joint funding plan was consistent with the aims both of Lloyds and of the Bank. As Mr Tookey put it:-

> “…getting HBOS funded to the point of acquisition was in our interests in the context of wanting to put a transaction to our shareholders that we believed would enhance shareholder value. It would have been in the… nation’s interest, without wishing to be overdramatic about it, because of the state of the market and the funding situation and general confidence in banks at that time. So I think we had a common perspective on these things, but my particular focus was on the ability of Lloyds to fund the enlarged group post completion…”

277. This joint funding proposal was put to the BoE on 25 September 2008. In outline, it suggested an industry-wide solution to the severe difficulties being experienced by all banks (by pumping in extra liquidity and by extending the classes of eligible collateral under the SLS scheme); and in the alternative, it suggested that (i) Lloyds would create a “deal specific” facility of £10 bn for HBOS (the Lloyds Repo having not at this stage been agreed) (ii) the Bank should make an additional £25bn available to HBOS under the SLS scheme, and (iii) the Treasury should make available a facility of up to £60bn to be drawn upon if necessary. The first proposal was prescient (in that the BoE was in the course of implementing those measures and duly did so): the alternative proposal was not taken up, but the idea of the provision by the Treasury or the Bank of a special facility to assist in the Acquisition (in fulfilment of the indications given by Mr Bailey) was clearly put on the table.

278. That special facility (called at trial "ELA") was provided to HBOS on 1 October 2008. It is now known (though at the time known only to a tightly-knit circle of those directly involved) that on that day (i) the BoE Transactions Committee was informed of "the seriousness of the immediate position of [HBOS]" and that "[HBOS] might not be able to settle its outstanding positions today" and (ii) the Chancellor decided to authorise the grant to HBOS of an initial uncommitted facility of up to £10 billion (available in a succession of collateral swap transactions). The Bank of England Transactions Committee had noted that

> "the Bank would offer Treasury Bills in return for claims on a pool of underlying mortgages. Unfortunately, [HBOS] had not to date managed to complete the securitisation of these assets. In the interim period [HBOS] would declare a trust which would give the bank security in relation to those assets..."

The offering of Treasury bills for use by HBOS in the market differentiated this support from the immediate cash provided to Northern Rock.

279. The Treasury bills offered were from the pool created for use in the SLS scheme. The collateral offered by HBOS was a pool of mortgages that were already in the process of being securitised. The Bank was, in fact, prepared to consider lending against a much wider range of assets, but in the event HBOS was able to offer a total of four mortgage pools which afforded access to sufficient liquidity for its purposes. It was the nature of the collateral offered and of security interest taken (an interest under a trust of the mortgage pool) that took this lending outside the parameters of the SLS. Unsecuritised loans were not eligible in any of the bank's market wide operations - though securitised loans of similar quality were. (Indeed, 70% of the ELA collateral was eventually securitised and accepted into either the SLS or the Long Term Repo scheme). The mechanism of the facility (and the repo documentation itself) mirrored SLS, and the transaction followed a familiar procedure. The collateral was valued and the "haircut" assessed in the same manner as in the Bank's conventional market operations: the "haircut" averaged 48%, but varied with the quality of the underlying loans. (In the event, none of the collateral was ever realised because the ELA was repaid in full). The facility itself was for the term of one month, but each swap within it had a 14 day maturity, with the repo being renewable. The facility was therefore temporary and gave the Bank regular opportunities to review the necessity for and the scale and terms of it. At its largest the facility amounted to £25.4bn (about 4% of HBOS' funding requirement).

280. The chosen structure enabled the Bank to keep the facility covert. Because it took the form of a collateral swap the transaction was "off balance sheet" and so not visible in the Bank's weekly return: and because the Bank's interest arose under a trust and not a charge there was nothing that needed to be registered publicly. It is now known (but could not at that time have been known to those outside a small circle of Treasury and Bank officials) that the extension of ELA to HBOS was not reported to the Court of the Bank of England. The *"Review of the Bank of England's Provision of Emergency Liquidity Assistance"* prepared by Ian Plenderleith in October 2012 judged that the adoption of that course was reasonable given the need for secrecy and given that a number of members of Court of the Bank of England had potential conflicts of interest as a result of positions on the boards of other financial institutions. Neither the initial grant of ELA to HBOS nor its periodic extension was detected by the market or the

press. As the Plenderleith Report observed, since the structure of the ELA was very similar to the structure of SLS, the provision of additional Treasury bills to HBOS, and the use by HBOS in the market of those bills, was indistinguishable from liquidity provided under SLS, and the emergence of the recapitalisation scheme also provided "camouflage" for the operation.

281. I should note one further point. The Bank could only extend ELA to an institution which it considered was illiquid *but not insolvent*. That was both an internal constraint and an external limitation imposed by European law (for otherwise the extension of the facility would constitute unlawful State aid). The Bank assessed HBOS to be a solvent institution with a temporary liquidity issue. That assessment must have focused upon the position at the time of each extension of support without looking far into the future: for I think it was recognised that HBOS could not survive as "standalone" bank for long. The assessment may have been influenced by a view that the Acquisition would complete and that HBOS would form part of a recapitalised Enlarged Group.

282. The Government's proposal concerning the capital requirements of UK banks announced on 8 October 2008 was discussed at the meeting of the Lloyds' Group Executive Committee on 10 October 2008. The minutes note:-

> "These proposals presented issues concerning the group's plans for project [HBOS]. Various alternatives were under consideration but the committee needed to consider the impact of a substantial capital raising by [HBOS] on the viability of the acquisition project, since any such capital raising would require the group's consent, as well as the implication of [the Treasury] owning a substantial proportion of [HBOS's] share capital. The committee noted the alternative which was for the group to raise capital under [the Treasury] scheme and continue on a standalone basis. The choice recommended by the committee would be influenced by the price at which an acquisition of [HBOS] could be renegotiated, and the structure of any acquisition. The [HBOS] transaction on the right terms was a highly attractive transaction for shareholders. However, if a satisfactory outcome could not be agreed, then the alternative of continuing as a re-capitalised, stand-alone entity relying on organic growth, was also potentially attractive. "

283. The application of the Tripartite's general proposals to each particular bank was to be discussed over the weekend following the announcement of the object that they be announced to the market before it re-opened on 13 October 2008. This tight timetable was only announced by the Tripartite early on 10 October 2008 and caused a degree of consternation. Lloyds decided to put in a proactive "bid".

284. To that end Mr Greenburgh of Merrill Lynch prepared some material for consideration which was circulated (to Mr Pietruska and Mr Taylor amongst others, but not to Mr Tookey, Mr Daniels, Mr Kane or Sir Victor) under the subject heading "Pre-emptive Offering - Alternative Structures". These suggested structures had different starting points as regards the assumed fair value adjustments and excess provisions on the HBOS book that might need to be made, the assumed impairments and adjustments lying at the lower end of the range estimated by Mr Roughton-Smith on the "1 in 15"

scenario. (His latest work had estimated the range of impairments and FVAs for the second half of 2008 to be in the range £9.7bn-£15.4bn and for H208 and 2009 combined to be £16.2-£25.5bn). But, after deducting the assumed cost of new capital to be injected, each gave a negative net value for HBOS (ranging from £4bn to £10bn). The nub of the pro-active proposal was that the Government should nationalise HBOS for a nil consideration, should then inject £15.5bn into HBOS (and £5bn into Lloyds) and that Lloyds should acquire a nationalised HBOS for £15.5bn (i.e. a sum equal to the new capital, giving nothing for HBOS as it stood pre-recapitalisation). Deferred shares were to be issued to the original HBOS shareholders which would be extinguished on a £1 for £1 basis if HBOS incurred losses actually exceeded the estimated impairments and FVA, and otherwise converted into preference shares. Depending on various configurations the Government would end up owning between 66% and 48% of the Enlarged Group.

285. The points upon which Mr Hill QC dwelt were that in these calculations (i) HBOS was treated as worthless and (ii) it is postulated that an injection of £20.5bn might not be sufficient to absorb all HBOS impairments and FVAs (hence the loss-sharing provided by the deferred shares).

286. I have already noted that the Group Executive Committee met on 10 October 2008. Sir Victor, Mr Daniels, Ms Sergeant, Mr Tate and Ms Weir were amongst the members present. Mr Tookey, Mr Pietruska and Mr Greenburgh were amongst those in attendance. Mr Kane was a member of the committee who attended by telephone. The Minutes record that

> "the committee considered a number of issues including the implications of a potentially large HM Government shareholding in the combined group.."

287. Mr Kane made some notes of what he heard of the meeting: he did not physically attend the meeting and did not have Mr Greenburgh's material. After identifying Mr Tookey, Sir Victor, Mr Daniels and Mr Greenburgh the notes read:-

> "Willing to go forward.
>
> But no value left in HBOS.
>
> Proposal - to go ahead
>
> a) Nationalise - then we buy for new issuance £15 billion shares
>
> b) a bad bank - we would pay more for good bank "

It was Mr Kane's evidence that these notes possibly represented the negotiating strategy being developed by the investment bankers, and that he was noting Mr Greenburgh running through a potential set of negotiating tactics. He did not accept that he was noting either his own or somebody else's concluded view that there was no value left in HBOS.

> "I don't think that's what that means. I think what that means is in terms of the negotiations at the current price there is no value

> left. So therefore he's probably constructed a set of scenarios from a negotiating point of view whereby the arguments could be taken into the negotiating room by whomsoever, and using those sort of arguments to renegotiate the price. That's what I think he would have been about."

288. I share Mr Kane's view that his notes do not record concluded views reached about the worth of HBOS, which were then omitted from the GEC minutes, but rather the presentation of arguments to be deployed in negotiation, designed to secure a level of Government support and to do so in a way that cut down on due diligence requirements. That is why Mr Greenburgh's analysis focuses on downsides (impairments) and ignores upsides (synergies and brand values); why Mr Tookey was not provided with the paper; and why the GEC continued to consider the Acquisition as a possibility dependent upon "the price at which an acquisition of [HBOS] could be re-negotiated". Mr Daniels also gave strong evidence that there was no discussion about the net value of HBOS being zero. My view that the surviving documents record an argument and not a conclusion is supported in some measure by the evidence of Mr Pietruska, Mr Tate and Ms Weir: though I do not place great weight on that evidence in view of its tentative tone.

289. I do not accept Mr Kane's suggestion that the negotiations in view were with HBOS over the price. I think that the negotiations in view were with the Tripartite as to the extent of the new capital which the Treasury could be induced to introduce so as to de-risk the transaction for Lloyds and cut down on the due diligence required. This interpretation is consistent with a later note ("...need deal with govt. not HBOS…") and accords with the evidence of Mr Daniels, Mr Tate, Ms Weir and Mr Pietruska (though it must be said that none of that evidence is very strong). It is also in line with what happened next.

290. What then happened was that Merrill Lynch prepared and (after review by Mr Wilmot-Sitwell of UBS, who had been co-instructed as investment bankers) submitted to the Tripartite, but without and subject to board approval, an "Indicative Conditional Proposal". This Proposal referenced both events since the Announcement and the identification of further substantial losses within HBOS, and it recorded the belief that HBOS would be greatly enhanced by the application of Lloyds' management approach and risk practices. The Proposal grounded itself upon the assumptions that for the period to the end of 2009 additional impairments and fair value adjustments of £17.5bn were required to HBOS's books, and that the enlarged group should have a Core Tier 1 ratio of 6.5% (rather than the 6% minimum). On that basis it sought (i) an injection of £17bn Core Tier 1 capital into HBOS, coupled with (ii) a loss sharing arrangement under which the Tripartite would bear 80% of any losses in excess of £17.5 billion (subject to a cap of £5bn). Lloyds would issue £4.5bn ordinary shares and £5bn of preferred dividend ordinary shares at a price of 189p per share to acquire HBOS (a total price of some £13.5bn). Lloyds itself would raise additional capital to reflect the increased risk profile resulting from acquiring the HBOS portfolio, namely, by the issue to the Government of £2.5bn of ordinary shares and £2.5bn of preferred dividend ordinary shares. The Proposal stated that in the absence of the Acquisition Lloyds would not propose a capital raise *of this extent* or Government involvement. (In fact, the calculations undertaken by Mr Greenburgh showed that on a "standalone" basis it was possible that Lloyds required £5bn additional capital if it aimed to reach a Core Tier 1 ratio of 7% by 31 December 2008, assuming a "1 in 15" scenario).

291. The Indicative Conditional Proposal was of course the most favourable package for which Lloyds' negotiating team felt it could ask and could support with reasonable argument: it was one which, if accepted, could be presented in an attractive light to Lloyds' shareholders because it minimised the amount of new capital injected into Lloyds. The Indicative Conditional Proposal does not represent a "red line" below which Lloyds could not justify the Acquisition. Even so, there were voices within Lloyds which felt the Indicative Conditional Proposal itself did not go far enough in providing for anticipated losses within HBOS. It was again Mr Taylor who emailed Mr Pietruska to say that "… at £17bn pre-tax this is less than ½ what we think it could be on the one in 25 scenario…." (an indicator that sufficient work had been undertaken on that more adverse scenario to arrive at that rough figure). The Indicative Conditional Proposal was in any event dismissed by the Government immediately.

292. It cannot be said that the Merrill Lynch preparatory papers or the terms of the Indicative Conditional Proposal demonstrate a recognition by the individual Defendants (or even an awareness by the individual Defendants of the possibility) that HBOS had no value or that even an injection of £20.5bn of capital into the Enlarged Group would be insufficient to avoid a further capital raise. They were arguing for a result, and marshalled the figures that support the desired result.

293. Thus Lloyds started the Recapitalisation Weekend knowing that matters would be settled before the market opened on 13 October 2008, and soon learned that its own proposals were not acceptable to the Tripartite.

<u>Knowledge of ELA</u>

294. Before turning to a consideration of what were intended to be the permanent solutions implemented during the Recapitalisation Weekend I should record my findings concerning the knowledge of the Lloyds directors and executive team about the interim ELA facility extended by the Bank to HBOS. Like SLS the extent and terms of the facility were confidential to the Bank and HBOS: but unlike SLS the very existence of this bilateral facility was kept secret (for reasons which the Plenderleith Report later considered were entirely reasonable having regard to the fragility of the market). However, because of the potential Acquisition and the cooperative approach to the funding of HBOS (where the funding plans developed by HBOS with BoE were shared with Lloyds in order to facilitate drawdowns under the Lloyds Repo), Lloyds was in a position different from the market in general, and some of its personnel knew directly or indirectly of the special facility.

295. Paragraph 11(a) of the Re-Re-Amended Defence (served on 3 August 2017 and endorsed with a Statement of Truth) contained an admission that "the Director Defendants had knowledge…that…HBOS was accessing ELA from the Bank of England…". However, the witness statements which had by then been served disclose a more complicated position, as emerged at trial.

296. Mr Tate was aware that HBOS had access to a further funding scheme enabling it to use a wider category of assets as collateral than was eligible under SLS or the LTRO. This scheme was not called (nor did he think of it as) "emergency liquidity assistance". It was referred to as "Project Package" or "Fox" , and Mr Tate thought of it as "the BoE secured facility". He first referred to it in an email which he wrote on 6 October 2008 (emphasising that further drawdowns under the Lloyds Repo were dependent upon the

BoE's providing a "clear plan for funding through to completion"). In that context he noted that the BoE was providing extended collateral and enquired whether they were agreeing "that the "secured" facility will make up the difference". From 15 October 2008 Mr Tate received from the HBOS team weekly spreadsheets setting out the short term tactical funding plan, containing details of HBOS' funding requirements and anticipated sources (on a range of different assumptions). Such sheets went also the Mr Bailey at BoE. Alongside SLS and LTR these referred to "Project Package" or "Project Pre-Package" or "BOE Bridge Facilities" as contributing a small element of the overall funding requirement of £681bn. Some of the spreadsheets showed that as at 31 January 2009 there would be no utilisation of such "Package" or "Bridge" sources. Mr Tate was clearly aware that from early October 2008 there was a bilateral special arrangement between the Bank and HBOS to alleviate the latter's funding difficulties.

297. Mr Short also knew about "Project Package" and knew that this was BoE funding provided to HBOS outside the SLS and LTRO schemes: his understanding was that this was because HBOS did not have sufficient collateral eligible for SLS and capable of being securitised within the necessary timescale. So he also was clearly aware that this was a bilateral special arrangement between the Bank and HBOS to alleviate the latter's funding difficulties.

298. In his written evidence Mr Daniels acknowledges being told by somebody that the Bank was providing liquidity to HBOS outside the strict requirements of SLS and that the information should be kept confidential. When cross-examined on this evidence he explained that he thought that the provision was by way of an extension of SLS rather than a separate facility. In his oral evidence (when being questioned about the events of 3 November 2008, to which I will come) he also said that he believed that the board as a whole knew the position.

> "Q: So far as you are aware, were all the board aware of the fact that HBOS was by that stage being kept going by ELA?
>
> A: That, I believe that the board was fully informed of ELA…
> Q: did you consider that the board took into account the fact that HBOS was dependent on ELA when it made its recommendation ?
>
> A: I believe so ."

The evidence of other board members contradicted this evidence of Mr Daniels.

299. Mr Tookey became aware in early October that HBOS had received a line of funding outside the strict requirements of SLS, the source of this knowledge being Mr Daniels or Mr Tate: this line was not referred to as "ELA", and the specific framework within which or programme under which the funding was made available did not at the time seem to him to be material.

300. Mr Pietruska acknowledged in his evidence that he was aware that the Bank was granting a bespoke bilateral facility to HBOS: but it did not strike him as "emergency liquidity assistance" either.

> "… ELA was effectively an SLS by another name, where rather than having securitised assets that were eligible collateral, you basically have the underlying assets in non-securitised form to fulfil the same function."

301. Ms Weir could not recall whether she was aware of ELA or not, but thought it was common knowledge that HBOS was making extensive use of all the different funding sources that were available.

302. Sir Victor had become aware on 27 September 2008 of an impending funding crisis at HBOS and he had telephoned Gordon Brown to alert him. In cross-examination it was put to Sir Victor that the gist of the conversation must have been that he wanted the Bank of England to make some individual facility available to HBOS: but he denied this, saying that he was simply putting a very serious concern before the Government without looking at possible solutions, leaving them to the Prime Minister and his advisers. HBOS did open its doors on 29 September and thereafter Sir Victor accepted (i) that he must have known that the situation was unlocked somehow or another and (ii) that it was improbable that Mr Daniels should have kept from Sir Victor (as confidential information) the fact that HBOS was receiving a line of funding outside the strict requirements of SLS. I find that Sir Victor did know that HBOS was accessing a source of liquidity outside SLS.

303. Mr Kane said was not aware of the grant of ELA. Mr du Plessis was under the impression that BoE was providing support to HBOS (as it was in relation to Lloyds and a whole number of other banks): but he could not now recall whether he was aware of anything different in the arrangements between BoE and HBOS. The evidence of Dr Berndt was that he understood HBOS was in an emergency situation and would utilise all sorts of funding made available by central banks, but he did not recall being given a precise breakdown of the exact schemes in fact being used "because in the total scheme of things it is a detail, it is not one of the fundamental questions that have to be asked".

304. This then was the evidence in detail. But the admission in the Defence of knowledge by the Defendant directors of ELA stood unamended throughout the trial.

305. So going into the Recapitalisation Weekend the key members of executive team at Lloyds believed that the main drivers behind the Announcement remained valid, but knew that the financial environment had continue to deteriorate, and that their own due diligence processes had identified the need to make allowance for further impairments or adjustments, estimating the range of those on a "1 in 15" scenario at £16.2-£25.5bn and on a "1 in 25" at something over £34bn. The "1 in 15" scenario had a probability somewhere around 35%, and the "1 in 25" a probability of 15%: but the most likely outcome was anticipated to be a downturn milder than a "1 in 15". They knew that HBOS was in the meantime receiving special Government assistance to overcome liquidity pressures.

<u>The Recapitalisation</u>

306. The purpose of the Recapitalisation Weekend was to enable the Tripartite to give concrete form to the statements of general principle which it had made on 7 and 8 October 2008 and to announce those specifics before the market opened on 13 October 2008. Specifically the Tripartite was seeking to determine how much capital each bank

would require (i) to remain above prescribed minimum capital ratios given the losses and increases in RWAs which were calculated to occur in an assumed stressed scenario of a severe economic downturn and (ii) to continue to lend into the real economy in that assumed stressed scenario. In short, to render the banks "bullet-proof". It was hoped that these measures would restore the markets to normal functioning: and that the resumption of normal market functioning would reduce funding costs. The Tripartite had modelled a scenario in which reduced funding costs enhanced the return on equity enough to eliminate in the medium term the dilutive effect of the new capital issued.

307. Mr Sants gave some insight into the process in a letter which he wrote on 28 October 2008 describing the key factors as:-

> "1. Ensuring that the amount of capital for each institution would sustain confidence in that institution .
>
> 2. Ensuring that each individual institution would be able to have a sufficient Core Tier 1 capital, even after absorbing losses that might ensue from a severe recession….
>
> To ensure consistency the FSA used a framework which had a number of variables, the most important of which was that, by the end of 2008, each individual institution had to have a total Tier 1 capital of at least 8% and that their Core Tier 1 capital, as defined by the FSA, had to remain above 4% after the stressed scenario and above 6% on the company's central case forecast…
> "

308. Thus prior to the Recapitalisation Weekend the FSA's Executive Committee agreed the macroeconomic assumptions (reflecting a severe but plausible global economic slowdown modelled over 5 years) which would be used in the common stress testing exercise ("the Stress Assumptions"). Then the regulatory capital experts within the FSA together with each bank's FSA supervisor would apply the Stress Assumptions to that individual bank's balance sheet supplemented by the material gathered by the bank's FSA supervisor in the course of the continual monitoring of its liquidity and capital position under its Supervisory Review Evaluation Process (what Mr Sants called "the data we had in the building"). The FSA was later to refer to this as "weightings tailored to …specific institutions". The outcome was not the product of a mathematical calculation but included an element of judgment. The outcome was then shared with each bank. It was intended that each bank should then have the opportunity to proffer updated balance sheet data (and the FSA would decide whether it was appropriate to incorporate it in its modelling). Once the amount of the new capital to be raised had been determined there would necessarily follow discussion as to how it could be raised (by management action such as disposals or a reduction in the RWAs, by accessing the market, or by using the Treasury programme).

309. The amount of capital to be raised by a "standalone" Lloyds was determined to be £7bn.

310. In his oral evidence Mr Sants accepted that the FSA could not insist on an arbitrary "new capital" requirement, saying

> "We could choose to apply an amount of capital as long as the process to arrive that amount was justifiable and rational. That could include a judgemental element in relation to market confidence if we chose to. So it is not a mathematical calculation: it is a mixed mix of maths and judgement."

He went on to explain that the Stress Assumptions were not debatable by the banks:-

> "[T]here was a set of macroeconomic assumptions put in the stress test i.e. housing would go down X percent. Those were not debatable by the banks because they were the scenario that we, the FSA, supported by the authorities, had chosen to apply. They're not a forecast as to what was going to happen to the United Kingdom economy; it was a choice of the stress that we were going to apply… But that stress obviously is then applied to the bank's balance sheet, and we were, in the circumstances we were in, seeking to continuously monitor the liquidity and capital position of the bank. So the supervisors did have data on the state of a bank's balance sheet, as it were, in the building… and therefore once they had been given the parameters by the executive committee, they then applied that stress to the data they had in the building."

311. But some areas were up for discussion:-

> "[I]f a bank wanted to offer a more up-to-date data or say that we somehow or other – if we had made an actual arithmetical mistake – it's relatively unlikely, but it's possible; these are very very complicated models to work through, everybody was doing it in a very stressed environment. So if a bank had either fresh data or felt we applied our stress incorrectly to their data, then they could inform us of that, and it was the decision of the FSA whether to accept that new data or that perspective or not."

312. The proposal for the recapitalisation of Lloyds emerged in this way. It had been part of Lloyds' planning that (even absent the Acquisition) it needed additional capital, though it was initially anticipated by Mr Tookey that this could be raised through management action. When the Announcement was made there was a view in the market that, because of possible provisions for impairments and FVAs Lloyds would need to embark on a capital raising exercise. A note from Credit Suisse on 25 September 2008 put the suggested amount at £10bn: one from Deutsche Bank the same day put it at £4.5bn. As the Indicative Conditional Proposal acknowledged the Lloyds executive team also accepted that whether or not the Acquisition proceeded a capital raise was required (though they thought it could be argued that more was required if the Acquisition proceeded than if Lloyds remained a "standalone" bank). So following the Government announcements of 7 and 8 October 2008 and before the start of the Recapitalisation Weekend the Lloyds team (Mr Daniels, Mr Tate, Mr Tookey and Ms Sergeant) met with the BoE and the FSA and discussed a provisional estimate that Lloyds would need about £5bn additional capital and the combined entity about £17.5bn additional capital (though which entity was to take what portion remained to be determined). In the light of those preliminary discussions the Lloyds team considered the internal preparatory

paper put together by Mr Greenburgh, and formulated and then prepared and submitted the Indicative Conditional Proposal. This was rejected at about 4.30pm on 11 October 2008. The Tripartite was not prepared to let Lloyds take over HBOS (as entirely recapitalised with Government money) and at the same time waive all competition considerations.

313. At 5.00pm on 11 October 2008 Mr Fennell (the Head of the Major Retail Groups Division at the FSA) sent to Mr Gilbe (Head of Capital at Lloyds Group Corporate Treasury) a document called "The aggregate stress summary" which contained the stress assumptions and the calculated stress figures being used for Lloyds. It would not assist clarity were I to set out the Stress Assumptions (which consist of percentages and acronyms). Nor are the calculated figures resulting from the application of the Stress Assumptions illuminating, because there are no workings to show the underlying figures derived from Lloyds balance sheet or from "the data within the building" to which those Stress Assumptions were applied and which resulted in the calculated figure. But the result was that it appeared that in the scenario contemplated by the Stress Assumptions Lloyds needed to raise additional Core Tier 1 capital as a "standalone" bank sufficient to cover £6.494bn of adverse adjustments (of which £3.56bn resulted from losses, impairments and valuation adjustments, and £2.934 resulted from increased RWAs).

314. Mr Hill QC submitted (in my judgment, correctly) that of itself this document does not conclusively demonstrate the need to raise *additional* capital of £7bn: the document might show "raw figures" which would then need translation into capital adjustments. But the "aggregate stress summary" is the only document available within the proceedings relating to the calculation of the capital requirement for a "standalone" Lloyds. If there was some other element in the calculation then no surviving document records it. It is common ground between the experts that it is not possible to "reverse engineer" the process to identify the figures on which the FSA must have been working to reach the required capital raise.

315. The "aggregate stress summary" was seen at the time as highly significant; Mr Roughton-Smith was tasked with putting together a team seeking to understand and analyse the FSA numbers, whilst Mr Tookey contacted the Lloyds' Supervisory Team at the FSA seeking further information and offering to participate in a detailed discussion. Neither resulted in any additional light being thrown on the requirement. In the course of his calls (and later in e-mails) Mr Tookey told the FSA that Lloyds own "capital needs" assessment indicated that "standalone" Lloyds needed to raise only £3bn additional capital to ensure a Core Tier 1 ratio of 7% at the year-end in 2009 on a "1 in 15" credit crunch scenario. (The £3bn may understate the requirement because the supporting spreadsheet showed that this figure assumed no dividend in 2009 which was the equivalent of adding another £1bn to capital). In the evening of Saturday 11 October 2008 at the request of the FSA Mr Roughton-Smith sent to Mr Fennell some figures derived from his own modelling on the "Q3 MTP stress test". It is now not clear what this "stress" was: it may have been the Lloyds "credit crunch"/"1 in 15" scenario, or a slightly more negative version of it. Nor is it clear how it related to the FSA's severe downturn (or "worst shock") scenario: although it does appear (i) that the FSA "worst shock" approach assumed the simultaneous occurrence of all adverse events (and then added a further margin), whereas the Lloyds' modelling took account of events emerging over time; and (ii) that the FSA "worst shock" made more severe

assumptions in the specific areas of residential and commercial property markets, assuming a 50% "peak to trough" fall whereas Lloyds modelled a 32% fall. At all events the figures were at variance with those produced by the FSA on its scenario, with some differences arising from the tax treatment of impairments and losses, which reduced the FSA's £7bn requirement to about £4.5bn.

316. Neither Mr Roughton-Smith's efforts nor Mr Tookey's efforts yielded fruit. On the morning of Sunday 12 October 2008 Mr Sants telephoned Mr Daniels and told him that Lloyds had to raise £7bn in additional capital as a "standalone" bank, and that the capital requirement for the Enlarged Group would be an additional £17bn of which Lloyds would be required to raise £5.5bn and HBOS £11.5bn. If HBOS remained a standalone bank then it required £12bn. Mr Daniels described these requirements as "a completely different order of magnitude than what we expected". £7bn was equal to 60% of Lloyds' entire market capitalisation at the Friday closing share price. The numbers were indeed at first glance odd. Given the size and nature of Lloyds' asset base and the much larger, higher risk profile HBOS book, it was curious that Lloyds had to raise £7bn but HBOS only £12bn as "stand-alone" banks; and further that introducing the HBOS high-risk book into the Enlarged Group actually reduced the amount of capital required from Lloyds.

317. Of course, simple comparisons such as that might well be misleading. The variance may, for example, depend upon differing views taken by the respective FSA Supervisory Teams as to the level of provisions already made by the respective banks; or the extent to which the consequence of an internal ratings-based approach to valuing RWAs differed from a standardised approach in a stressed scenario; or how the incremental impact of a severe recession in which all stresses occurred simultaneously (as opposed to the economic model currently used for a particular bank) differed; or upon how the proportion of business exposed to a general vulnerability to a downturn in the UK economy (as opposed to the proportion of business exposed to calculable risks arising from specific lending structures) produced different requirements; or the impact of any insurance business element; or whether it was thought that Lloyds' management techniques would reduce anticipated losses on the HBOS book in the scenario of an enlarged group. The Defendants' expert Mr Sharma noted, for example, that from publically available information it could be demonstrated that Lloyds had a much higher proportion of "credit risk RWAs" to total RWAs than its peer group: of course he could not say that that feature *did* affect the additional capital required, and I do not find that any of the possible factors advanced in evidence (some of which I have listed above) were actually in play in the assessment of the Lloyds capital requirement. We cannot now know because it is impossible to derive the requirement for £7bn from the document that survives (and there is no equivalent material relating to the requirements for the Enlarged Group or for a "standalone" HBOS).

318. The nuanced position of Mr Sharma (from whose expert report I have drawn most of the possibilities outlined above) was summed up in this way:-

> "Q: The gist of your evidence, as I think you've just said, is that there are various possible factors which mean it's possible (but no more than that) that the stress test gives this outcome where the less risky bank (Lloyds) is required to have more capital than the more risky bank (HBOS)?

> A; Yes, I would have characterised it as plausible rather than merely possible.
>
> Q: We have been through the possible factors or explanations that you identify, and none of them are likely, are they, to explain why Lloyds should have a higher "standalone" requirement than HBOS?
>
> A: In my view, when I look at the totality of the explanations that I provided… they to me make the outcome of the stress tests entirely plausible. I can't go the stage further and say that I can take my explanations and use them to build an actual model for Lloyds and HBOS, and prove or disprove as a result of that. "

319. Mr Sharma went on to say that he had examined all of the inconsistencies suggested by the Claimants and all of the other potential inconsistencies that occurred to him, but was unable to conclude that they were in fact truly inconsistencies and had therefore concluded that the £7bn capital requirement for Lloyds was in fact probably consistent with a £12bn capital requirement for HBOS and a £17bn capital requirement for the Enlarged Group. I do not need to (and do not) follow Mr Sharma to this positive conclusion. It is sufficient to find that is clear (i) that the impact of stress tests embodying common macro-economic assumptions may have very different outcomes when applied to individual banks; but (ii) that the outcome in the case of Lloyds was open to challenge and merited discussion.

320. Mr Daniels recalls seeking an explanation, but being told that the figures were not up for discussion. His written evidence records:-

> "I then told [Mr Sants] that I wanted to talk to him about reducing both the Lloyds standalone capital number and the Enlarged Group's capital number, as we could potentially raise capital either through certain disposals or through other sources. He told me that there was no time to have these discussions because the FSA wanted an announcement to be made about the recapitalisation of Lloyds and HBOS before the markets opened the next day. If we wanted continuing access to SLS, we had to proceed in accordance with the FSA's instructions, and we could then discuss any issues later after the recapitalisation announcement was made."

Mr Sants confirmed this both in his written and in his oral evidence. Mr Daniels did not challenge the FSA's maths (as is common ground he could not simply on the basis of Mr Fennell's stress template). Accordingly, Mr Sants explained in his supplemental statement:

> "…what I was saying was that the way the capital was to be raised was discussable… Whether or not that capital was going to be raised from the market, by share issuance, whether it was going to be raised by government money or whether it was going to be raised by disposals was discussable. So the methodology of raising was discussable and the way the FSA would assess

> whether the plan being put forward was feasible would obviously be exercising judgement. So my role here was to engage in those conversations around the methodology of the capital raising…. The amount of money had been calculated: I was open to discussion as to how that money was being raised… The amount of capital… that the standalone Lloyds at that time had to raise was not discussable. What was discussable was how it was being raised, and therefore whether all of it had to be raised as external capital from shareholders..."

321. Mr Hill QC tested Mr Sants many times on this passage of his evidence. But his answers were consistent.

> "Q: Well, you were open, weren't you, to discussing the amount of capital injection actually required?
>
> A: No. Sorry. I think you misunderstood what I just said. Were you clear what I just said? I said the amount of money had been calculated; I was open to discussion as to how that money was being raised. "

Again:

> "All I can tell you is what I've told you now a number of times: that unless they pointed out to us inaccuracies in our calculation, the amount of capital that… the standalone Lloyds at that time had to raise was not discussable. What was discussable was how it was being raised, and therefore whether all of it had to be raised as external capital from shareholders. That is the way it was."

Again:

> "… [So far] as I was concerned, he could engage with me either to point out factual inaccuracies by the team, in which case obviously as the chief executive I had responsibility to engage with that – he did not do that – or he could engage with me around the questions of judgement which were principally focused on how the capital was to be raised. I was certainly taking responsibility for those questions of judgement…. He may well have chosen… to continue to want to return to some earlier questions, but that doesn't mean I was in any [way] open to returning to those earlier questions."

322. I accept this evidence as capturing the FSA's attitude during the recapitalisation weekend. I can see no purpose in Mr Sants insisting in evidence that he and the FSA were more inflexible and less open to reviewing their decisions than in truth they were, particularly where their original decision is not evidenced by any document setting out the reasoning that led them to their stated view.

323. Mr Hill QC also put to Mr Daniels that the £7bn capital requirement was itself negotiable (not merely *how* that £7bn should be raised).

> "Q: If in that discussion on a standalone basis it had become apparent there was no good justification for the FSA 7 billion figure, then obviously your discussions were likely to be more fruitful, weren't they, in negotiating the amount of capital?
>
> A: That… We had no expectation. I was hopeful but to say that we had an expectation of their being fruitful - I think that would be overegging the case."

324. The premise of the question (that it would become apparent that there was no good justification for the £7bn figure) is not one that can be established on the evidence. It is understandable why the capitalisation for the Enlarged Group should be lower than the aggregate of the capital required for two stand-alone entities: because of (i) synergies (ii) the application of the superior Lloyds' management techniques to the HBOS book (iii) the beneficial effect of Lloyds credit rating (iv) the elimination of the "credit risk" element of RWAs on what would become intra-group loans (where the counter-party risk no longer existed): and (v) the simple timing point that the peak capital requirement for Lloyds would not occur at the same time as the peak capital requirement for HBOS (which straightforward aggregation assumes).

325. What is not so readily understandable on the information available is (i) why the absence of the synergies available to Lloyds as a component part of the enlarged group and the persistence of the "credit risk" element of RWAs leads to a "standalone requirement" so significantly in excess of that required as part of the Enlarged Group: and (ii) why (in the absence of knowing the precise scenarios used in the modelling) there is an evident disparity between Lloyds' internal assessment of capital required and that estimated by the FSA.

326. On bare figures (based on data available on 15 October 2008) Lloyds had a pre-recapitalisation Tier 1 ratio of 8.6% (the same as HBOS and lower than most of its peer group). With a £7bn capital injection it would have had a Tier 1 ratio of 13% (the joint highest of its peer group) and (if the new capital was raised as planned through ordinary and preference shares) a Core Tier 1 ratio of 8.5% (compared with 6.4% as part of the Enlarged Group and the 6.8% Core Tier 1 ratio of an HBOS recapitalised with an additional £12bn). One must exercise considerable caution about comparing Lloyds with its peer group, because (i) there was no common agreement as to what precisely "Core Tier 1 capital" was and different banks assessed it differently and (ii) Lloyds' undertaking the Acquisition meant that its accounting treatment would differ from that of its peers. But on a more limited comparison one could certainly say that since the quality of the Lloyds asset book was higher than that of the HBOS asset book (and might therefore be less vulnerable in deteriorating conditions) one might in a general sense have expected the recapitalisation requirement of Lloyds to be proportionately lower than that for HBOS: but at £7bn it was not.

327. However, one cannot conclude from those considerations that in mid-to-late October 2008 it could be demonstrated by Lloyds that the FSA requirement of £7bn for Lloyds was arbitrary or irrational such as to compel an immediate concession of a significant reduction. (That of course is the question: not whether months later in judicial review

proceedings irrationality could be established, as the Claimants plead in paragraph 107(10) in their Re-Amended Particulars of Claim). With the benefit of knowing things about HBOS that were not known to Lloyds at the time (e.g. that HBOS was under-recognising impairments or not correctly assessing its RWAs) and with the benefit of knowing what in the event happened (e.g. the true extent of HBOS' losses in the actual recession that occurred) it is possible to demonstrate that the relationship between the capital requirement for HBOS and that for Lloyds was disproportionate. But that disproportion might be because the assessment of the capital requirement for HBOS was flawed as being too low. What Lloyds would have had to persuade the FSA of during the Recapitalisation Weekend was that on the FSA stress scenario the Lloyds requirement was too high.

328. As Mr Hill QC submitted there was some material available. The requirement to raise an additional £7bn entailed Lloyds having a higher capital ratio than any other UK bank, with a Core Tier 1 ratio of 8.5%. (as compared with 6.8% for a standalone HBOS). This was surprising given that Lloyds had a more conservative lending policy (and a higher quality book that was probably less vulnerable to deteriorating conditions) that ought to have been reflected in a lower capitalisation requirement if a consistent stress testing framework was applied across all banks. It was also surprising given that the market seemed to have more confidence in Lloyds than in HBOS. That was reflected in the fact that the Lloyds' Credit Default Swap ("CDS") spread was at the material time significantly narrower than that of HBOS. Of course, pursuing these general themes would also have compelled analysis of Mr Greenburgh's negotiating suggestion of £5.5bn additional capital for a "standalone" Lloyds adopted in the paper underlying the Indicative Conditional Proposal, of the £3bn/£4bn requirement suggested by Mr Tookey (and felt to be right by Mr Daniels), and of the figures produced by Mr Roughton-Smith in response to Mr Fennell's schedule. But it is not possible to compare what underlay those figures with what underlay the FSA calculations given the loss of documentary records. No expert now knows what model was run by the FSA and no back-calculation can be made.

329. It is essential to remember that the Lloyds' management had only hours to undertake *any* analysis of competing recapitalisation requirements, not the days that have been available in preparing and deploying evidence for a five-month trial; hours that had to be allocated amongst the competing demands of the Recapitalisation Weekend. In my judgment it cannot now be shown (nor could it then have been shown) that the FSA's £7bn recapitalisation requirement was so obviously arbitrary that over the course of the Recapitalisation Weekend the Tripartite would have been compelled there and then to reduce its requirement.

330. But if one accepts the premise of the question (that it would become apparent that there was no good justification for the £7bn figure), then Mr Daniels' evidence was unclear. At times he maintained that he understood that the *amount* of the capital to be raised was non-negotiable but the *manner* in which it was to be raised was discussable. At others he appeared to accept (in relation to Lloyds) that " if the deal were not to go forward…. we would have had to negotiate both the level and the terms of capital". Again (in re-examination about whether the HBOS (*sic*) capital requirements were "hard and fast")

> ".. We were given two sets of numbers by Mr Sants, we were each given the combined numbers and then each given an

> individual capital number. Now, once we had said that we were going ahead, the combined numbers were the ones that were germane. If we were not to go ahead, we were informed that, and we hadn't taken the government underwriting, both the amount of the capital raise and the ability to access the government capital would have to be negotiated, so those were not guaranteed."

These answers appear to acknowledge the possibility that in some circumstances the eventual capital requirement for a "standalone" Lloyds might be negotiable; and to suggest that sum might not be £7bn and might not be eligible for Treasury support. This requires examination.

331. Sir Victor was informed of these events. On the Sunday afternoon Sir Victor, Mr Daniels, Mr Tookey and Mr Greenburgh went to the Treasury and there met the Financial Services Secretary, Lord Myners and Sir Tom Scholar. Mr Tookey's notes record "L 5+2 Tripartite decision" and "we need to raise it"; and later "standalone 5+2 – 30% dilutive". I read these as shorthand references to the requirement to raise £5bn of conventional Tier 1 capital and £2bn in innovative preferred shares. The notes also seem to record a comment that the lower capital requirement for the Enlarged Group results from account being taken of synergies. There is no note of Lord Myners indicating that the requirement to raise £7bn was "discussable". But Mr Daniels does recall asking Lord Myners about the potential to raise capital from disposals or other sources in order to reduce the amount of capital that would have to be taken from the Government, both on a "standalone" basis and as part of the Enlarged Group. It is his recollection that Lord Myners responded that there was no time to discuss such proposals then but that they could be discussed after the announcement of the recapitalisation.

332. The context of many of the questions put to and answers given by Mr Daniels in cross-examination and re-examination related not simply to the events of 12 October 2008 but embraced events down to the issue of the Circular. Focussing on 12 October 2008 itself, I am clear in my mind that it was not possible, by mounting any such challenge, to reduce the £7bn requirement by discussion on that day, however strongly the views of Mr Daniels or Mr Tookey differed from those of the Tripartite as to what Lloyds needed. The true position is that £7bn is the sum upon which the Tripartite had settled and which Lloyds had to accept if Lloyds was to be included in the market announcement the following morning as receiving Government support. The true position was accurately summarised by Mr Tookey in an email sent at 3:14 PM on 12 October 2008:

> "Update on the deal and on the terms being IMPOSED on us which effectively force us to do it.."

333. The prospect of discussing *how* that figure *could* be raised (as between management action and fresh capital, and as between accessing the market and issuing preference shares to the Government) was on the table during the Recapitalisation Weekend. But there was no real prospect of discussing *whether* that figure *should* be raised. The negotiating position of the Tripartite was that the sum had been decided upon. On the Lloyd' side, Mr Daniels wanted to raise the issue: both because he thought £7bn would over-capitalise a "standalone" Lloyds compared to its peers, and because he did not like

the proposed terms of the preference shares to be taken by the Government and wanted to cut them down. But the Tripartite would not engage: and the best that could be hoped for was that it might engage to some degree after the market announcement.

334. What would a careful thinker (given time and space during the Recapitalisation Weekend) have made of the prospect of future negotiation with the Tripartite about the capital raising exercise? If Lloyds then and there accepted the required £7bn capital raise then the Government would always have stood by its commitment to contribute. But if (after participating in the recapitalisation announcement) Lloyds tried to renegotiate that requirement then there would be very significant doubt about the extent to which the Government would engage with process of reducing that £7bn.

335. In my view that engagement would depend upon the point in time at which the issue of Lloyds' "standalone" capital was raised. There is, I think, a real difference between Lloyds seeking to renegotiate the size of the proposed alternative "standalone" capital raise immediately after the public announcement and in the context of a continuing potential merger on the one hand, and re-assessing the size of the "standalone" capital raise at some later point in the context of the merger having been abandoned. In the former case, the attitude of the Tripartite would almost certainly have been "We stick by what we said unless you can show an error" because the Government wanted to foster the merger and to cut off alternatives. In the latter case, because the proposed merger appears to be off the table (itself a very disruptive event for the banking system as a whole with a threat of contagion for Lloyds and other banks) and because the Government is going to have to find a different solution for HBOS, the attitude of the Tripartite to an attempt by Lloyds to renegotiate its "standalone requirement" would probably have been have been: "How much you have to raise – be it more or less than £7bn– and the extent to which you can look to us to take some of the new capital on the original terms will have to be renegotiated: you cannot assume that what we said on 13 October holds good now because things have changed". As Mr Sants put it, when once again tested on the point:-

> "I am absolutely clear that what I've just said in the witness statement is exactly the same as what I've just said to you…. But I've made it clear, quite clearly, that we react to changing circumstances, we engage in a continuous supervisory approach, and if circumstances had changed, we would have always looked again."

336. So the effective choice that had to be made during the Recapitalisation Weekend was between (i) accepting the Tripartite's recapitalisation proposals (both as regards a "standalone" Lloyds and the Enlarged Group) and hoping to negotiate modifications later; and (ii) standing aside from the recapitalisation process, explaining to the market that Lloyds itself thought it was stronger than its regulators did and so would not be complying with its regulators' requests, and taking the risk of looking to a market (which knew that Lloyds was not meeting its regulatory requirements) to provide the amount of capital which Lloyds itself acknowledged was needed. Looking to the market was indeed a risk: as Mr Daniels put it in cross-examination:-

> "The markets were difficult at that point…We didn't think they would always stay closed. We were hopeful…if we were able to get a reasonable capital requirement , that we could raise some

> or all of the money in the markets. But at that particular moment
> the markets were closed."

337. Making the choice between accepting the Tripartite's recapitalisation proposals and standing aside from that process could not be divorced from a decision on the Acquisition.

The Revised Announcement

338. From shortly after the original Announcement the rapidly deteriorating financial situation had led to the tentative exploration of the idea of renegotiating the terms of the Acquisition. On 26 September 2008 a meeting took place at the Bank of England to discuss the Acquisition. In his written evidence Mr Daniels says that he spoke to Mr King about renegotiating the deal if market conditions continued to deteriorate, though he found Mr King to be resistant. Mr Tate stated in his evidence that he considered by that time that the terms of the Acquisition needed revising but that Mr Hornby of HBOS was also resistant to a renegotiation. The Lloyds team certainly did not have a blind commitment to carrying into effect the terms of the Announcement: HBOS probably did.

339. At the beginning of October 2008 the market began to speculate whether the Acquisition would proceed: but towards the end of the first week it began to settle down with an expectation that matters would proceed. Then came the Government announcements of 7 and 8 October 2008.

340. These announcements clearly made a reconsideration of the Acquisition imperative and inevitable: and the product of the due diligence gave Lloyds the material to do so. On 11 October 2008 following the rejection of the Indicative Conditional Proposal made to the Treasury work began in Lloyds on drafting a press release stating that Lloyds was walking away from the Acquisition (because "it was not possible to proceed with a transaction that would both recognise the UK Government's full investment in HBOS and be in the interests of Lloyds shareholders") and that Lloyds would seek additional "standalone" capital of £3bn: and an internal email from Mr Tookey at 09.14am on 12 October 2008 (the Sunday) suggested the Acquisition could go either way.

341. During 12 October 2008 at the same time as negotiating with the Tripartite, Lloyds was both negotiating with HBOS and assessing the impact of the recapitalisation proposals upon the Acquisition.

342. The negotiations with HBOS were undertaken within the tight timeframe set by the Tripartite, namely that decisions whether to accept the Government's recapitalisation proposals and whether to proceed with the Acquisition had to be reached by the evening of 12 October 2008 so that the market announcement relating to *all* banks could be made when the market opened on 13 October 2008. They were conducted on the Lloyds' side by Mr Daniels and by Mr Greenburgh in "face-to-face" and "breakout" sessions (with reference back to Mr Tookey). HBOS was looking for a price per share of about £1.60p. But as part of the recapitalisation package it had had to offer new shares to the Government at £1.11p. The Lloyds team went into the negotiation armed with the work that had been done by Mr Roughton-Smith on impairments, with Mr Foley's views on the economic outlook and with their own recent experience of the cost of capital: and (it appears) with the aim of securing the agreement of HBOS to a

takeover at £1.11p per share. This HBOS would not agree. One of Mr Tookey's contemporaneous notes records a report that HBOS was "astonished" that Lloyds should offer below the Friday closing price. There followed a lengthy and tense negotiation. The outcome was an "in principle" agreement on a revised ratio of 0.59 Lloyds share per one HBOS share. This was intended to represent the close of market prices of the respective shares on Friday, 10 October 2008, but with a 10% haircut applied to the HBOS price i.e. the same as the Government price. In broad terms this represented a reduction in the price that Lloyds was paying from approximately 60% of the HBOS book value to about 30% of the HBOS book value, reflecting a discount of approximately £14bn for potential after-tax fair value adjustments and write-downs (which Mr Roughton-Smith had estimated at £9.7-15.4bn for 2008).

343. The assessment of the impact of the recapitalisation upon the Acquisition was undertaken by UBS. A number of documents have survived, and their form and structure reflect the rapidity of their preparation: they seek to model such things as the Core Tier 1 ratio, the RWAs, the EPS impact and the return on equity on a number of different assumptions and in the light of evolving figures for Q3 forecasts and reviewed writedowns (resulting from overnight work continuing into Sunday morning).

344. A board meeting was convened for 7.00pm on Sunday 12 October 2008. At this time negotiations with the Tripartite over the recapitalisation were very well advanced, although matters of detail remained to be settled: in particular, the initially indicated £17.5bn additional capital for the combined entity was being reduced to £17bn. All of the Lloyds directors (save Mr du Plessis) were present in person or by telephone. Of the Lloyds' non-director executive team Mr Tookey, Mr Pietruska and Ms Sergeant were in attendance: as were the advisers Mr Greenburgh of Merrill Lynch and Mr Willmot-Sitwell of UBS. The purpose of the meeting was to enable the executive team to "walk" the board through the events of the Recapitalisation Weekend and to obtain a decision upon what was to be announced to the market twelve hours later .

345. It is well to begin with the Minutes of the meeting. The Minutes record that Mr Daniels began with an update to the board of the events following the government announcements of 7 and 8 October 2008. He made clear that participation in the Government "rescue programme" was not mandatory, but that in order to continue to have access to the Government guarantee for medium term funding it was necessary for a bank to be able to establish that it was "well capitalised". Discussions with the Tripartite as to what "well capitalised" meant for Lloyds itself had revealed that for Lloyds "the final view of the Bank of England had been that £7 billion of additional capital was needed by the bank". He noted that the Bank was "becoming increasingly reluctant to fund HBOS". (A surviving handwritten note of the meeting made by Mr Kane records that the Bank was looking to Lloyds to fund HBOS to completion of any acquisition). The Minute is not expressed in sufficiently full terms to treat this as notice to the board that HBOS was in receipt of some specific and entirely discretionary line of funding (such as ELA). Mr Daniels disclosed that the Tripartite was supportive of an enlarged group with a combined capital injection of £17.5 billion. Taking that into account he told the Board that a revised proposal had been put to HBOS based on a share exchange ratio of 0.59 Lloyds share for each HBOS share. He explained that if accepted this would result in the Government owning approximately 40% of the Enlarged Group (assuming Lloyds shareholders did not themselves take up any of the new capital).

346. Mr Daniels went on to deal with the terms upon which the additional capital would be available (dealing with the coupon on the preference shares, the restriction on dividends, the restriction on bonuses for directors, and nomination rights to the board). It seems clear from the significance accorded to issues like restrictions on dividends and on directors' bonuses (and from the fact that they formed part of the subsequent board discussion) that nobody present was contemplating a looming recession of such depth and length that dividends and bonuses would be an irrelevance. At the conclusion of his update he is recorded as saying:-

> "It was clear that HM Government would take steps to recapitalise the banks in order to make them "bullet-proof". The amount of capital to be raised by the group, whether stand-alone or enlarged, was not negotiable. The only choice was whether to raise the capital as equity or Preference Shares. Capital in these amounts was not available from other sources and the Government was demanding announcement by the following day. [Lloyds] could either decide to proceed with the acquisition of [HBOS] (assuming the board of [HBOS] agreed the revised terms) and raise capital jointly with [HBOS] for a total of £17.5 billion or to proceed without the acquisition of [HBOS] and raise capital of £7 billion. "

347. The board was then advised by Mr Greenburgh, whose reported views are as follows:-

> "…it would not be possible for the bank to access the government's guarantee in respect of medium term funding without a capital raising of this size but it would prove to be very dilutive. In comparison the acquisition of [HBOS], compared to the stand-alone position, whilst also dilutive was enhancing when the synergies were taken into account. The new terms proposed to [HBOS] had also contributed to a de-risking of the transaction. Whilst therefore, there was value destruction inherent in the capital raising required by HM Government the acquisition of HBOS was far less destructive of value and offered the potential to create value as a result of the transaction… [T]here was currently no market for the issue of bank preference shares and he was of the view that it would also not be possible to raise £5 billion in equity capital particularly when the other issues currently being undertaken by banks were taken into account. Consequently, the bank's only access to share capital at the current time was through the government's scheme and the better way to access that capital was by accessing it as part of the [HBOS] transaction."

It is possible to make out from some contemporaneous handwritten notes made by Mr Tookey at this meeting which have survived that Mr Greenburgh provided the meeting with figures. A recapitalisation of a standalone bank by means of the issue of £5bn of Tier 1 capital and £2bn of preference shares would be about 30% EPS dilutive. If the HBOS deal was done and the new capital taken then by 2011 (i.e. year 3) the transaction could be 20% EPS accretive.

348. The board was then advised by Mr Wilmot-Sitwell. His recorded views are as follows:-

> "There was a very clear choice for the board to take between the stand-alone capital raising and a combination. He endorsed Mr Greenburgh's view that the combination was less destructive of value in terms of shareholder dilution. In his opinion the board should decide on a strategy that had the best long-term benefits with a view to achieving the most rapid exit strategy for HM Government in relation to its shareholding. Mr Wilmot-Sitwell advised that he was reasonably confident that it should be possible through a process of clawback to reduce HM Government's shareholding as well as by means of a share placing in due course. In his opinion, therefore a combination with HBOS was the more attractive of the two alternatives although he acknowledged that the steps being imposed on the banking sector were very Draconian."

349. The board then embarked upon discussion: part-way through it (and before any decision had been taken) Mr Daniels left. The terms of the Minute enable some of the topics covered in that discussion to be discerned. First, the board looked at the progress of due diligence and was satisfied that it was now proceeding more smoothly. Second, the board looked at impairments and noted that the due diligence had been reviewed on a "1 in 15" basis but had not been stressed on a "1 in 25" basis, so that there was a risk of higher impairments should that scenario be relevant. Mr Daniels said (and I consider it probable) that that brief note records the occurrence of a discussion but does not attempt to summarise its extent or content. It is not possible to identify what papers were tabled at the meeting but given that the board looked at "impairments" it seems to me inherently probable that they had available to them in some form the impairment figures produced by Group Risk in the range £16.2-£25.5 bn, but knew them to be provisional and subject to work that was even then being undertaken on further data. Third, the board considered the impact upon the Lloyds' franchise of the Government becoming a major shareholder. Fourth, the board compared the alternative proposals.

350. Neither the official minutes nor the surviving handwritten notes of Mr Tookey and of Mr Kane give any real insight into the nature or depth of the discussion of the alternatives. Looking at the inherent probabilities it seems to me that it is likely that it was robust, but acknowledged that the proposal had a history. At the meeting on 26 September 2008 the board had adopted a cautious approach and had not evidenced any desire to proceed headlong with the proposed transaction. There was now the new element of enforced recapitalisation: and the amount of additional capital that the Tripartite was requiring a standalone Lloyds to raise was above the expectation of the executive team and greater than anything that had previously been put before the board. Moreover, the terms upon which capital would be made available to the combined entity were in some respects stringent. Further, the market had deteriorated since the Announcement to the extent that the original deal no longer stacked up. It is unlikely that this highly experienced board decided to plunge ahead with the acquisition of HBOS, carried away by the prospect of a "once-in-a-lifetime deal", without testing whether the strategy of growth by acquisition could survive the Tripartite's requirement for the "bullet-proofing" of the banks.

351. That estimate of the probabilities is supported by the evidence of those actually involved. It is not realistic to expect any detailed recollection of the course of the debate. But it is entirely credible that the participants should have a recollection of the sense of this crisis meeting. Mr Daniels (who was not present for all of the meeting) recalls a wide ranging discussion in which the board members generally participated, with a number of good questions being asked. When cross-examined about the brevity of the note concerning impairments in a "1 in 25" scenario and invited to accept that there was no attempt to discuss or factor in or identify or analyse the consequences of those risks he said: "That is absolutely a conclusion I do not agree with". That was the tenor of his response to other similar questions. But he readily acknowledged that because the relevant information was recent and the situation complex and developing, any analysis presented to the Board could not be thorough: in another passage of cross-examination he said of the emerging material that he had the benefit of calculations, albeit not as thorough as they eventually ended up undertaking, but enough to provide "a pretty good indicator". Mr Tate (who participated by telephone) thought the Board conducted a robust and considered examination of the relative attractions of the courses open.

352. Mr Kane recalls that notwithstanding the pressure put on Lloyds by the Tripartite to reach a decision that evening the Board carefully reconsidered the Acquisition to see if it still made commercial sense: and he felt that if HBOS did not renegotiate a sensible price (based on a discount to the Friday closing price) then Lloyds would have considered walking away. He thought that the board pondered the various inputs. Dr Berndt thought that the directors had remained firmly focused on ensuring that the proposed acquisition was appropriately scrutinised from all angles. Mr Pietruska recalls the agitation of the board at learning of the Tripartite's requirement of a £7bn capital injection into a standalone Lloyds, and the collective intake of breath as the investment bankers were asked whether Lloyds could raise that sum without Government aid. There is no question but that this is the honest recollection of each of them: they are not lying. I have of course had to consider whether it represents a collective self-delusion: this is what they ought to have done and so each of them believes it is what they actually did. But having seen them (and having seen some of them cross-examined at very considerable length) I do not believe this to be so. Their evidence is supportive of what I regard as the inherent probability.

353. But whilst expressing the view that the Board was not bedazzled by the possibility of transformational change and was not determined to proceed headlong (but rather questioned what course ought to be taken), it is right to observe that the board was not starting afresh with a blank sheet of paper. It had a long-established strategy to grow the business, and to do so by acquisition: and it had already expressed a desire to acquire HBOS.

354. I am sure Mr Tookey is right in his recollection that

> "…the general tone of the discussion was, I would accept, one of a desire to continue with the transaction, recognising that it was substantially or materially – whatever the right word might be – de-risked from the actions that the government were taking over the week-end, and likely to be benefitting from the significant insight that the regulator would have had as to the way that the target business would perform in a stress."

I am equally sure that Mr Pietruska captured the essence of the choice facing the board when he described it as a choice between (i) "boring old Lloyds" with the same strategic vulnerabilities or (ii) the enlargement of the business to achieve a 30% market share and the benefit of synergies; but in each case with (to differing degrees) shareholder dilution and substantial Government ownership.

355. At the conclusion of the discussion (and in the absence of Mr Daniels) the board endorsed the continuation of discussions regarding a combination with HBOS and noted that the steps would be taken to secure the best available terms in relation to capital raising. They authorised a committee (consisting of Mr Daniels and any two other directors) to do whatever was necessary in relation to the offer for HBOS, the issue and admission of ordinary or preference shares, the making of announcements and the convening of meetings and the settling of any relevant documents.

356. In the early hours of the morning of Monday 13 October 2008 shortly before the market opened Mr Hornby of HBOS telephoned Mr Daniels to point out that there was a difference over the application of one of the calculations and that the correct exchange ratio was 0.605 of the Lloyds share for each HBOS share. Mr Daniels accepted the point. It was not suggested at trial that this was a significant change in the grand scheme of things.

357. There was another change effected in the early hours of Monday morning. Mr Tookey gave evidence that at about 4.00am on Monday 13 October 2008 he was telephoned by the Bank's legal advisers who informed him that the Bank required (effectively as a condition of continued support) the removal of the "material adverse change" clause which the initial acquisition agreement had contained, and which empowered the Lloyds' board to withdraw from the Acquisition without penalty in defined circumstances. The choice as he saw it was whether to acquiesce in the change or whether to attempt to reconvene a board meeting at 5.00am. The advantage to the Bank was that the change cut off one exit route from the transaction (into which the Tripartite was increasingly anxious to tie Lloyds). The consequence for Lloyds was (i) that in the perception of the market the change would signal a reduction in the risk of the transaction not proceeding, and so reduce the share price volatility which that risk generated; (ii) it left unaffected the power of the shareholders to reject the Acquisition should any materially adverse changes actually occur (though, I would observe, it did leave Lloyds exposed to material adverse change after shareholder approval but before completion); and (iii) co-operation with the Bank reduced the risk of the Bank restricting Lloyds' access to SLS or to guaranteed funding or reducing its assistance to HBOS. Putting on one side for the moment Mr Tookey's analysis of the pros and cons of the change, taking the evidence as a whole I do not think this account is wholly accurate.

358. Mr Daniels also gave evidence that late on Sunday or early on Monday *he* was contacted by a Treasury representative requiring the removal of the "material adverse change" clause in order to reduce the risk of the deal not proceeding, a proposal which he discussed with Mr Tookey, and also with Sir Victor and Mr Parr before acceding to it. This strikes me as a more probable account of the actual events (and accords with the recollection of Sir Victor, though not of Mr Parr): however, I consider it probable that Mr Tookey's analysis of what drove the request and what drove the acceptance is entirely correct. The evidence of Mr Parr (which I accept) was that in terms of the transaction itself (as opposed to signals and levers) the alteration was not of great

practical consequence, MAC clauses not being regarded as especially commercially valuable since the circumstances in which the Takeover Panel will permit them to be activated are extremely limited.

359. When the market opened on 13 October 2008 Lloyds made its announcement ("the Revised Announcement"). The Acquisition would proceed but with 0.605 Lloyds share for each HBOS share. There would be a recapitalisation of the Enlarged Group of £17bn. Lloyds would be raising £5.5bn of new capital: £4.5bn of ordinary shares would be taken by the Government at £173.3p per share (an 8.5% discount) subject to clawback by existing Lloyds shareholders, together with £1bn of preferred shares. The Revised Announcement explained that Lloyds had had discussions with the Treasury on the additional capital that the Government required Lloyds to have if it was to retain access to Government-backed provision of liquidity. HBOS was to raise £11.5bn (split as to £8.5bn in ordinary shares and £3bn in preferred shares). The commercial logic behind the takeover was explained again: and a number of indications were given about the shape and objectives of the Enlarged Group. The Revised Announcement explained that the Acquisition was conditional upon the absence of any reference to the Competition Commission, the passing of the necessary resolutions at an EGM of Lloyds' shareholders, and the requisite approvals from HBOS.

360. It is not possible to ascertain from movements in the relative share prices of Lloyds and HBOS what the market thought of the Acquisition following the Revised Announcement because of the heavy overlay of the recapitalisation itself. First, the effect of the recapitalisation was that Lloyds (in common with those other banks who submitted to the Government directive to cease dividend payments in order to fund lending to SMEs and other businesses) had ceased to be an "income" stock, resulting in the emergence of sellers. Second, the terms of the announcement by the Government gave the impression that Lloyds was to be ranked alongside HBOS and RBS, whereas the Lloyds' team had understood that they would be clearly differentiated. So Lloyds had to embark on a communications offensive to re-assure investors.

361. Reflecting on the events of the Recapitalisation Weekend (and writing on 16 October 2008) Mr Tate expressed his own view to the market in these terms:-

> " The vision was to combine two of the strongest franchises in the UK to create a powerful platform which would provide greater breadth of choices to the consumer and would create value for shareholders, employees and customers alike. Why? Fundamentally, we share a customer/relationship focus we have complementary footprints (we tend to have smaller shares of markets where they have largest shares and vice versa) and we have some of the most desirable and trusted brands in the country…. We have gained access to approximately 20,000,000 customers and, combined with our own passion and expertise in cross selling, we should open up this opportunity as never before….. There has been much noise around the fact that their profits were derived from an unsustainable business model and that might be the case… if nothing was changed! The fact is that we have the opportunity to marry so many of their strengths with our prudence, our disciplines and our culture and, while the shape will be altered, we have no doubt that the profit

> opportunity more than merits the investment. We have looked closely at the value of their assets and, without question, there will be adjustments…. But a combination of the cost of the acquisition to us and the steps that we can take going forward… make us confident that the economics more than a work."

Key external events following the Revised Announcement and before 29 October 2008

362. I will again look at events thematically rather than attempt a comprehensive chronological account. I begin with competition issues.

363. On the domestic front on 24 October 2008 the OFT issued its report on the Acquisition and on the same day legislation was introduced giving the Secretary of State for Business, Enterprise and Regulatory Reform the power to not refer a proposed transaction to the Competition Commission if it would be in the public interest not to do so in order to ensure the stability of the UK financial system. The legislation was passed. On 31 October 2008 Lord Mandelson (who had become the Secretary of State for Business, Enterprise and Regulatory Reform on 3 October 2008) decided not to refer the Acquisition to the Competition Commission. In doing so he relied on a submission from the BoE that a failure of HBOS risked contagion of other financial institutions, the re-emergence of a loss of confidence, and significant negative consequences for the UK economy overall. He also received and took into account advice from the FSA that temporary public ownership would not cure the structural weaknesses in HBOS' balance sheet, whereas a merger would provide a sustainable medium term future for HBOS: by this the FSA meant that through a change of management and the introduction of Lloyds' expertise there would arise an opportunity to revise, reform and refocus the HBOS business model. Domestic competition issues were therefore overcome in the way envisaged since the possibility of the Acquisition was first canvassed.

364. But there was also an EU aspect, generated by the Government support for the financial system announced on 8 October 2008 and given shape over the Recapitalisation Weekend. On 11 October 2008 the European Commission was notified of the UK Government's proposed support measures, though there is no suggestion in the evidence that anyone in the Lloyds team was aware of that. However, the thought did occur to Mr Parr of Linklaters on the Saturday of the Recapitalisation Weekend (11 October 2008) that the proposed Government recapitalisation might be regarded as State aid, and would therefore raise issues of European competition law. The evidence establishes that he raised the possibility in discussion and that Slaughter & May (legal advisers to the Treasury) gave oral comfort that State aid issues were being addressed by the Government. This is reflected in the terms of the Revised Announcement which indicated that EU requirements in relation to state aid issues would be met by a restriction upon the growth in balance sheet volumes.

365. Late in the evening of 22 October 2008 Linklaters submitted to the Lloyds team a memorandum of advice. In essence it said that everyone was in uncharted waters, and that in the absence of precedents the EC was seeking to approach the recapitalisation plan as something of a hybrid between state aid to remedy a serious disturbance in a

member state and state aid to facilitate rescue and restructuring. The memorandum said:-

> "Having spoken to Slaughter & May who act for the Government on this, it seems that neither HMG nor the EC has a clear or detailed picture of what the restructuring plan would look like in this case. Further, it is particularly unclear whether EC appreciated that by the time the six months were up the LTSB/HBOS merger would have completed and so a single or merged plan would be submitted. The Slaughter's view was that the plan would show how recipients were planning to wean themselves off the guarantees and seeking to exit structurally loss-making businesses… It will also need to cover the likely duration of the Government stake and plans for redeeming/otherwise dealing with the prefs. More generally though Slaughters are clearly not expecting this to be too controversial."

366. The message that the Lloyds' team received was that its plans for the integration of the HBOS business (including the elimination or reduction of loss-making activities) and for the redemption of the preference shares would probably suffice as a restructuring plan. But after about a week it became apparent that in order to satisfy the EC the Government might require a more formal restructuring plan (possibly requiring a downsizing of the Enlarged Group). Such a move would tend to negate the synergy benefits of the Acquisition. So by 23 October 2008 Mr Daniels was recommending the Board to send a clear message to the political establishment that any intervention to restrain or break up the Enlarged Group was unnecessary and would frustrate the achievement of the public interest benefits of the merger (so as to influence the direction of travel, which was far from clear). The inchoate risk of restructuring could be mitigated by adopting a relatively conservative approach to the estimation of such prospective benefits: and this was done. Although at a stretch the synergies might amount to £2.4bn Lloyds generally said that they would "exceed £1bn". (The slant of this litigation has meant that there has been little consideration of synergies: but it is important to appreciate that when a figure is put upon anticipated synergies the figure is an annualised one. In total Lloyds anticipated synergies of between £5bn - £8bn).

367. In fact, the signal from the Government was that a downsizing of the Enlarged Group was not a significant risk. When considering the question of a reference to the Competition Commission the Secretary of State had a power (under s. 43(4)(b) of the Enterprise Act 2002) to require Lloyds and/or HBOS to give undertakings as to restructuring in order to address or mitigate anticipated competition concerns. Notably he did not do so. I take this as an indicator that the Secretary of State did not at that point anticipate that any significant divestment programme would be required to address the competition consequences of any state aid issues.

368. Just to tie off this theme, that signal from the Government was later affirmed. Lloyds had been pressing for some written record of the Government view, and this was provided in a letter from the Treasury on 31 October 2008 in these terms:-

> "The Commission has already approved the overall recapitalisation scheme, and has indicated that it will work

> expeditiously to scrutinise individual restructuring plans. It has also indicated that ….. in scrutinising plans it will take into account whether banks' difficulties are due to the present extreme situation in the financial market rather than a structural solvency issue linked to their particular business model or investment strategy. The key requirement for a successful application will be a plan that demonstrates a clear path to an exit from state aid. Central to that will be adequate capital and liquidity, and future profitability. You indicated to us that your plan would meet these requirements and we have undertaken to work constructively with you to secure Commission approval."

369. The second theme I want to take up relates to capital. Following the Revised Announcement discussions continued with the FSA focused upon the capital requirements of the Enlarged Group. Mr Daniels records in a report to Sir Victor on 17 October 2008 Mr Sants' acknowledgement that there had not really been any discussions over the Recapitalisation Weekend regarding an adjustment to the amount of capital that the Enlarged Group should carry, and that the FSA had not had the opportunity to consider available managerial actions which might be factored into the analysis. These, Mr Sants is recorded as saying, were "absolutely discussable" and that he would be flexible. In cross-examination Mr Daniels accepted that if the capital requirements for the combined group were "discussable" then so also must have been the capital requirements for a "standalone Lloyds" (insofar as that remained a relevant comparator).

370. The strategic objective of the Lloyds' team was to reduce the size of (or eliminate) the issue of £1bn Preferred Shares, which were expensive (with a 12% coupon) and disruptive (because they were one of the reasons why dividends on ordinary shares were blocked). The campaign plan was to produce proposed managerial actions in a sum equal to the proposed issue of Preferred Shares, and to suggest to the Government that the existence of plans for the former obviated the need for the latter.

371. Mr Daniels took the view that the capital raising requirements put upon Lloyds during the Recapitalisation Weekend were not remotely fair, and he (with the assistance of Mr Tookey) set about trying to achieve a reduction so that the eventual circular to shareholders could announce a lower requirement. He pursued the matter with the FSA. On 16 October 2008 Mr Sants said that he would not re-open the historical discussion of the Recapitalisation Weekend, but he invited Mr Daniels to come forward with a series of management actions to reduce the capital requirement of the Enlarged Group. The same day the supervisory team for Lloyds at the FSA told Mr Tookey that no new capital numbers would be agreed at that time, but that a process of "understanding" could begin.

372. The following day (17 October 2008) Mr Tookey and his team (with the assistance of UBS) nevertheless set about showing how management action could reduce the need for some extra capital. They expressed the view that the Recapitalisation Weekend had run to a very compressed timetable which had left them with the feeling that they had not been able fully to explain their capital position, the conservative nature of their forecast and the robustness of their marks. Their presentation to the FSA sought to

demonstrate that the preference shares were not required (and indeed in some respects had adverse consequences), and that only £13bn (not £17bn) was required as additional capital for the Enlarged Group. On that footing Lloyds was predicted to have a Core Tier 1 ratio of 8.2% in 2009 on its central case, and 6.6% on a pessimistic case. The Lloyds team stated that they wanted to put in the proposed Circular a lower figure for additional capital than that presently required.

373. Mr Daniels repeated this line in a telephone conversation with Mr Sants on 22 October 2008 (the speaking notes for which survive) in the course of which he appealed for a swift solution to the discussions which the teams from FSA and from Lloyds were having. In these discussions the additional capital requirements of the Enlarged Group "got more airtime" as Mr Daniels put it, because that was the publically announced plan. However, it is not the case that all mention of the "standalone" alternative for Lloyds was entirely overlooked (and there is documentary reference to it, in particular the Lloyds' presentation worked out the comparative Core Tier 1 ratio for a "standalone" Lloyds on the basis of £5.5bn capital contribution which eliminated the preference shares). But since the objective of the campaign was to secure a lower capital requirement for announcement in the shareholder circular I do not consider that there was any concentrated attempt to renegotiate the capital requirements of a "standalone" Lloyds. However, any such a discussion would inevitably have covered substantial parts of the same territory, in particular whether anticipated managerial actions, in this case relating to Lloyds alone, should be taken to reduce capital requirements.

374. On 23 October 2008 Mr Daniels wrote to Mr Sants with a plan to dispose of five identified assets by the second half of 2009, setting out the benefit to Tier 1 capital of so doing. He continued:-

> "The disposals and the risk reduction measures set out above would, if all achieved, significantly change our capital and risk profile and provide some £2.6 billion of relief at core Tier 1 capital level against the FSA's severe stress scenario. We did not have time to discuss these matters during the weekend capital discussions nearly 2 weeks ago but reflecting on our commitment to the above points, I believe that I am being entirely reasonable in asking for a reduction of £2 billion in the amount of share capital that the government are requiring us to take."

This letter was the subject of telephone conversations between FSA officials and Mr Tookey. Mr Tookey urged that the FSA's modelling had not sufficiently factored in existing balance sheet impairment provisions so that any further reduction in the estimate of Lloyds' present capital position (at which the FSA was hinting) would be resisted: and he pressed the case for account to be taken of planned disposals. In the course of that conversation the FSA made clear that on their stress assumptions the Core Tier 1 ratio of the Enlarged Group under the present recapitalisation plan was projected to be 4.6% at the end of 2008. That was, of course, above the 4% minimum in extreme stress which the FSA required: but a reduction of £2bn in the proposed recapitalisation would have put that at risk.

375. At the same time UBS and Merrill Lynch prepared a proposal to the Treasury with the same objective, namely, a £2bn reduction in the requirement for new preference shares

as a result of management commitment on disposals and potential actions in respect of debt restructuring.

376. Neither approach was successful. The determination of the appropriate level of capital was the responsibility of the FSA. On 24 October 2008 the FSA team made clear its expectations on capital. Banks had to meet a 6% Core Tier 1 ratio and an 8% Total Tier 1 ratio on their base case. If a bank were to fall below the 6% ratio then the FSA would expect that bank to discuss the reasons for this and to agree an appropriate course of action to restore the ratio to 6% within an appropriate timescale. In an extreme stress scenario a 4% Core Tier 1 ratio would be acceptable, but that was the minimum amount necessary to give the FSA comfort that a bank would survive a deep recession. The FSA considered that with a capital addition of £17bn the Enlarged Group would have a Core Tier 1 ratio of 4.6% in a deep recession. If this view prevailed then the elimination of the preference shares was not achievable.

377. Mr Sants then wrote on 28 October 2008 recording his view of what had happened and his view of the way forward. By way of explanation of the stress test he wrote:-

> " The underlying assumptions utilised in the stressed test were of a standard type, but the overall weightings were, of course, tailored to the specific institution. To ensure consistency the FSA used a framework which had a number of variables, the most important of which was that, by the end of 2008, each individual institution had to have a total Tier 1 Capital of at least 8% and that their Core Tier 1 Capital, as defined by the FSA, had to remain above 4% after the stressed scenario and above 6% on the company's central case forecast… It is important to recognise that this approach has been adopted in the context of implementing the Tripartite support package. This included access to Government support through the Credit Guarantee Scheme, and the level of capital required for that was determined by a thorough and consistent application across institutions of the framework described above. It should not be presumed that this represents the FSA's view of the appropriate long-term capital framework for deposit taking institutions."

He then put on record (with the specific and expressed intention of "avoiding confusion") the FSA's view of what that meant for Lloyds (as part of the Enlarged Group and as a "standalone" entity). For a "standalone" Lloyds: £7bn consisting of £5bn ordinary shares and £2bn preferred shares. For the Enlarged Group: £17bn of which £4.5bn ordinary shares and £1bn preference shares would be "allocated" to Lloyds.

378. As to the request to reduce the immediate capital requirement in the light of planned future disposals, Mr Sants formally responded:-

> "In principle, I agree it would be reasonable for the FSA to take into account such a course of action. However, given the uncertainty in the current market conditions of executing the disposal strategy, and of possible valuations, I believe it is more appropriate to consider the option of the subsequent disposals

> paying back an element of the capital programme rather than modifying the agreed level of capital at the outset…. May I also stress that if the HBOS merger were not to occur, our capital requirement of £7 billion from Lloyds TSB alone made up of £5 billion of equity and £2 billion of Tier 1 instruments remains unchanged."

379. That is in my judgment an accurate and authoritative summary of the FSA's internal view during and following the Recapitalisation Weekend. It was consistent with the messages that the FSA had been sending in the course of telephone conversations between its team and the Lloyds team since the Recapitalisation Weekend, so that whilst the Lloyds' team was disappointed by the formal response, it was not surprised by it.

380. It is here appropriate to expand a little upon the 4%/6%/8% capital adequacy test points identified by the FSA, and to make two points.

381. First, the FSA statements of this test might be read as communicating that for the duration of a period of extreme stress a 4% Core Tier 1 ratio would be regarded as acceptable; or they might be read as communicating that at the commencement of a period of extreme stress a 4% Core Tier 1 ratio would be acceptable but that during the period of extreme stress the bank would be expected to agree an appropriate timetable to restore the Core Tier 1 ratio to 6%. In my judgment the former is essentially the correct understanding of the requirement (though some nuance is required). Outside circumstances of extreme stress a bank was required to maintain a minimum Core Tier 1 ratio of 6%: if for idiosyncratic reasons it fell below that ratio then it had to agree with the FSA an appropriate timetable to restore the "buffer" over the 4% absolute minimum. In a general climate of extreme stress (as applied to an individual bank) a 4% Core Tier 1 ratio for that bank was acceptable to the FSA as sufficient to enable the bank both to withstand the challenging economic conditions and to enable that bank to continue to lend on normal commercial criteria. The ability of that bank to continue to lend was a necessary palliative in an economically distressed scenario: as the stress eased or as the bank accommodated continued lending during the stressed circumstances then the level should be restored to 6%.

382. This rationale emerges from an FSA statement on its approach to regulatory capital made in in January 2009 and was explained in the evidence of Mr Sharma. Of course, "base case" "downside" and "extreme stress" are not states defined by brightline boundaries, and (provided that continued lending was not jeopardised) I think it is fair to assume that the FSA would regard 4% as an interim state and would look to the restoration over time of the "buffer" provided by the 6% Core Tier 1 ratio. Mr Daniels captured this in his evidence in cross-examination:-

> "…the FSA had published in their 8/6/4 was that in times of extremis that they would be able to look to the 4% as a floor as opposed to the 6% and, no, that wasn't meant to be a permanent state, but it is requiring a plan. Now, the length of that plan and the time it would take to implement it left very much the discretion of the FSA.."

In my judgment he also correctly understood the potential impact that the level of regulatory capital would have upon funding:-

> "Q: As we agreed yesterday, once you are down to 4% you are even facing funding issues ?
>
> A:…. It depends entirely on the circumstances. We are speculating here.
>
> Q: Well, that evidence you accepted yesterday.
>
> A: That, if a single institution were notably an outlier in the crowd of banks, then perhaps you could speculate that. But if the entire market has no access to liquidity, the entire market has been impacted by the procyclical nature of the capital requirements and then I think the market will take that into consideration. But again we are speculating."

383. Second, the evidence of Mr Sants was absolutely clear that "the most important number as we saw it at the time …was the stressed number" ; and again that "the one we were most focused on was the 4% stressed".

384. To return to the narrative, even after the FSA's formal response Lloyds continued to seek permission from the FSA to say to its shareholders that, if the Acquisition did not proceed, then a "standalone" Lloyds might have to raise £5.5 bn (i.e. the same as its allocated share of the additional capital for the Enlarged Group) but that discussions were continuing. The purpose of this was to head off any potential public concern as to Lloyds' standing arising from the requirement that Lloyds had to raise more additional capital as a "standalone" bank than it did as a component part of the Enlarged Group. But the FSA declined to respond to the suggestion, and its formal position was that £7bn had to be raised by a "standalone" Lloyds.

385. The third theme I want to take up in relation to external events is liquidity. It is now known (but could not have been known to Lloyds at the time) that as at the Recapitalisation Weekend HBOS had drawn down to the limit of its bilateral facility with the BoE. Following the Recapitalisation Weekend there was some improvement in money market conditions, but the markets had not returned to normal functioning. So on 20 October 2008 the Bank announced a modification to its standing facilities and the immediate introduction of a Discount Window Facility ("DWF"). One of the modifications to the standing facilities was that the Bank ceased publication of various data about the use of its standing facilities and about which banks had signed up for access: the market was therefore deprived of this information flow in the interests of stability. The DWF enabled UK banks to obtain either cash or gilt-edged stock in exchange for certain assets not otherwise acceptable as collateral under other liquidity schemes, and then to use those gilts in the market or in the BoE open market operations. However, the purpose of the DWF was to provide liquidity insurance for (an extendable) period of 30 days: it was not intended for banks facing fundamental problems of solvency or viability.

386. The fourth theme I wish to comment upon is the overall Government strategy. I have commented upon this in relation to the period following the Announcement. Following the Recapitalisation Weekend and the Revised Announcement the Bank confirmed to HMT:

> "Notwithstanding these interventions it remains the view of the Bank of England that the proposed takeover should proceed without delay. Now, as in mid-September, we see risks to UK financial stability in the event of a failed transaction. Foremost amongst these is the risk of leaving HBOS without a credible long term strategy and the associated loss of confidence amongst depositors and market counterparties that would be likely to emerge. Both could seriously undermine confidence in the consistency and effectiveness in the authorities' recent interventions which have been key to re-establishing confidence in and the stability of the UK banking sector."

I am in no doubt that the view of the Tripartite was that that all necessary support should be given to Lloyds and to HBOS to ensure that the Acquisition completed because this was seen as a key component of the plan to restore order: but because of the perceived benefits to Lloyds of acquiring HBOS Lloyds was not to be given a "free ride" but was expected to share some of the risk.

387. Of course the Board of Lloyds (and the market in general) were unaware of these confidential communications between the Bank and the Treasury. But it is important for a present understanding of the contemporary events and for a consideration of possible alternative courses of action that this was the Government approach to the needs of the financial system: and equally important to reiterate that this approach did not mean that the Tripartite forced or pressured Lloyds to take over HBOS. Lloyds was throughout a willing and able acquirer.

Key internal events following the Revised Announcement down to (and just after) the 24 October 2008 Board meeting

388. I will retain the thematic (rather than strictly chronological) approach looking at (i) dealings between Lloyds and HBOS; (ii) the progress of due diligence; (iii) liquidity; (iv) consideration of working capital; and (v) progressing the Acquisition (reviewing its terms and preparing the documents). In some instances it makes for a more coherent narrative if I do not stop at 24 October 2008.

389. As to interbank dealing, Lloyds continued to provide facilities to HBOS under the Lloyds Repo. The total facilities used never exceeded £6bn at any one time: but the ceiling was never lowered from £10bn. Each drawdown was the subject of separate consideration and each collateral package separately assessed.

390. For the purposes both of considering the grant of facilities under the Lloyds Repo and of gaining a thorough understanding of the funding needs of the Enlarged Group Mr Short (as Head of Liquidity and Funding Management) required and obtained access to the HBOS funding data. This included the provision by HBOS of spreadsheets showing actual funding flows and collateral utilisation and projections in differing scenarios. As I have recorded above, this showed a line of funding provided by the BoE outside the

SLS scheme secured on collateral that was not eligible for SLS, this line of funding being referred to as "Project Fox" or "Project Package". The "ELA" label was not applied, but from the associated e-mail traffic it could be gathered that collateral moved from "Project Fox" to SLS, so that "Project Fox" in part operated as a bridging facility. These schedules also showed that "Project Fox" funding would be repaid at (or immediately after) completion of the Acquisition. The spreadsheets also showed use of Federal Reserve funding (but this related to only about 2% of the HBOS wholesale funding requirement).

391. I turn to consider due diligence. I will look first at the ground work that was done, and then at the economic context as it was viewed at the time this due diligence work was being done. Even as the Board was meeting on 12 October 2008 Mr Roughton-Smith was preparing an updated version of his analysis of the HBOS impairments and fair value adjustments to take into account the latest disclosures by HBOS (satisfactory access to HBOS' records having only been obtained on 6 October). This was put to a meeting of the GEC on 14 October 2008.

392. The earlier version of Mr Roughton-Smith's H208/2009 impairment report (placed before the GEC on 10 October, used in the Indicative Conditional Proposal and before the Board on 12 October 2008) had estimated an impairment range of £16.2 to £25.5bn on the assumption of a "credit crunch" (or "1 in 15") scenario. Further work now enabled Mr Roughton-Smith to *narrow* that to a range of £15-£21bn. The disclosure of the HBOS forecast for the third quarter (made during the negotiations over the Recapitalisation Weekend) also enabled him to compare HBOS' own impairment analysis with that of the Lloyds' team. The HBOS assessments were all below the bottom of the Lloyds range, but in part the margin was attributable to the use of different valuation approaches to the fair value adjustments. Mr Roughton-Smith signed off his impairment analysis of the retail and corporate books and of the international portfolio on the "credit crunch" scenario. His assessment was

> "To achieve material improvements in our impairment analysis would require several weeks of intensive work at a much more granular asset by asset level. Given the acquisition timescale, we do not believe this additional work would be worthwhile at this stage."

The work on the corporate portfolio did not, however, cease: some further analysis together with modelling a "1 in 25" scenario continued alongside work on the HBOS treasury assets.

393. Mr Roughton-Smith's key findings at that stage were as follows:-

> "(i) [HBOS'] corporate portfolio is highly concentrated in relatively risky counterparties. We have reviewed most of their top 200 corporate exposures: these total c.£30bn yet only two are FTSE 100 companies or overseas companies of similar size. Instead the largest exposures are predominantly FTSE 350 companies, private companies or special-purpose vehicles, many with a property component. However the size of these exposures is similar to those Lloyds would have to FTSE 100 companies.

> This unusual distribution makes impairments highly cyclical and volatile.
>
> (ii) In many of the larger deals [HBOS] are in several layers e.g. senior debt, mezzanine and equity; the latter two components are inherently more volatile and are correlated with senior debt.
>
> (iii) We believe the property related exposure is larger than the classification analysis in the published accounts would suggest. The concentration in property will also increase the cyclicality of impairments.
>
> (iv) [HBOS] has large self certified and [buy-to-let] mortgage portfolios. Whilst we have been able to model the forecast impairments, it is more difficult to estimate the cyclicality of these portfolios will exhibit in a severe downturn (e.g. our 1 in 25 recession scenario)."

394. The Lloyds Group Strategy and Corporate Development team then took Mr Roughton-Smith's latest work and the latest available HBOS forecasts and on 17 October 2008 reached the view that allowance would have to be made for write-downs and FVAs of £3.1bn (on a realistic case) and £10bn (on a pessimistic case) *over and above what HBOS were contemplating* (which was at that time £8.4bn). This estimate they provided to Mr Tookey.

395. At about the same time a different group within Lloyds (the Credit Risk Oversight team in W&IB Division) was considering the adequacy of the internal stress testing of *Lloyds' own business*. They put together a draft "View on FSA Stress Test" which embodied their view that "we are heading for a severe downturn/recession" and modelled a "1 in 25" event. Their "View" combined both the construction and modelling of a scenario and a forecast of an outcome:-

> "The bank's internal 1 in 25 stress (based on the original Q3 MTP) forecasts an impairment level of £1,313m (excluding market dislocation) in 2009, which is Risk's realistic view of the likely impairment level (excluding market dislocation) in 2009."

This draft document was not sent to Mr Tookey (or, so far as I can see, circulated to the senior management team). To get to that level of management it would have to have been considered and approved by Group Risk. It was deployed at trial by Mr Hill QC as a basis for suggesting that the *HBOS* impairment assessment ought also to have been approached on the footing that a "1 in 25" recession was the realistic probability. I do not accept that. Whilst I accept that the Credit Risk Oversight team and, indeed, Group Risk itself would not only calculate outcomes of assumed stress scenarios but would to a degree express a view about the likelihood of the occurrchiwence of that stress scenario, economic forecasting was not its province. The Board was entitled to act on the views of Lloyds' Chief Economist who had himself at an early stage drawn a distinction between prudent planning assumptions and realistic forecasting. On 7 October 2008 Mr Foley (having advised the Group Executive Committee upon the probabilities the various available scenarios for planning and budgeting purposes) had emailed the Group Executive Committee, saying:-

> "The "credit crunch" scenario is just one of several scenarios, and has a probability of less than 50% and equal to the old "base case" scenario. *Hence, whilst it might be very prudent to budget and plan on such a scenario, I wonder whether we have to use it as a basis for the Prospectus – which should I assume be based on what we think is the most likely outcome rather than a deliberately prudent planning assumption*. An alternative might be to use (for the Prospectus) an average of the old base case scenario and the credit crunch scenarios. This average will be close to the current consensus forecast. This would also avoid a potential problem with HBOS wish to use a mild downturn scenario and we are using a more severe one ." (Emphasis supplied).

396. On the 23 October 2008 Mr Daniels (with the assistance of Mr Pietruska) prepared a memorandum dealing in some detail with the potential impairments disclosed by the due diligence, and containing a yet further analysis. Noting that at the time of Announcement Lloyds had only been able to conduct "a high level due diligence exercise" which had resulted in estimated FVAs and writedown requirements of £3.5bn on top of HBOS' own estimates, Mr Daniels now reported that detailed due diligence had led to a revised estimate for the net negative capital adjustment on completion of £3.1bn to £10bn (in a credit crunch) on top of the HBOS forecast (which was the figure that had been reached by the Group Strategy and Corporate Development team). But so as to set those figures in context Mr Daniels also reported that after the Revised Announcement Lloyds was only paying 30% of HBOS' book value (which he underestimated at £21bn instead of its actual £25bn): the suggestion was that the price being paid afforded sufficient headroom for the impact on capital of impairments and FVAs.

397. How (if at all) do the figures in this memorandum relate to the work of Mr Roughton-Smith? This was explained by Mr Pietruska in his written evidence and by Mr Daniels in his oral evidence (and is referred to in a 17 October 2008 update of the Group Strategy and Corporate Development document prepared for Mr Tookey). The short point is that the interaction between impairments and net negative capital adjustments is tenuous because they are different approaches to the valuation exercise. The former adopts a "bottom-up" analysis of individual samples. The latter applies adjustment factors (derived from movements in interest rates or credit spreads) across a portfolio. Thus Mr Roughton-Smith's writedown/FVA adjustment of £15-£21bn was (in unvarnished form) *one* of the inputs into a calculation of the anticipated net negative capital adjustment, which calculation included comparative valuation approaches (using interest rates and credit default swap rates), potential crystallised loss on Available for Sale ("AFS") assets, HBOS' own impairment forecast, adjustments for different valuation methodologies ("mark-to-model" in place of "mark-to-market") and an assumed ability to write off losses against tax. So an increase in impairments does not automatically lead to a corresponding increase in the figure for net negative capital adjustment. There is nothing in the documentary evidence itself to suggest that the figures deployed in the memorandum resulted from a conscious manipulation or juggling of the figures to reduce the impact of impairments, and Mr Roughton-Smith's

raw impairment estimates appear on the face of the document from which the memorandum figures derive.

398. It was this memorandum that was placed before the Board for its meeting on 24 October 2008 and to which Mr Daniels spoke at that meeting.

399. It is now necessary to consider the context in which this due diligence work was being undertaken i.e. perceptions about the course of the economy. The effect of the Recapitalisation Weekend (the recapitalisation of banks, the provision of additional liquidity to the market and the required commitment of those taking Government funding to maintain lending in the mortgage market and to SMEs) had to be factored into Mr Foley's economic forecasts for the purpose of planning the conduct of the Enlarged Group's business.

400. His initial work (following immediately upon the Recapitalisation Weekend) was to construct a new "mid-case scenario", less optimistic than the then-current "base case" but less aggressive than the then-current "credit crunch" scenario. This was intended to reflect the recent government actions on capital and funding which together were intended to alleviate the credit crunch. The scenario was prepared for planning purposes, to support a refocusing of the planning and budget strategy upon capital affordability and funding sustainability. The assumptions in the "mid-case" postulated a dip in H208 and 2009, but an increasingly strong recovery through 2010 and the years following. The dip was not severe: GDP was assumed to grow 1% in 2008 and to fall 0.5% in 2009. House prices were assumed to fall 16% in 2008 and a further 10% in 2009. The GDP assumptions made by Mr Foley were more testing than the consensus view of a substantial body of a prominent financial and economic forecasters as that time, including the BoE and the Treasury. Mr Foley recognised it was unclear to what extent the real economy would react to the government initiatives and also to what extent the stronger capital and funding positions would support credit growth. So he thought that whilst the mid-case scenario was "now the highest probability outcome", the "credit crunch" scenario remained a distinct possibility (though with a lower probability than before). Mr Foley incorporated this "mid-case" scenario into a presentation intended to be placed before the GEC in draft and subsequently before the board. Mr Foley attended the meeting of the GEC on 14 October 2008 on the item of business called "November board meeting preparation" and it is probable that he put before the meeting his draft presentation in its then state (so that his views on the economic outlook for planning purposes were communicated to Mr Daniels, Mr Tate, Ms Weir, Ms Sergeant, Mr Tookey and Mr Pietruska).

401. The following day Mr Foley, in an email to the GEC, tentatively modified his views in the light of further analysis, moving the probabilities back towards the "credit crunch" scenario: but he did not alter his formal advice. Thus the Chief Economist's advice to the GEC (of which key board members would have been aware) was that a "mid-case scenario" (a tough "base case") was the most likely outcome: but with the caveat that a "1 in 15" could not be discounted.

402. Having dealt with the economic outlook as it appeared in mid-October 2008 I turn to consider views on prospective liquidity issues. Late in the evening of 12 October 2008 Mr Short and a team at Lloyds prepared a Powerpoint presentation drawing together the Lloyds' perspective on the funding position of the Enlarged Group. Inevitably this contained speculative elements, in particular the extent to which the Government

initiatives announced on 7 and 8 October 2008 (and being given concrete form at the very time the presentation was prepared) would succeed in achieving their objectives. Further it was based on HBOS' known cash requirement. Setting the target of a £20bn overnight funding requirement the work identified that (assuming a "base case" scenario) the target figure would be breached in October and November 2008, but would be met thereafter until December 2011 (when current SLS funding would mature, assuming there was no equivalent replacement). In the meantime there was a significant refinancing risk, because the funding plan was dependent on access to Government funding (the newly extended SLS, the newly announced guaranteed loan facility and the opening up of the market generally). The forecast was prepared too late for presentation at the Board meeting: but its contents were communicated to Mr Tate and to Mr Tookey (and thus could inform their actions over the night of 12/13 October 2008).

403. The Powerpoint presentation remained a work under review, and was constantly updated in order that it could be presented to a board meeting intended to be convened for 24 October 2008.

404. I turn to consider working capital. Lloyds retained its auditors, PricewaterhouseCoopers ("PwC"), to tender advice in relation to the working capital requirements of the Enlarged Group. Their letter of engagement (eventually dated 31 October 2008) required them to prepare a working capital report both on Lloyds and on the Enlarged Group to be addressed to the directors, the joint sponsors and the bookrunner. Amongst the inputs would be Lloyds' management's projections prepared down to 31 March 2010, and cash flow projections and the working capital requirements of HBOS prepared by its auditors KPMG (whose report on HBOS would be addressed to PwC amongst others). PwC would then conduct a review of the systems and controls of Lloyds and of the Enlarged group in the management of liquidity risk and regulatory capital, including a review of the regulatory capital requirements on a base case and stressed scenarios. As to those, it would be for the addressees of the report to form their own opinions on the reasonableness of the assumptions, but PwC undertook to report if any material assumption was in their view unrealistic.

405. At the outset of their work PwC received Mr Short's initial Powerpoint presentation relating to funding requirements. PwC's strong recommendation was that Lloyds seek written confirmation of the oral indications given on behalf of the Tripartite that adequate funding would be available to the Enlarged Group. I think the point of the advice was to ensure that it was clear that Government funding would be available in some form not only to secure the completion of the Acquisition but also during the period that it was thought had to be covered by a working capital statement.

406. On 16 October 2008 the possibility arose that a formal working capital statement in the customary form might not be required for the upcoming Circular. But according to advice received from Merrill Lynch (who conveyed the news) the proposed revised statement

> "…would still require the same level of diligence to produce this statement as for a traditional working capital statement, but…is much less onerous on management to sign off."

So the proposed revised wording did not affect the work being undertaken by PwC or the view of Mr Tate and Mr Tookey that the Board would need to be satisfied as to the capital requirements of the Enlarged Group following the Acquisition. Nor did the potential absence of a formal Working Capital statement affect the view of the sponsors. In my judgment the position was accurately summarised in an e-mail which the Lloyds Group Corporate Treasury sent to the FSA supervisory team on 24 October 2008:

> "…whether or not the UKLA requires the statement, neither our board nor the sponsors would wish to enter into the transaction without satisfying itself, through their own review and that of the reporting accountants, as to the adequacy of resources.."

In my view the analysis of working capital requirements was undertaken to the same standard as if a working capital statement was to be included in the Circular – as indeed appeared likely until the last moment.

407. I turn to the preparation of the documents. The Circular was bound to comply with a number of highly technical requirements. For that reason, of course, its preparation was in the hands of the specialists – the investment bankers took the lead on the preparation of the Chairman's letter, and the specialist team at Linklaters assumed responsibility for the preparation of the rest of the Circular.

408. Various drafts of the proposed Circular were submitted to the UKLA for supervision and comment. In responding the UKLA made clear

> "we are examining the document primarily from a UKLA standpoint and that it should not be assumed that our comments will necessarily cover all aspects of FSA regulation. … It should not be assumed that lack of comment implies approval or agreement from other FSA areas."

409. Listing Rule 13.3.1(3) required the Circular to contain all the information necessary to allow the shareholders to make a properly informed decision. This was specifically drawn to the attention of Linklaters by the UKLA, who noted it and confirmed that it was so.

410. Listing Rules 13.5.6 to 13.5.9 required all financial information not extracted without material adjustment from audited accounts of HBOS to be appropriately sourced and adequately explained. Linklaters amended their drafts to secure that this was so.

411. The UKLA considered a draft of the Chairman's Letter to be included in the Circular and commented:-

> "Please ensure that the document is clear with regards to the position that the company would be in should the shareholders vote down the proposals. We would expect for example the company would need to indicate a further fundraising if necessary, expand on possible discussions and positions with regards to Treasury involvement and indicate where possible the potential consequences for shareholders of any alternative proposals i.e. perhaps no longer being pre-emptive."

In relation to a later passage the UKLA commented:-

> ".. please make it explicitly clear within the document that the various proposals are conditional and that the fundraising will not continue if the acquisition is not approved."

412. Partly in response to this, and partly because of internal decisions independently made, those preparing the Circular decided that it was necessary to incorporate the effect of Mr Sants's letter of 28 October 2008 confirming that a standalone Lloyds would be required to raise a total of £7bn additional capital. The UKLA later required the addition of words indicating the difficulty of raising those additional funds in the public markets.

413. It was a requirement of Listing Rule 13.4.1.2 and its associated annexes (reflecting the then-current guidance from the Committee of European Securities Regulators) that the necessary shareholder circular seeking approval of the transaction should contain a working capital statement by the Lloyds' directors, prepared on the footing that the Acquisition completed. Ordinarily a working capital statement will address whether (looking forward for a minimum period of 12 months) a company's anticipated cash requirements can be satisfied from its available facilities. But working capital statements for trading banks pose difficulties because fundamentally their business model is in part to borrow "short" (customer deposits) and lend "long" (mortgages and corporate term loans). So such working capital statements tend to focus on the processes and controls which the bank employs to manage liquidity and monitor its regulatory capital requirements. The sponsors would then have to comply with Listing Rule 8.4.2(5) and only submit the circular to the FSA if, following due and careful enquiry they were of the opinion that the directors had a reasonable basis for making the required working capital statement.

414. On 16 October 2008 the UKLA let it be known that the FSA might, in the current financial crisis, waive the requirement of a working capital statement for a small number of UK banks. But the evidence was clear that the fact that the UKLA might be (and was in the event) prepared to waive the requirement of the customary Working Capital Statement in the Circular was not seen by the Lloyds' internal team (in particular Mr Tate and Mr Tookey) as relieving the Board of it obligations to consider and to be satisfied as to the working capital requirements of the Enlarged Group.

The Board Meeting on 24 October 2008

415. On the morning of 24 October 2008 the Lloyds board met to assess the current position and to prepare for the decisions that would have to be taken in the immediate future. Of the Director Defendants Sir Victor, Mr Daniels, Mr Tate and Ms Weir were present. Mr Tookey (who was still not yet a director) was in attendance, as was Ms Sergeant (the Chief Risk Director to whom Mr Roughton-Smith reported) and Mr Parr (from Linklaters). Mr Roughton-Smith was not in attendance. A great range of business was before the meeting: amongst the items which I will not address for the purposes of this case (but which did require consideration by the Board) were:-

    (a) discussions with a sovereign wealth fund investor;

    (b) discussions with the First Minister of Scotland in relation to Scottish issues;

(c) detailed issues relating to synergies and their verification (on which there were sundry reports and analyses from different sources, both internal and external);

(d) papers on financial reporting procedures;

(e) timetables;

(f) drafts of Acquisition documents;

(g) conflicts of interest; and

(h) another unrelated project being undertaken by Lloyds.

416. Before turning to the matters addressed at the Board meeting which are material to the Claimants' case, I must add one brief comment on synergies. The nature of the case advanced has meant that at trial attention focused on the downside risks of the Acquisition: no equal attention was paid to the perceived benefits. The board meeting on 24 October 2008 was the first opportunity that the board had had to look in detail at the benefits. The anticipated synergies referred to at the time of the Announcement where of the order of £1bn. Further work now identified a range of £1.9-£2.6bn, but the proposal before the board was to include a deliberately conservative estimate of only £1.5 billion in the intended circular. Some 250 people had been engaged in this work, including a team from Deloittes (who thought the process undertaken by Lloyds was thorough and of high quality). The work of this team was cross-checked by PwC in order to verify its suitability for inclusion in the Circular. The outcome of the work on synergies arising from the integration of the two businesses (whatever form the board decided that should take) was a key part of the Acquisition, because Lloyds was not simply buying assets (book value less write downs and FVAs) but also the business opportunities afforded by the HBOS brands, and the contribution they would make to the income of the Enlarged Group (which would feed through to the EPS enhancements) partly through synergies.

417. Turning to the matters material to the Claimants' case, the primary record consists of the Minutes of the meeting. But there is a secondary record in the form of some surviving handwritten notes made by Mr Tookey.

418. The first issue addressed was the current state of the transaction. This was covered by Mr Daniels, utilising the memorandum that had been prepared by himself and Mr Pietruska, which had concluded with a final version dated the 23 October 2008. I have already considered and noted how it dealt it suggested capital adjustment of £3.1bn-£10bn (instead of the originally estimated £3.5bn) over and above HBOS existing provisions (and how the work on impairments by Mr Roughton-Smith fed into the commentary). I want to pick up on three other items in the 7-page memorandum, which assist in assessing its likely impact on the directors.

419. First, the overall view given:-

> "The revised offer is financially an attractive proposition for [Lloyds] shareholders, since it results in as (*sic*) significant de-risking of the HBOS acquisition. The original transaction paid

> 60% of book value to reflect the uncertain downside risk, the revised transaction pays only 30% of book value and discounts approximately £14 billion for potential after-tax fair value adjustments and write-downs. Furthermore while the transaction is less accretive than previously, it still leads to a significant EPS uplift for [Lloyds] shareholders. ”

A table then showed that the 2011 EPS accretion had originally been forecast to be 22.3% but was now forecast to be 19.8%. The table also showed that whereas the share of the Enlarged Group taken by Lloyds shareholders had originally been assessed at 56%, following the recapitalisation weekend it would now be 37%.

420. Second, in a section concerned with the communication of key messages to stakeholders was a summary of why it was thought HBOS remained a great deal. Part of it read as follows:-

> “HBOS has a fantastic franchise with a huge long-term value, particularly in savings and mortgages…However, HBOS has a challenged business model with major short-term issues (wholesale funding, non-conforming loans etc)…[Lloyds] has a clear plan to work through the short-term issues and integrate HBOS and deliver synergies… [Lloyds] has the management team and credibility to deliver… [Lloyds] has a hugely experienced leadership team and they saw the value and understood the problems and how to fix them… Lloyds has reviewed the HBOS portfolio and is satisfied that it understands and can manage the issues and achieve a high return on investment…”.

421. Third, in a section relating to messages to the political establishment there was an item suggesting that intervention to restrain or break up Lloyds was unnecessary and would delay or frustrate achievement of the public interest benefits of the merger. Included in it was the following:-

> “The bank has to submit a restructuring proposal. This requirement was never flagged nor agreed to. It could potentially require a breakup or significant downsizing of the combined institution and negates the merger benefits that are required by shareholders in order to subscribe to the clawback.”

This outlined for the board an emerging risk and proposed a public stance to minimise it. The adoption of that stance was necessary in order to keep the Government to the position that it had signalled to the Lloyds’ senior management, namely that essentially the Government had the matter of state aid in hand and that Lloyds’ intended integration and disposal plans would probably suffice.

422. It is apparent from Mr Tookey’s note that Mr Daniels did not simply repeat the memorandum. For example, he told the Board that there was “growing heat” over the conditions attached to the capital injection, over “taking over HBOS” and about “why not go it alone?”. This warned the Board that their provisionally favoured course was not free from controversy. He told them that the Tripartite had set the Lloyds’ capital

requirement at £7bn and £5.5bn which was "[a] clear push towards [the] HBOS deal". He told them that Lloyds objected to the capital setting methodology and wanted changes, one of which was an immediate £2bn reduction in the amount to be raised (because management action and proposed disposals had not been taken into account). This warned the Board of potential pressures to adhere to their provisionally favoured course.

423. Although there was no pleaded case that, in breach of his duties as director, Mr Daniels, in the preparation and presentation of this memorandum negligently or deliberately misled the Board as to the risks inherent in the Acquisition, this was the undertone of Mr Hill QC's cross-examination. Mr Hill QC suggested that the reference in the memorandum to the impact of fair value adjustments and write-downs upon capital as being of the order of £3.1bn-£10bn was misleading because Mr Roughton-Smith's figure for fair value adjustments and write-downs was £15-£21bn. Mr Daniels responded that one cannot not simply apply anticipated impairments to the figure for negative goodwill at completion: it was necessary to assess the impact of impairments on capital, taking into account existing provisions, tax recoveries and so forth. Mr Hill QC suggested that the board was not aware of the range of Mr Roughton-Smith's figures. Mr Daniels responded that he could not be sure that at that stage all of the board had seen Mr Roughton-Smith's latest schedule: but that he believed the board was aware of the range of figures. (As well as Mr Daniels the other participating directors who had certainly seen in full the latest Roughton-Smith figures were Mr Kane, Mr Tate and Ms Weir). Mr Hill QC suggested that the figure of £3.1bn-£10bn was not fairly compared with the earlier forecast of £3.5bn. Mr Daniels responded that the figures were comparable since each of them was a figure over and above existing HBOS provisions. Mr Hill QC challenged the way that the memorandum dealt with the EPS uplift. Mr Daniels responded that a financially aware board (such as Lloyds') would understand that *any* recapitalisation would involve a dilution, and that the point being made was (given the new requirement to take additional capital) to compare the dilution involved in the recapitalisation of a "standalone" Lloyds with the dilution involved in the recapitalisation of an enlarged group with beneficial synergies (and to note that synergy benefits were deferred). Mr Hill QC suggested that the memorandum failed to draw out that the requirement to take £7bn was "discussable". But Mr Tookey's note shows that the board was told of the challenge to the FSA's methodology, and of what seemed to be the desire of the Tripartite to give a clear steer in favour of the Acquisition. (Mr Daniels was insistent that although the capital requirement of the Enlarged Group "got more airtime" the capital requirement of a "standalone" Lloyds was not overlooked). Mr Hill QC characterised the memorandum as a "sales pitch", and not a fair and objective analysis of the transaction and its attendant risks. Mr Daniels begged to differ.

424. I was not persuaded that the terms of the memorandum or Mr Daniels' presentation of it at the board meeting on 24 October 2008 misrepresented the transaction to the board. Viewed in isolation the memorandum is undoubtedly an endorsement of the policy recommended by management and hitherto adopted (with caution) by the board, and it is being considered at a meeting where the positive aspects of the transaction (the anticipated synergies) feature prominently. But, as Mr Daniels said, the memorandum (to the criticism of which he responded well) has to be read along with the body of work that accompanied the board papers and has to be seen in the context of other meetings: and it is clear from Mr Tookey's record that the contentious aspects of the Acquisition

were placed before the board by Mr Daniels. It was a consistent theme of the directors who gave evidence that it was not right to measure each meeting in isolation: and that aspects of the Acquisition adumbrated in one meeting were carried forward to the next without the necessity for repetition at each subsequent meeting. I accept that evidence. I do not think that Mr Daniels presented a "sales pitch": and I do not think that the directors fell for any "sales pitch".

425. One particular criticism made of Mr Daniels was that both in his board memorandum of 23 October 2008 and in his presentation to the board on 24 October 2008 Mr Daniels took it as read that a "standalone" Lloyds would have to raise £7bn additional capital and did not tell the board that there was a real possibility of reducing this (which would undermine his analysis that a "standalone" Lloyds would face an EPS dilution of 31.7%). I do not think that Mr Daniels misread the situation in presenting matters on 24 October 2008: and the FSA's view was to become clear over the next few days.

426. The next issue addressed was the draft transactional documentation that was before the meeting. Mr Parr dealt with that item. As the minute records:-

> "It was noted that the circumstances of this transaction are unusual as the company circular will contain substantial information about HBOS to enable the company shareholders to decide on the merits of the transaction. The directors would have to take responsibility for the entirety of the class 1 circular and therefore a key issue for them is to ensure that the contents of it are correct, complete and accurate not only as regards the group but also in respect of HBOS and the enlarged group. Mr Parr explained that it is possible for the directors to minimise the potential for liability arising and to avail themselves of the defences should liability arise by conducting an appropriate legal and financial due diligence exercise…. The main way to address this issue is to seek to ensure that the due diligence processes are completed as far as possible in advance of the publication of the circular and the results reflected in the circular. Efforts continue to be made to obtain to obtain some direct comfort for the directors from the HBOS directors in connection with the Lloyds TSB circular. However, the fact that HBOS will be publishing an interim management statement on the day both the Lloyds TSB and HBOS circulars are published, a draft of which Lloyds TSB will be able to review (and the final version of which will also be reviewed by Lloyds TSB) should give the board further comfort in relation to the HBOS information in the Lloyds circular. "

I have no reason to doubt that this is a faithful record of the advice tendered by Mr Parr. It guided the board as to the extent to which they could properly make statements about HBOS.

427. Mr Parr also gave advice as to third-party comfort that would be available to the Lloyds' directors in relation to the contents of the Circular. This had been the subject of a note prepared by Linklaters and circulated to the Board in advance of the meeting. That note recorded that HBOS had prepared a prospectus for its rights issue launched on 29 April

2008 and that in relation to that document both UK and US legal teams had been able to state that nothing in the due diligence process for it had led them to believe that that prospectus contained any untrue statement of a material fact or omitted to state a material fact: and that in relation to matters since the prospectus date Linklaters had (together with Allen & Overy as solicitors for HBOS, and Freshfields as solicitors for the sponsor banks) attended meetings between the Lloyds and HBOS due diligence teams. Telling the directors about this level of professional scrutiny was intended to inform the Board as to the extent that they could properly rely on the accuracy of material produced by the due diligence process.

428. A third area of work addressed was that of working capital requirements. The minute of the meeting records:-

> "Mr Tookey explained the briefing slides produced by Group Corporate Treasury on the enlarged group's Working Capital and Regulatory Capital position and the work being undertaken by management and PwC to support the working capital statement that the directors would be required to give in the circular."

These briefing slides had been prepared by Mr Gilbe and Mr Short: they were therefore the work of senior Lloyds personnel.

429. The presentation began with a summary which explained that the key dependencies for a successful funding programme included the sustained recovery of the money and capital markets, access to SLS and access to the government guaranteed debt issuance. It emphasised that confidence in the funding strategy of the Enlarged Group depended on certainty of access to government capital and guaranteed facilities in order to provide a bridging mechanism that would allow an orderly refinancing in the public markets. It then commented:-

> "The refinancing model indicates that if markets return to even moderate health, the combined entity will have manageable funding exposure
>
> <u>However</u>
>
> If at any stage the markets collapse to the chronic state recently experienced, the combined entity will not survive without access to additional central bank/government supported funding "

430. Accompanying tables indicated that if the identified sources of government funding were utilised then a "pinch point" would occur in the second half of 2011 when that government funding matured, with the Core Tier 1 ratio falling to just above 5% on a highly pessimistic basis. The presentation indicated that further work was under way and that it would be updated: so I will return to an updated version of this paper later. In addition to this crisp presentation there was a 145-page draft report on working capital prepared by PwC: since their work was not complete PwC was not prepared to accept responsibility for it in its then form. But it identified the sort of working capital statement that it was anticipated the Board would have to sign off, namely:

> "Lloyds believes that, despite the current financial turmoil, taking into account all of these sources of capital and liquidity, the Enlarged Group has adequate resources to support its business activities over at least the next 12 months."

I am satisfied that, whether or not the Circular might ultimately contain a working capital statement it was against that standard that the directors measured the Acquisition.

431. The draft report produced by PwC was the outcome of close liaison between PwC and the Lloyds Group Risk team (i.e. senior Lloyds personnel). Although based on HBOS estimates those estimates themselves had been adjusted in the light of Lloyds' own work, and were then cross-checked against Lloyds' internal work. On 21 October 2008 PwC had received from the Group Risk team Mr Roughton-Smith's impairment estimates on the "1 in 15" scenario (maximum £21 bn) and a preliminary view on the "1 in 25" which was then being modelled. PwC was undoubtedly aware of that ongoing work, and incorporated it. The relationship between Mr Roughton-Smith's work and PwC's work was addressed. The Lloyds' Group Risk team suggested that their work

> "…which is looking at the economic position rather than a point in time valuation now, would be substantially covered by the credit spread adjustments. "

PwC was specifically asked to address whether this assumption was reasonable. The following day Ms Sergeant of Lloyds met with PwC. I have seen no note of that meeting but it would be extraordinary if the highly attuned Ms Sergeant and a competent PwC did not discuss these issues further, particularly since both she and PwC would be attending the 24 October 2008 board meeting.

432. The point of drawing attention to these matters is to underline that when these matters came later to be discussed, preparatory work had already been put before the board. That indeed was the principal objective of the board meeting on 24 October 2008

Events between the Board Meetings of 24 and 29 October 2008.

433. I will retain a thematic approach and look first at continued due diligence.

434. Mr Roughton-Smith had continued his due diligence work, with a team of 26 of Lloyds' most experienced risk and middle office professionals with specific expertise in HBOS' principal business areas. This included work to comply with a US standard shortly referred to as "the 10b-5 process". In the light of this work he was able to update his report in the evening of 28 October 2008. He identified his starting point for forecasting HBOS's H2 2008 and 2009 impairments as a high level risk-based review of the entire balance sheet using only publicly available information: he thereby indicated that attention had focussed upon where the perceived risks were most material. He had taken a "1 in 15" "credit crunch" mild recession as the base case, but had subsequently undertaken a high-level estimate of a "1 in 25" "deep recession" scenario. After the latest work undertaken down to 27 October 2008 Mr Roughton-Smith presented a revised assessment of the reduction in net values to December 2009 (resulting from the impairment and fair value analysis) of £16.9bn-£22.3bn in a "1 in 15" scenario (a modification of his earlier range of £15bn-£21bn). The increase in the bottom of the

range was attributable to a reassessment of the concentration in joint venture property exposures. (These were, once again, the total adjustments required: if one was looking for the figure for impairments under Lloyds' methodology additional to those forecast by HBOS the revised range was £8.5bn-£13.9bn). Of these figures Mr Roughton-Smith said:-

> " We believe our revised impairments forecast range is robust, with the range resulting from inherent uncertainties which would not be reduced materially by further asset level analysis. "

435. It is right to record that he expanded upon that general comment in relation to particular asset classes.

(a) In relation to the corporate book he explained the sampling methodology used and explained that to achieve a significant improvement in the robustness of the analysis it would be necessary to undertake a detailed examination of a statistically significant sample of individual loan files and to conduct detailed discussions with HBOS's credit officers: but he considered that the inherent uncertainties in the economic environment meant that even such work would be unlikely to narrow materially the impairment range.

(b) In relation to treasury assets (bonds) he explained the methodology of reviewing prices on a statistically significant sample, and noted that £2bn of the adjustment was attributable to the Lloyds' use of "mark-to-market" valuations in place of the "mark-to-model" basis approved by HBOS' auditors. In the version of his report tabled on 29 October 2008 he said that further work would not produce more precise or accurate results. For the purposes of his impairment analysis he adopted the conservative Lloyds approach (rather than the approach adopted by HBOS's auditors, KPMG).

(c) In relation to the international portfolios he explained that there had been a review of portfolio level management information with HBOS' international portfolio manager, and conversations with senior managers in Australia and Ireland, that greater comfort could only be obtained by a "deal level" review of transaction files using credit officers with expertise in local markets and local valuers conducting revaluations of sample properties, a resource-heavy course likely to encounter resistance from HBOS: the work undertaken had not led to an increase in the impairment forecast.

(d) In relation to private equity and joint venture investments he explained that the team had undertaken "portfolio level" analysis using HBOS's management information,

> and had conducted brief reviews of the top six investments and of the higher risk investments: he considered that a more in-depth review would make the impairment calculations more robust but would not materially alter the forecast range.

436. Mr Roughton-Smith's consideration of the additional impact on HBOS of an assumed "1 in 25" "deep recession" occurring in 2009 led him to the view that there would be additional impairments for H2 2008 and 2009 in the range of £3.75-£6.5bn.This would bring the total assessed reduction in net values as at December 2009 within a range of £20.65bn-£28.8bn (Looking only at 2009 with these adjustments the HBOS impairments for 2009 using the "1 in 25" scenario came to £10.25bn-£16.6bn). Looking at H2 2008 and 2009 the reduction in estimated net asset values at December 2009 (i.e. the additional adjustment over and above HBOS' own forecasts) would be in the range £12.25-£20.4bn. (These were gross figures without any tax adjustment). He considered that the relative impact of a "1 in 25" deep recession on HBOS would be greater than upon Lloyds because of the size of the HBOS specialist mortgage book, corporate concentration in relatively risky counterparties and exposures to private equity and joint ventures.

437. During the period in which Mr Roughton-Smith and his team were preparing the revised impairments report on the "1 in 15" and "1 in 25" basis there was frequent contact between the Lloyds Group Risk team and PwC as the latter worked on the material with which they had been provided: the e-mail trail and circulating drafts indicate that PwC was undertaking a verification and cross-checking process, and notes on the working capital model confirm that PwC specifically considered the prudence of the adjustments they were making when compared with the impairment figures and fair value losses produced by Mr Roughton-Smith on 14 October 2008. The Lloyds team working alongside PwC on the preparation and testing of the capital model were also conducting a cross-checking exercise: they concluded (as at 4.30pm on 27 October 2008) that the impairments suggested by Group Risk were adequately covered by the credit spread adjustment and that the fair value adjustment was prudent.

438. Mr Roughton-Smith's revised impairments report was sent to the Lloyds' advisers (Citi, Merrill Lynch, UBS and Linklaters) and to Mr Tookey and Ms Sergeant at 9:26pm on 28 October 2008. Its existence and conclusions were therefore known: but there was very limited opportunity for the writers of other reports to consider its ramifications for their own work. It appears from the documents that Mr Tookey (rather than Ms Sergeant) assumed the responsibility for presenting Mr Roughton-Smith's revised report to the forthcoming board meeting: but she was in attendance at the board meeting.

439. Linklaters also updated their memorandum of advice to the Board (though it remained in draft until the Board meeting itself). Amongst the matters covered was the financial due diligence on HBOS conducted by Lloyds. Here Linklaters advised:-

> "In the UK, there is no set threshold of due diligence which will guarantee compliance with the relevant obligations… Accordingly acceptable due diligence procedures will vary from case to case depending on the circumstances….. As [Lloyds] is acquiring HBOS, [Lloyds] rightly feels the need to carry out

> additional financial due diligence on HBOS. In the context of a UK public takeover, as this is, it is usual for the acquirer only to get limited access to the target's personnel, books and records. However in the current circumstances, partly because [Lloyds] has to produce a prospectus covering the enlarged group, [Lloyds] has been able to gain more access than might normally be the case. "

After a reference to Mr Roughton-Smith's work (in terms which he specifically approved) the Linklater's memorandum continued:-

> "In conducting this work and producing the paper, we understand that [Lloyds] has taken a risk-based approach to the due diligence exercise, namely focusing on the areas where material risks are most likely to arise and therefore where investigation should be targeted. In the context of a public takeover where access is necessarily limited, this is appropriate. [We understand that the placing agents (Citi, Merrill Lynch and UBS) have reviewed the work conducted and the paper produced and have confirmed that they consider the level of due diligence conducted to be reasonable in the circumstances.] [To be updated at board meeting]."

Although I have inserted "[Lloyds]" in that citation, the other text in square brackets is as in the original. This advice was reiterated at the end of the memorandum in the same format and in these terms:-

> "In Linklaters' view, the legal due diligence conducted is customary and adequate under the circumstances. [We understand that the placing agents feel that the financial due diligence conducted by Lloyds is also adequate]… Linklaters, Freshfields and Allen and Overy will not be able to deliver their 10b-5 disclosure letters unless they feel that the material issues discovered in due diligence have been adequately reflected in the prospectus and that no material issues are omitted."

Once again, the square brackets are in the original.

440. The memorandum also gave advice about the role of directors in relation to due diligence in these terms;-

> "[Lloyds'] executive directors may be involved in the management due diligence sessions referred to above but in any case, as all the [Lloyds] directors have responsibility for the prospectus, all the [Lloyds] directors will be expected to read the prospectus and input and comment as appropriate to ensure it is complete, correct and accurate as far as they are concerned. Notwithstanding the above, it is appropriate that the directors delegate the task of due diligence to appropriate people in their organisation and their counsel; they need to ensure in doing so, however, that they are comfortable that an adequate

> investigation has been conducted and that material areas of risk have been adequately explored and reported on."

441. It is now necessary to set the outcome of this due diligence in context. The due diligence process enabled the measure of impairments to be assessed in various assumed scenarios. But as a basis for action it would be wise to assess the likelihood of the occurrence of any of those scenarios: this was the role of Mr Foley. By 7 October 2008 Mr Foley was articulating the understanding that the shareholder circular and the prospectus relating to the open offer "should, I assume, be based on what we think is the most likely outcome rather than a deliberately prudent planning assumption". In advising the GEC for planning purposes he told them at that time that the combined adjusted base case (or "mid-case") and "1 in 15" recession scenarios had a probability of 70% (each having a 35% probability) and that the prospect of a "1 in 25" recession was 15%. His further work during the remainder of October did not lead him to advise GEC or the board of any change to that. By 28 October 2008 he had prepared a paper showing that the UK economy had entered a recession, but (as he was to confirm at the "awayday") he adhered to the view that the "mid-case" scenario represented the most likely outcome. Thus Mr Roughton-Smith's "1 in 15" scenario (if treated as a base case for risk assessment purposes) was a prudent and cautious one.

442. I turn to the liquidity issue. Here, Lloyds itself managed to access up to £30bn in overnight funds during this period (outside the limit which management considered optimal in normal circumstances but well below what management considered to be Lloyds' maximum capacity). It had drawn on SLS funding to the extent of £14bn and had begun to draw upon Government guaranteed funding. It appears from the PwC work that the Government had indicated that up to £110bn would be available to Lloyds through the SLS and Long Term Repo facilities and that £75bn would be available to Lloyds through guaranteed debt issuance.

443. HBOS was also using the like facilities. Because Lloyds had extended both overnight and significant term facilities to HBOS, Lloyds was able to obtain detailed information about HBOS' funding requirements on a daily basis. These were the spreadsheets to which I have referred and which on close reading disclosed that HBOS (though fully funded until completion) was drawing on a special facility of some sort outside SLS.

444. I turn to "working capital". The preparation for the 29 October 2008 Board meeting included continued development of working capital reports for the Enlarged Group. The first of those reports was the Group Corporate Treasury presentation that had been put before the board on 24 October 2008. This set out in a prominent place the terms of the proposed statement to be made in the circular in the place of the customary working capital statement. It told the directors that notwithstanding the absence of the requirement for a formal working capital statement

> "… the directors of [Lloyds], who would normally be required to make a public statement confirming the expected adequacy of working capital, would be clearly remiss in allowing a transaction to proceed if there were grounds for doubting its adequacy."

It then explained the work that had been undertaken, including a review of HBOS projections to align them in respect of accounting policies, economic assumptions and

fair value adjustments. As to that review of HBOS material the authors advised the board that the report's assumptions on corporate insolvencies were more conservative than those of HBOS, and that for the purposes of capital protection the report had made a conservative estimate of the adjustments that needed to be made to FVAs. The outcome of that was that the Group Corporate Treasury felt that the net adjustment that needed to be made to the Core Tier 1 capital ratio in respect of FVA's was £10bn negative in the pessimistic scenario and £8bn negative in the cautious case. The conclusion of the executive summary noted that

> "[a] critical factor is the extent to which reliance can be placed on the various statements made by HM Treasury."

445. The report informed the directors of the scenarios that had been constructed for the purposes of analysis. The pessimistic scenario combined the Lloyds "1 in 25" and the HBOS worst-modelled "stagflation" scenario (a scenario approved by the FSA as appropriate to HBOS) and modified that combination for further sensitivity to corporate insolvencies and high FVAs i.e. Lloyds senior personnel had treated some HBOS figures as being on the optimistic side and had adjusted them to show a worse picture. Even on that scenario it was predicted that the Core Tier 1 ratio would remain above 5% compared with a 4% FSA "extreme stress" target. The report concluded:-

> "The board is asked to note that based on our work, reviewed and reported on by PwC, we believe the Enlarged Group has sufficient working capital for at least the next year."

446. So I turn to consider the work of PwC. On 28 October 2008 PwC had presented a further draft working capital report for the Enlarged Group (and a separate appendix in respect of a "standalone" Lloyds including liquidity and capital projections). This drew on a memorandum (then in draft) from HBOS as to its working capital provision and a draft report prepared by KPMG (HBOS' auditors) on the HBOS working capital position. To these latter documents I will come later.

447. The PwC report began by drawing attention to the fact that the proposed alternative statement about capital was in a substance an unqualified working capital statement; and in view of management's assessment that if at any stage markets were to revert to the chronic state recently experienced, then the Enlarged Group would need access to additional central bank or government supported funding, it was critical to the directors' assessment, in making the working capital statement, that they were satisfied that such additional funding would be available if and when required. In their final advice to the Board PwC put it this way:-

> "The Directors will…need to be satisfied that they have appropriate evidence of central bank/governments' intentions in relation to this funding based upon their discussions with the bank of England and H M Treasury"

448. Mr Tate had already set about obtaining that satisfaction from the Treasury and the BoE. He caused to be prepared a draft letter (to be signed by the Bank) confirming the existence of sufficient facilities under ordinary programmes (SLS, LTR, DWF and guaranteed issuance) to support the anticipated (itemised) needs of the Enlarged Group. But the draft also referred to the possibility that (notwithstanding the recent

Government action) the markets might return to their state of chronic seizure so that the Enlarged Group's access to market funds would be cut off at a "pinch point" some three years in the future. In that event, the letter noted, the Enlarged Group would need access to additional Government funds outside the ordinary programmes and to an extent beyond its anticipated needs. The draft letter sought an assurance that the Government would give an unlimited commitment to make available whatever funds were necessary. Mr Tate acknowledged in his correspondence with PwC that it was "a bold shot to seek an unlimited commitment".

449. On 24 October 2008 Mr Tate had a meeting with Mr Bailey of the Bank to discuss the terms of any commitment. Mr Bailey was willing to confirm the existence of sufficient facilities within the ordinary programmes for the anticipated needs of the Enlarged Group, to say so in writing, and to help in obtaining the like written assurance from the Treasury. But unsurprisingly he was unwilling to give a written commitment, open-ended in time and unlimited in amount, as to the availability of additional funds some three years hence. PwC appear to have understood the sensitivities around the Bank committing to give a blank cheque to the Enlarged Group, but asked Mr Tate to explore with the Bank whether it would clarify what it had meant when it said publicly that it would "take all actions necessary to ensure that the banking system has access to sufficient liquidity" and that it would "extend and widen its facilities in whatever way [was] necessary to ensure the stability of the system". The question was a fair one, given that the scenario postulated by PwC (a chronic seizure of the markets) was a systemic one, not one that affected the Enlarged Group alone.

450. The response of the Bank in the continuing discussions was to increase the funding under its ordinary programmes the availability of which it was prepared to confirm (so reducing the degree of reliance of the Enlarged Group upon market funds) to £110bn (against an anticipated requirement of £96bn for the Enlarged Group), but to hold back on Lloyds' request for written confirmation that the Bank would make available *any* necessary funds in periods of extreme market stress. The Lloyds' team had provided the Bank with the detailed workings of the funding plan for the Enlarged Group (including on a pessimistic scenario): accordingly the intended written commitment already covered a "downside" case, so the request was for an open commitment to be made to Lloyds as a specific institution in times of systemic stress.

451. On 28 October 2008 there was a further meeting with an Executive Director of the Bank ("PT"). A representative of the team preparing the PwC working capital report was in attendance. A revised draft of the letter that Lloyds was intending to send to the BoE seeking the requisite confirmations had been prepared the preceding day: its terms still sought some open-ended assurance over support in circumstances of extreme systemic stress. At the meeting the response of the Bank was

a) to confirm the availability of the Government funds sought by Lloyds (even on the pessimistic scenario):

b) to explain that "the tenor of facilities and amounts would be flexed according to perceived market needs" and that "the mechanism was there to extend them if conditions worsened":

c) to decline to go any further.

The note of the meeting records:-

> "PT said that there were no guarantees for individual institutions but "speaking as a citizen" he would expect PwC to take comfort from the public statements by the Government that they would continue to support the banking system. As he had explained…the Bank of England facilities were designed to be adjustable to address market conditions. They were however not there to address solvency issues in a particular institution as the Tripartite Authorities had other powers/tools to deal with this."

452. A board meeting on 29 October 2008 would therefore have had to work on the basis that the Bank had confirmed the availability of Government funds to the maximum anticipated need of the Enlarged Group, but had not promised to go beyond its general public statements as regards "doing whatever was necessary" by making a specific written commitment to Lloyds (though it had given a "nod and a wink").

453. In the event on 31 October 2008 the Bank expressed its commitment in these terms:-

> "We are content that you have presented to the Bank a funding plan for the merged Lloyds-HBOS which is satisfactory and provides sufficient comfort that the funding will be viable . In view of that we are content that the merged bank will have access to the Special Liquidity Scheme up to 20% of its Eligible Liabilities (as calculated by the Bank, in line with the published methodology). I also confirm that the merged entity will have access to the Bank's facilities and operations conducted under the Bank's Sterling Monetary Framework provided it continues to meet eligibility criteria for such operations as published by the Bank of England."

This was formally confirmed in a letter dated 3 November 2008. Mr Tate's assessment of the text was that whilst it was not exactly what Lloyds had been looking for

> " …it is damn good and I "think" that it is the only letter like this that they are providing!"

So Lloyds was being singled out by the BoE for assurance as to funding. In his letter of thanks to the Lloyds' team he said he was "ecstatic" at the outcome.

454. The draft PwC working capital report then addressed the assumptions being made in it. Before examining the assumptions themselves I would observe that insofar as they related to HBOS, the grounding for the assumptions had been provided by HBOS, was being reviewed by KPMG, had been analysed by Lloyds and had been scrutinised by PwC in consultation with Mr Tookey and with the Lloyds Group Corporate Treasury department to ensure a consistency of approach when compared with the outputs from Mr Roughton-Smith's work.

455. The PwC report was based on Lloyds' own figures for the anticipated capital requirements of Lloyds, and on HBOS' figures (but subject to adjustments made by Lloyds) for the anticipated capital requirements of HBOS. Amongst the assumptions being made was that adjustments would be required to the fair value of HBOS assets as at the date of acquisition, which were expected to result in substantial reductions to the carrying value of those assets, thereby reducing Core Tier 1 capital. The assumed adjustments were £8.7bn negative on a base case and £10.3bn negative on a downside scenario (these being the amounts estimated by HBOS as adjusted by Lloyds, drawn from the work of the Group Corporate Treasury). In its own estimates HBOS had already factored in impairments of £8.4bn on its base case and £11.3bn on its pessimistic "stagflation" scenario, so PwC was being asked to adopt a manifestly cautious approach. The working capital report noted that the Lloyds risk team had reviewed these estimates "in mid October", had compared the results against their own analysis and considered the estimates to be prudent. (In fact the documents show the review process continuing until 28 October 2008).

456. On these cautious assumptions the PwC working capital model showed that (taking into account the £17bn proceeds of the recapitalisation) on the base case scenario the Core Tier 1 ratio of the Enlarged Group would remain above 6% at all times, and on the pessimistic case it would remain above 5.1%. (thus providing a 1.1% buffer over the absolute minimum). The pessimistic case was aligned with stressed circumstances in which the FSA would accept a reduction on the Core Tier 1 ratio to 4%, but (depending on the duration of the stress and the ability of the Enlarged Group to continue to lend commercially) would expect the restoration of the "buffer" by means of an appropriate plan.

457. At trial an issue arose as to whether the PwC calculations in the draft of 28 October 2008 took into account the latest impairment figures that had been produced by Mr Roughton-Smith. It is not a pleaded Particular of negligence that the board of Lloyds relied on the Working Capital report of PwC when they knew or ought to have known that it did not incorporate all of Mr Roughton-Smith's work: so the issue only arose in the course of the trial itself and fell to be addressed on the material then available (which did not include PwC's working papers on the matter, save insofar as individual cells in the surviving spreadsheets could be accessed).

458. The witness evidence presented a confused picture. Mr Tookey was of the view that the PwC report did not include Mr Roughton-Smith's last impairment figures (in the sense that they had been modelled and analysed), but he thought it inconceivable that PwC would not have seen the figures. Mr Daniels was clear that Group Risk's work had been used to cross-check the adequacy of the net negative capital adjustment and thought that PwC had incorporated Mr Roughton-Smith's latest figures (but the only document he could identify as supporting that belief proved not to do so). Mr Tate thought that Mr Roughton-Smith's figures had not been incorporated "line by line" but had been used as an input into an assessment of probabilities. Dr Berndt thought that the capital adjustment had been checked for "plausibility" but could not recall how. Mr Williams (the Defendants' expert) said that he had seen material that reconciled Mr Roughton-Smith's figures with the PwC modelling but was unable to identify it. None of this material is really reliable.

459. But on the available material I find as follows:-

a) The PwC working capital report incorporated and modelled Mr Roughton-Smith's impairment figures as at 14 October 2008 (as appears from cells behind the spreadsheet).

b) The drafts of the PwC Working Capital report are consistent in their reference to ongoing work being undertaken on impairments and FVAs. It is unlikely that PwC would choose totally to ignore the output of that known continuing work.

c) The PwC report assessed fair value adjustments of £10.3bn based on figures derived from HBOS as reviewed by KPMG and adjusted (in relation to corporate insolvencies) by Lloyds.

d) The detailed notes on the working copy of the PwC capital model show that there was a specific cross-referencing to the impairments analysis undertaken by Mr Roughton-Smith on 14 October 2008 and note a decision that the PwC adjustments already took sufficient account of them.

e) The potential adjustments to be made to HBOS's figures were the subject of consideration by Lloyds Group Risk (including Mr Roughton-Smith) and Lloyds Group Corporate Treasury and of conversation with PwC right down to 28 October 2008 (with updated figures being provided at 10:26am and corrected by PwC at 11:47am that day). Both PwC personnel and Mr Roughton-Smith were on the circulation list. The object of that consideration was to ensure consistency between the Lloyds approach and the HBOS approach to their respective impairment and FVA figures.

f) Notwithstanding that process, the PwC draft Working Capital report of 28 October 2008 as placed before the Board probably did not include a specific modelling of the figures that Mr Roughton-Smith reported upon in the late evening of 28 October 2008 resulting from his work on 27 October 2008 (because the PwC draft appears to have been circulated before Mr Roughton-Smith's late report and continued to state that it used HBOS impairment forecasts modified by Lloyds). The specific modelling would have included impairments on the base case up to £21bn (the figure adopted in the impairments report of 14 October 2008 and the subject of subsequent contact). Thus it would only be any increase over those figures that was not formally modelled.

g) However, because Mr Roughton-Smith was undertaking the "10b-5 work" on 27 October 2008 and because (i) PwC participated in some of this work and (ii) PwC were in any event in conversation with Lloyds throughout this period about the capital model, it is likely that there was a flow of information about Mr Roughton-Smith's impairment work that continually fed into the cross-checking process.

h) PwC continued to work on the draft Working Capital report and sent their latest version to Mr Tookey and to the Lloyds Group Corporate Treasury team (but not to the Board) at 1:57am on 29 October 2008. This

version of the draft noted that the Enlarged Group downside forecasts were based on aggregating the two group's separate downside forecasts with a sensitivity analysis overlaid, and that Lloyds considered the most damaging scenario to be a "1 in 25" recession. The significance of the impact of a "1 in 25" recession was therefore noted on the face of the report, and it was the subject of a separate section entitled "The key differences in downside assumptions are around fair value estimates" which explained how the FVA of £10.3bn had been reached. There was a 95 page Addendum containing 9 appendices. Appendix 8 set out in spreadsheet form the capital models for the Enlarged Group on the base case (i.e. "1 in 15") and "1 in 25" scenarios.

i) Mr Roughton-Smith's full report was tabled at the board meeting on 29 October 2008; although its figures were not modelled in the 1:57am version of their report PwC would probably have been aware of the full report during the course of that day (since they knew the ongoing work was being done and may be taken, as competent accountants, to have enquired as to its outcome - given the recognition of the significance of "downside scenarios" on the face of their draft report).

j) PwC continued to work on the Working Capital statement and in the revised version produced (probably on 30 October 2008) did not make any significant alterations as regards further adjustments to the "stagflation" scenario (as is apparent from the schedule of amendments which accompanied the updated draft) and so as to the sufficiency of the modelled capital requirement.

k) PwC's final report did not depart significantly from its draft, and in particular did not explicitly address any additional impact of Mr Roughton-Smith's final adjustments to the range of "1 in 25" impairments upon the capital model. It simply noted that "further evaluation of potential fair value adjustments giving rise to a reduction in Core Tier 1 capital is likely to be required". This probably reflects a position in which the existing PwC models had not been reworked to incorporate the final "1 in 25" figures, but in which PwC (which had worked alongside Mr Roughton-Smith whilst he was preparing his last impairment report) knew the outcome and remained content with the tenor of their advice.

l) In particular I think PwC must have considered whether in the light of Mr Roughton-Smith's latest work the "buffer" built into the capital model remained sufficient: it is highly improbable that they would have signed off their report having observed further work being done but without having any idea what figures that further work produced.

m) Mr Roughton-Smith's figures were shared with UBS, with Merrill and with Citi (as sponsor banks). As sponsor banks they had the obligation (both under the Listing Rules and under their letters of engagement) to review the working capital report. Mr Roughton-Smith's figures were provided to enable them to do so. It is therefore very unlikely that data

would have been provided to the reviewers but not provided to the authors, being entirely kept from PwC.

460. The PwC report therefore did not in its modelling incorporate the final Lloyds internal work: but it did not suggest that its own conclusions were incompatible with that work.

461. In relation to regulatory capital the PwC report recorded the following (itself a re-statement of a position outlined to Mr Tookey on 17 October 2008 by the FSA):-

> "The FSA confirmed (in meeting held on 24 October 2008 attended by [Lloyds] PwC and the FSA) that it now expects banks to meet a 6% Core Tier 1 ratio and an 8% Total Tier 1 ratio. If a bank were to fall below the 6% ratio, the FSA would expect the bank to discuss the reasons for this and to agree an appropriate course of action to restore the ratio to 6% within an appropriate timetable.
>
> The FSA also confirmed that in extreme stress, a 4% Core Tier 1 ratio would be acceptable to them. The 4% is considered the minimum amount necessary to give FSA comfort that a bank would survive a deep recession."

The PwC report advised that regulatory capital was critical for market perceptions of the Enlarged Group and warned that the Core Tier 1 ratio would be below the target 6% ratio in a "downside" scenario, dropping to 5.1% at the end of 2008. It advised that (based on discussions with the regulator) the FSA was likely to expect the Enlarged Group to demonstrate a capital plan and any remedial action to restore ratios to 6% within an appropriate timescale. Whilst commenting on a "downside" scenario it did not specifically address the "extreme stress" scenario (in which a 4% Core Tier 1 ratio would be acceptable). But the analysis of the Defendants' experts Mr Deetz and Mr Williams (which seems to me to be sound) was that total impairments of £26.8bn (pre-tax) would be needed before the 4% Core Tier 1 ratio was breached (thereby rendering the raising of additional capital potentially necessary). This was also the view of Mr Tookey at the time.

462. The PwC work also addressed the key sensitivities to the assumptions upon which those projections were based. It indicated that a further reduction in attributable profits of about £6.9bn (post-tax) more than the losses and impairments already included in the "downside" or "pessimistic" scenario would have to be incurred without management action before the Core Tier 1 minimum of 4% was breached. It is not clear on the evidence what figure for "impairments" in the "downside" scenario was taken in that calculation. The report warned that there was a residual risk (unquantified) that the economic assumptions might get worse than those predicted in the downturn forecast.

463. The losses and impairments assessed in the downside scenario included (alongside Lloyds' own estimates of its own forecasts) Lloyds' own fair value adjustments to HBOS' net assets estimated by HBOS management with advice from KPMG. PwC's report informed the directors that these estimates had been compared by the Lloyds' risk team against their own analysis and were not considered to be imprudent but that

> "..a detailed exercise to assess the likelihood of further impairments or other adjustments…. has not yet been performed."

464. The material produced by HBOS itself was a 70-page draft memorandum concerning its working capital position. After dealing with its governance and monitoring models (the focus of a working capital statement by a bank), HBOS then set out its divisional funding preceding a section entitled "Adequacy of Financial Resources". This latter section made clear that "HBOS is very dependent on..the UK Government and Bank of England to facilitate funding and liquidity…". Drawing on a Funding Plan submitted to the HBOS board in October 2008 the memorandum noted a continued attrition to customer deposits before an anticipated recovery to pre-September 2008-crisis levels in March 2010, and, in consequence, the significant reliance being placed on "various UK Government supported funding arrangements". These were simply described as "BoE Facilities", "Government Guaranteed Funding" and "Central bank Repo": there was no separate identification of the ELA component. The HBOS memorandum set out a table showing an FSA-compliant Core Tier 1 ratio predicted to be 5.7% in December 2008 and 5.4% in June 2009 on a base case and 5.3% on a stress case. The commentary was that

> "…even in very severe scenario target capital ratios would be met, other than the Core Tier 1 in the stagflation plus other stresses scenario and in this case Core Tier 1 would still be above the minimum FSA requirements."

465. The conclusion of the report to the HBOS Board was expressed in these terms:-

> "Events have moved on at pace during September and October 2008. As a result of these developments, in addition to our existing sources of capital and liquidity HM Treasury announced on 8th October a package of measures to increase the availability of capital and liquidity to UK banks and subsequently announced, on 13th October, that HBOS capital resources specifically would be increased by a total of £11.5bn. We also continue to access BoE facilities and have started to issue off new term funding programs under the Government guarantee. The end result of these initiatives is that our capital plans look robust and our funding liquidity position is also improved though clearly dependent on continuing Government and BoE support throughout the period under review… Taking into account all these sources of capital and liquidity and based on the results of management's review of working capital requirements the Board is requested to conclude that HBOS has sufficient working capital for its present requirements. Assuming that the Board is satisfied that the above conclusion can be reached the Board is requested to approve submission of this assessment of working capital to the Directors of Lloyds TSB group plc."

466. Key parts of this work were carried over into a document prepared by Mr Ellis for the HBOS board dealing with "Working Capital Statements in Shareholder

Communications". After noting the intended recapitalisation this summarised the position for the HBOS board thus:-

> "Applying our sustained stagflation assumptions with a range of other potential (but unlikely) charges would still produce a Core Tier 1 ratio above 5%. From a working capital perspective the injections will therefore satisfy the objective of taking any issues or concerns over capital ratio out of the equation for the foreseeable future."

That statement was to be approved by the HBOS Audit Committee and then by the HBOS board for transmission to the Lloyds board.

467. As to the KPMG work, at the request of PwC KPMG prepared for the Lloyds board a commentary on the Working Capital Memorandum prepared by HBOS concerning both funding and regulatory capital (and analysing the assumptions behind and the outputs from the forecasts). It approached the task by treating HBOS as a component part of the Enlarged Group (for the purpose of examining available capital) but did not otherwise consider the impact of the Acquisition.

468. The report conveyed a number of clear messages. First, that the wholesale markets upon which HBOS depended for funding were difficult, and that its funding model assumed the availability of BoE facilities and the Government's bank funding and liquidity schemes. Second, the degree of dependence on such funding could be affected by abnormal withdrawals of deposits (over which HBOS did not have complete control). Third, that capital sensitivity was driven by losses (which reduced capital resources) and by the effect that a worsening economic climate had upon RWAs (which increased capital requirements): but that

> "[u]nder both the base case and the stagflation scenario, HBOS remains within FSA capital limits, albeit only just under the stagflation scenario. However, after the proposed share issue under the Government's scheme, the capital ratios under all scenarios remain at at least 6.5% which is above the 5% minimum required by the FSA."

Fourth, on the assumption that the recapitalisation was completed the management forecast was that HBOS would have sufficient capital to allow the Core Tier 1 ratio withstand a severe economic downturn. Fifth, that there was a possibility that the immediate economic future would be worse than the assumed severe economic downturn given that most economists were now predicting a recession, that the main impact of such an event would be on forecast capital requirements, but quantification was impossible. Last, that whilst the scope of KPMG's work was simply to comment on the funding and working capital projections prepared by HBOS and the assumptions which underlay them, the usual production processes and governance and review procedures had been observed by HBOS management.

469. The sizeable file of documents prepared for board members for 29 October 2008 also included a draft of the KPMG engagement letter, a draft comfort letter addressed to the Lloyds' directors on the sufficiency of HBOS' working capital, a comfort letter from

HBOS as to the accuracy of information about HBOS, and a letter from KPMG confirming the “no significant change” statement to be included in the Circular.

470. All of this material had been prepared to enable the Lloyds board to reach a decision on the Acquisition, and it is its cumulative effect that one must have in mind before alighting upon particular phrases or figures.

The Board Meeting of 29 October 2008

471. The board meeting of 29 October 2008 was clearly an extremely important one, because the board was being invited to “press the button” on the Acquisition (subject to a meeting of a committee of the Board pencilled in for 31 October 2008). Those attending would have known that there was an “awayday” planned for shortly after publication of the Circular at which the Medium Term Plan for the Enlarged Group was to be discussed and decided, including a review of the liquidity profile of the Enlarged Group and of regulatory capital adequacy. This compression of events (each addressing aspects of the purpose and consequences of the Acqusition) means that there is a risk that the Court cannot confidently ascertain what were the decisive arguments or what were the compelling convictions on 29 October 2008 (as opposed to later). But this risk is countered by the fact that the participants were called upon to reflect upon why they did what they did so soon after the events themselves that for some participants the memory will have acquired a vivid (if not immutable) form. The documents are of little assistance in this regard because they record the decisions made but not the way in which the decisions were reached.

472. Each of the Directors (Mr Tookey was still not a director) had squarely to address whether they could conscientiously be part of a unanimous body of opinion recommending the Acquisition to the shareholders: because both the draft Chairman’s Letter and the draft Circular contained such a recommendation. Mr Tookey knew that he was due to be appointed a director on 31 October 2008 and would be a director at a time when the Chairman’s letter and the Circular were published: so he knew that he had at 31 October 2008 to address the same issue. Each director also knew that he or she would be required to confirm that the best of his or her knowledge and belief (having taken all reasonable care to ensure that such was the case) the information contained in the Circular was in accordance with the facts and did not omit anything likely to affect the import of such information.

473. The meeting had to consider some three dozen documents (some of very considerable length and others of some complexity and density) relating to the Acquisition alongside six or seven other items of business. Dr Berndt and two other directors participated by telephone: all other directors were present. In attendance (amongst others) was Mr Tookey (still not a board member), Ms Sergeant (Chief Risk Director) and Mr Parr. It is the evidence of Mr Tookey (supported in hesitant terms by Mr Tate and in general terms by Mr du Plessis) that Mr Roughton-Smith was also in attendance though his attendance is not recorded on the signed minutes and there is no record of him saying anything.

474. In the ordinary course a judge might be inclined simply to accept the contemporaneous documentary record (signed by the Chairman as accurate) in preference to individual recollection at a distance of nine years. But in the instant case the issue is more difficult.

475. First, Mr Tookey gave specific evidence both in writing and orally as to Mr Roughton-Smith's contribution at the Board meeting, on which he was not challenged (though he was challenged on Mr Roughton-Smith's attendance at the meeting on 24 October 2008 and accepted that his recollection may be at fault if the signed Minutes did not record Mr Roughton-Smith's attendance). Mr Tate's hesitant recollection was not challenged: and nor was the evidence of Mr du Plessis that Mr Roughton-Smith presented his paper.

476. Second, Mr Roughton-Smith's report tabled at the Board Meeting was actually dated 29 October 2008. The idea that he should have participated in the part of the meeting (by physical or phone attendance) to enable the directors to digest the late product of his workings is entirely credible. Mr Daniels was also clear in his evidence that there was a "rigorous and full-bodied" discussion around Mr Roughton-Smith's paper including a wide ranging discussion regarding what could have an impact upon the capital requirements.

477. Upon consideration of all the evidence I consider that Mr Roughton-Smith probably did *not* attend the board meeting on 29 October 2008 and that Messrs Tookey, Tate and du Plessis are mistaken in their recollection. The compression of events makes such a mistake understandable. Ms Sergeant (who otherwise bore the executive burden of risk issues and to whom Mr Roughton-Smith reported) is likely to have required the attendance of Mr Roughton-Smith to be recorded in the Minutes if he was there: and the absence of such a record is on analysis significant. Further, if Mr Roughton-Smith had attended and there had been a rigorous and full-bodied discussion of impairments in his presence I would have expected it either to have generated some further traces in the documents or to have produced answers (particularly relating to the severity of his assumptions) that lodged in the memory of the participants at the meeting. But the only contribution from Mr Roughton-Smith that is recalled is one relating to the accuracy of his impairment and fair value estimates and any potential improvement to be gained from further work (a matter covered in the tabled report anyway).

478. The position in which the Board found itself was therefore that there was a late-tabled paper from Mr Roughton-Smith containing some specific figures not previously placed before the board (estimating impairments below his original figure but above his last revised figure) and a draft working capital report from PwC which took account (under the ordinary flow of information) of the trend of due diligence work being undertaken by Mr Roughton-Smith and his team but which did not explicitly bring his late-tabled figures into the text of the report. It was no part of the Claimants' case that consideration of this item of business should have been adjourned for further consideration. It was accepted that the Board had to make a decision and to do so on the basis of the material with which the Lloyds' management had provided it. The case advanced was that no reasonably competent board could, on the basis of that material, have decided as the Lloyds board did decide.

479. At the board meeting the first item of business (after receipt of updating reports) was a consideration of the HBOS IMS due for release on the 3 November 2008 and which was to be incorporated in the Circular (and to be the subject of a letter of comfort from HBOS as to its factual content). The evidence establishes that this was not simply "nodded through" but was the subject of serious consideration. The evidence of Mr Tookey was that the content and tone of the HBOS IMS was scrutinised and that the Lloyds board requested certain changes. The changes are exemplified by one passage (there are others).

480. In the "Outlook" section the draft stated:-

> "While the credit environment will remain challenging, HBOS's existing strong capital position, to be further enhanced by the injection of capital and liquidity facilitated by the UK Government, leaves the Group well positioned."

In the IMS incorporated into the Circular this becomes:-

> "While the credit environment will remain challenging, HBOS's robust capital position, to be further enhanced by the injection of capital and liquidity facilitated by the UK Government, reinforces the group to meet such challenges."

481. The evidence of some Lloyds witnesses (Mr Tookey, Mr Tate, Dr Berndt and Mr Williams) was that in the analyst's lexicon "strong" denotes a better position than "robust" so that Lloyd's was signalling a watering down of the HBOS assessment: even if that is so, I doubt that any ordinary retail investor who read the Circular would pick up the nuance. It may well have been that the Lloyds board was simply seeking to align the HBOS IMS with the language used in its own material. But what I draw from the event is

(a) that the Lloyds board was anxious not to "oversell" the proposition to its shareholder base;

(b) that the Lloyds board sensed a potential for the HBOS executive team and its advisers to overstate the strength of HBOS.

482. The meeting then considered (in their then-current forms):-

(a) the Lloyds IMS;

(b) the Circular;

(c) the Chairman's Letter as prepared substantially by the sponsor banks (UBS, Citigroup and Merrill Lynch);

(d) the list of Risk Factors;

(e) advice from Linklaters on due diligence;

(f) Mr Roughton-Smith's work on HBOS impairments;

(g) PwC's work on the sufficiency of working capital for the Enlarged Group;

(h) a summary of the HBOS Working Capital Report

(i) the Working Capital Report on HBOS prepared by KPMG;

(j) the text of the letter to be sought from BoE;

(k) various "comfort" letters.

The board Minutes also record the taking of various formal steps (including the establishment of a Transaction Committee): but they do not record the content of discussions, save briefly in relation to the HBOS IMS, the Chairman's Letter and the Risk Factors. Consideration of the note about impairments and a discussion about the contents of the Circular are specifically noted (but without elaboration). The absence of a record does not indicate that there was no discussion.

483. All of the basic components of the Acquisition had already been considered (most recently on 24 October 2008), and this meeting was "document heavy". This Board meeting could have simply been formal. But I am confident (based on the general history of the matter, the character of those directors I have seen and the tenor of the documents themselves - with their sundry detailed statements of opinion and of advice to which each director was expected to "sign up") that there was further discussion at the board meeting about the merits of the Acquisition, and not simply a perusal of the text of proffered documents. As to the content of that discussion, the evidence is scant.

484. Sir Victor acknowledged gaps in his memory and his written evidence speaks only in hesitant terms about the board meetings on 24 and 29 October 2008. But in cross-examination he confirmed that the board (i) did see and consider Mr Roughton-Smith's impairments report tabled on 29 October 2008 (ii) regarded his "1 in 15" scenario as his base case and the "1 in 25" as his stress case (iii) understood that the working and regulatory capital figures that were put before the board had been compiled with knowledge of Mr Roughton-Smith's figures but had not been built up with those figures specifically included (iv) treated Mr Roughton-Smith's figures as a type of sensitivity analysis in relation to the figures produced by HBOS and its auditors. However, he was not sure if there was any specific analysis done factoring in Mr Roughton-Smith's last impairment estimates (though he expressed himself "astonished" if it was not done at some point).

485. The written evidence of Mr Daniels is clearly shaped by the form and contents of the Board minutes: it was in cross-examination that he spoke of the "rigorous" discussion of Mr Roughton-Smith's impairment note. But one can gain a sense of his thinking from the evidence which he gave to the Treasury Select committee in early February 2009. He considered the Acquisition to be a "prudent" one, albeit one that would be "painful" in the short term. Looking beyond the potential short-term risks Mr Daniels considered the Acquisition to be "strategically …very good" and that the Enlarged Group would have a leading market share in a large number of markets and one which ultimately (probably by 2011) would sustain a 19.8% increase in EPS (compared to proceeding on a 'stand-alone' basis and having to raise £7bn the additional capital).

486. On this last point (concerning the £7bn additional capital requirement) Mr Daniels did give a somewhat puzzling answer to a question from the Treasury Select Committee in 2009:-

> " Q: Do you think you would still have had to take government money, irrespective of whether you had taken [over] HBOS or not?

> A: No, we would not have had to have taken government money had we not bought HBOS."

The silent assumption in that answer is that the Government had *not* (as an alternative to the HBOS takeover) required a "standalone" Lloyds to recapitalise with an additional £7 billion: and it further assumes that such new capital as Lloyds had in any event to raise could have been raised in the market (notwithstanding the advice of investment bankers that the market had no appetite for new bank equity). This is the tenor of Mr Daniels' evidence on the subject. In his written evidence he explained that it was indeed his personal view that Lloyds was well capitalised and not in need of Government money: but that the Tripartite had altered the rules about what "well capitalised" meant. The bare answer to the Select Committee does not convey that message and (in my view) does not square with the realities of the Recapitalisation Weekend. I do not see how Lloyds could realistically have resisted submitting to the Tripartite's requirements over the Recapitalisation Weekend and I do not see how (if they did submit) they could realistically have avoided taking Government money (or why Lloyds would have wanted to, given the relatively attractive terms upon which it was available when compared with likely deep discount the market would have required).

487. The written evidence of Ms Weir also established that Mr Roughton-Smith's latest impairment figures were discussed at the 29 October 2008 board meeting. Her recollection is that within her own field or speciality she and her team were comfortable with HBOS's estimated impairments in respect of the retail bank: and I have no doubt that that influenced her approach to other impairment estimates. She had no actual recollection of the meeting. But her present belief as to what she would then have thought about those other estimates is (i) that it would be inappropriate to use internal estimates based on less than full access to HBOS's books coupled with an assumed downside scenario as a basis for commenting on HBOS's impairment figures as signed off by HBOS's management and tested by its auditors; and (ii) that it would not be appropriate to attempt to put Mr Roughton-Smith's figures into the HBOS "stagflation" model because of the need for internally consistent assumptions (particularly in relation to RWAs). She asserted that the function of Mr Roughton-Smith's impairments estimates was to assess how significant the risk would be in a potential downside scenario: "a piece of information to be thoughtful about as part of the overall review of the acquisition".

488. In his written evidence Mr Tate (as I think, mistakenly) thought that the latest impairment figures were *presented* by Mr Roughton-Smith himself at the meeting on 29 October 2008: but his evidence contained no recollection of the content of any such presentation (beyond what was in the document itself). He made the points that (i) the impairments analysis was performed at the time when Lloyds was taking a conservative view of the HBOS portfolio and (ii) as an experienced banker he did not think that the Enlarged Group would actually realise all of those impairments as actual losses if the Enlarged Group continued to hold the portfolio of assets until such time as asset prices recovered (and in oral evidence he gave a specific example). In cross-examination he acknowledged that the board did need to understand the impact of impairments upon capital, and that he could not recall an "on-paper" analysis of capital requirements in the light of Mr Roughton-Smith's latest impairment figures: but he made two points. First, that he would not recommend a capital level to cover a low probability event at the extremity of a range, and that he had never seen a modelling of the most extreme

positions. Second, that "factoring in" an input does not necessarily mean taking it as a "driving number", so that (on his evaluation of the severity of the assumptions made by Mr Roughton-Smith) he factored in his range but did not find it as compelling as to be realistic.

489. Those are the defendants who were directors at the time of the meeting. It is useful to look briefly at the evidence of directors at the time of the meeting who are *not* defendants to the action.

490. Mr Kane has no handwritten notes of this meeting to assist his recollection as to whether there was anything in particular at the meeting on 29 October 2008 that persuaded him to support the Acquisition. For his own particular area of responsibility the due diligence returns had been favourable and he regarded the Acquisition as excellent for insurance and investments (as in the event it proved to be). In relation to the broader business it is likely that he stood by his belief that the perceived advantages flowing from the Acquisition outweighed the perceived risks. The advantages he saw were principally (i) the strategic value of HBOS as creating market share for the Enlarged Group, making it No.1 in current accounts, mortgages, savings accounts, personal loans credit cards and household insurance and No.3 in commercial and corporate loans (ii) the creation of synergies which in the near term (2 or 3 years) produced cost savings and (iii) access to HBOS' successful savings and investment products. The risks he saw were (i) taking on HBOS assets that were exposed to and likely to be affected by an economic downturn (with the consequences that that entailed) and (ii) dealing with HBOS' liquidity and funding pressures. As to those, his evidence was that the board tried to make "a probable realistic set of assumptions given a base case and then a stress case": and where those cases did not produce a single answer:-

> "So there is a wide range of outcomes, and what you do is you tend to distil these down into the most probable. So you don't take the extreme ends of the outcomes."

491. The general view of Mr du Plessis was that Lloyds was a mature, established bank but with limited organic growth prospects, so that the Acquisition would address the strategic challenges it faced by creating a very strong organisation with a significant market share in multiple areas and substantial market and cost synergies after completion. He recognised that there were risks for Lloyds in proceeding with the Acquisition, and that the economic circumstances in which the deal was being proposed were unusual: but he considered that it was those very circumstances which provided Lloyds with an opportunity to do a transaction that would not have been possible in more normal circumstances. Overall he considered the Acquisition to be a relatively low risk way of creating significant value for Lloyds shareholders.

492. By "relatively low risk" he meant that he measured the "downside" risks against the "upside" opportunity: and did so knowing that HBOS had a large risky balance sheet and that Lloyds had a comparatively small balance sheet with which to address those risks and exploit those opportunities. By "creating significant value for shareholders" he was not attaching particular significance to EPS accretion but rather looked to the creation of a valuable business. He may be taken to have maintained that approach at the board meeting on 29 October 2008.

493. Mr du Plessis had no direct independent recollection of that board meeting, save that there was a discussion of Mr Roughton Smith's work. But asked to assume that at the meeting Mr Roughton-Smith's latest valuation was available but that the meeting did not have any other presentation or analysis which showed the impact of his impairment figures Mr du Plessis responded:-

> "I hesitate because one must see a correlation - it's not easy for me as an outsider to say what the correlation should be between the risk work …. done by the Chief Risk Officer in terms of impairment and how that impacts necessarily on the modelling work that is done in a different context by the valuation team…. Should it have been taken into consideration somehow? I guess, yes. But it's hard for me to say how that should have been reflected in the modelling work."

Later he said:-

> "[A]s an ex-finance person and as a business manager, I have seen countless financial projections and scenarios in my life, over and over and over again, and one thing I've learnt, you cannot pick one variable, stick it in a model and… you run a grave risk of coming up with the wrong answers. Modelling needs to be done by people who understand all the variables that in a coherent manner interplay one with the other… I can't say much more than that. I don't think it was possible for us as a board to take that one piece of work and specifically insist that that is somehow reflected in the model."

494. Dr Berndt was another who took the view that the Acquisition presented a once-in-a-lifetime opportunity for Lloyds to achieve its long-held strategic aim, but whose evidence noted that the board did not get carried away with the possibility of the deal, recognising that it was not without risk. The nature of that risk was explored with him in cross examination. The view he took was (i) that as a board they had to arrive at a balanced and understandable position for the company and its prospects and not a position based on the worst-case scenario (ii) that the extreme ends of the "1 in 15" and "1 in 25" scenario ranges had single digit probabilities (by which he meant that in his view the last £3bn of the upper end of the "1 in 25" scenario had about a 3% probability) (iii) that whilst he put those values on, he did not know that other directors did (because he could not remember the specifics of a discussion) though he knew that they all ended up at the same general position, namely, that "downside" risks were manageable. He said:-

> "When I say the 3% is a "downside", that doesn't mean that that gets ignored… You look at it and you will ask yourself: Will that sink the ship before I get the long-term benefits? And the answer to that was: "No"…"

495. He was later pressed with the point that the events which actually occurred in late 2008 fell within the scope of Mr Roughton-Smith's "1 in 25" scenario, to which Dr Berndt responded:-

> "A: So you're absolutely right, but it has I think almost no bearing on whether, at the time the decision was made and the proposal was made to the shareholders, whether….anybody could know about that and use it in order to come to a fair and balanced proposition on the position of the company and the prospects.
>
> Q: Well, they could know about it, couldn't they, because all you needed to do was to look at the figures Mr Roughton-Smith was generating at a "1 in 25" ?
>
> A: No but the probability of those numbers, based on the world we were in in September and October was so low that they shouldn't be the basis of a proposal to shareholders that needs to be, as the corporate governance code [requires], fair and balanced.
>
> Q: Well, it wouldn't be difficult, would it, to produce a piece of analysis which would project the situation something like this?...
>
> A: Right, but what is the basis in reality of that kind of scenario? I mean, you could postulate all kinds of hypotheses, but the realities in which we were operating, the information we had available at the time, made the proposal we advanced the right thing to do."

496. He summarised his position in this way:-

> "…we went into it with our eyes open…we went into it knowing that there [were] downsides that at the time were not the most likely scenario, but there were downsides, and that the economy has shifted dramatically during the last two quarters into a position where the downsides became the reality, and not what was at the time the expectation….."

497. I have noted the evidence of the directors who are Defendants, and of the directors who are not Defendants. All this evidence is (save where I have indicated otherwise) reliable. I should now consider the evidence of the key executive team member who was not (at the time of the board meeting on 29 October 2008) a director, namely, Mr Tookey.

498. I have already observed that in my judgment he had taken responsibility for presenting Mr Roughton-Smith's late paper to the board meeting, and that he probably did so in the absence of Mr Roughton-Smith himself: certainly Mr Roughton-Smith's report was considered, as the Minutes record. I have accepted evidence that there was a robust discussion about the paper. Mr Tookey's evidence about that discussion is sparse: but it is apparent from the documents that there was a flurry of late activity and also that Mr Tookey held certain views. A presentation of Mr Roughton-Smith's work would very probably have referred to these activities and related these views.

499. I am confident that in the course of that discussion Mr Tookey would have (i) stressed the degree of confidence that Mr Roughton-Smith had that further work would not lead

to tighter ranges (not only as noted in the memorandum itself but also as conveyed in a remark Mr Roughton-Smith passed to the effect that even with twice as many people and twice the time he could not have made better assessments); (ii) reinforced that with the confirmatory opinions given to Mr Tookey by others in the Credit Risk team; (iii) informed the board that the net negative capital adjustment figure at completion estimated at £10bn had throughout been the subject of a cross-check between the HBOS calculations and Mr Roughton-Smith's impairments and fair value analysis and were broadly consistent; (iv) informed the board that Mr Greenburgh had suggested that a lower figure of £5.2-£9.6bn might be adopted in the Circular but that Mr Tookey had adhered to the more conservative £10bn figure; (v) drawn attention to the fact that the PwC Report showed that on a pessimistic scenario the prospective Core Tier 1 ratio might fall as low as 5.1%, that this represented a buffer of 1.1% over the minimum acceptable Core Tier 1 ratio of 4%, that this "buffer" was the equivalent of £9.6bn of additional impairments (pre-tax) or a total of £26.8bn, and that in his view even the upper extremity of Mr Roughton-Smith's estimates fell within this "buffer". (This last item was clearly his belief: the Claimants' experts Mr Ellerton and Mr McGregor say the belief was incorrect, whilst the Defendants' experts Mr Williams and Mr Deetz say it was correct. What matters for present purposes is the existence of the belief and its communication to the board, not its correctness).

500. As to this last item his written evidence was in these terms:-

> "Applying the more conservative 1 in 25 year recession scenario, Mr Roughton-Smith and his team forecast impairments of between £14.5 billion and £21.9 billion (again including the reported £1.3 billion of HBOS impairments for the first half of 2008). The top end of the range fell comfortably below the £26.8 billion of impairments which the PwC Working Capital Report indicated would be incurred before the 4% Core Tier 1 capital ratio would be reached. "

I do not doubt that that is what he told the board.

501. Further, I consider it likely that reference would have been made by Mr Tookey to the Memorandum which Mr Daniels had prepared on the economics of the deal for the board meeting on 24 October 2008 (to which the Minutes of the meeting on 29 October 2008 refer back). In addition I think it probable that at some point Mr Tookey made reference in outline to Mr Foley's views about the immediate prospects for the economy as a whole (which Mr Tookey had received the preceding day but which he had decided not to circulate before the "awayday"). In essence, this view was that a "1 in 25" recession was improbable.

502. Finally, I would note that whatever discussion did take place on 29 October 2008 concerning Mr Roughton-Smith's latest impairment figures took place in the presence of Ms Sergeant (to whom Mr Roughton-Smith reported) and Mr Scicluna (who was the Chair of the Risk Committee). If either had felt at all uncomfortable with the presentation of Mr Roughton-Smith's views they would have spoken, particularly because (according to an e-mail which Ms Sergeant was to send to Mr Roughton-Smith in January 2009) she had made it very clear to the board on several occasions that the review of the HBOS figures had been conducted on the "1 in 15" basis and that if events turned into a "1 in 25" scenario then "things could get much worse".

503. At the conclusion of the meeting the directors approved the Circular (subject to final drafting amendments) and resolved to issue it and to make the recommendation it contained. So the Acquisition was approved.

Events of 31 October 2008

504. The final form of the documents was approved at a Board Committee meeting on 31 October 2008. As to the contents of the Circular:-

a) PwC confirmed that the pro-forma financial information had been properly compiled consistently with Lloyds' accounting policies;

b) PwC confirmed that for the purpose of presenting consolidated financial information the unadjusted financial information of HBOS had been correctly extracted and correctly adjusted to present it on a basis consistent with Lloyds' accounting policies;

c) Linklaters confirmed that they were not aware that any requirements of the Listing Rules had not been satisfied or that any matters required to be disclosed under the Listing Rules, the Prospectus Rules or the Financial Services and Markets Act 2000 ("FSMA") had not been adequately disclosed (but that this did not amount to positive confirmation that all such requirements had been satisfied);

d) KPMG confirmed to the sponsor banks that they had disclosed everything material to be disclosed;

e) KPMG confirmed to Lloyds and to the sponsor banks that (amongst other things) the impairment figures and negative FVAs for 2007, the value of its liquidity portfolio of marketable assets and the amount and nature of its wholesale funding requirements accorded with the audited consolidated statutory financial statements, and that the figures for June 2008 accorded with the condensed consolidated HBOS half-year statement;

f) KPMG confirmed to Lloyds and to the sponsor banks that save as disclosed in the Circular (which set out the current trading, trends and prospects of HBOS) there had been no significant change in the financial or trading position of HBOS since June 2008 ("change in financial position" being a change in total assets, customer accounts, total or subordinated liabilities or shareholders' equity: and "change in trading position" including impairment losses on loans and advances compared with the corresponding period in the preceding year) – but warned that procedures undertaken in relation to changes since 30 September 2008 had been limited in essence to enquiry of HBOS staff whether a Schedule prepared as at that date remained representative;

g) UBS, Merrill Lynch, Citigroup and Lazards gave their consent to the inclusion of their respective names in the Circular and (in compliance with rule 8.4.13R(3) of the Listing Rules) confirmed to the FSA that they

were not aware of any matters that ought to be disclosed in the Circular but were not so disclosed.

A digression: a Scottish counterbid

505. At the end of October 2008 there occurred an (ultimately unsuccessful) attempt by two groups of Scottish businessmen (the Burt/Mathewson and Spowart interventions) to "spike" the Lloyds bid and to keep HBOS (or some part of it) as an independent Scotland-based entity. Its relevance to the issues before me is that the attempt generated some material upon which Mr Hill QC relied (i) in support of his argument that there was flexibility in the Government's views on recapitalisation (and that the requirement upon Lloyds to raise £7 billion as a stand-alone entity was not set in stone); (ii) as undermining what I consider was the general (but not universal) view that HBOS had no independent future; and (iii) in suggesting that it generated confounding "noise" which distracted attention from a story relating to a "leak" of the existence of the Lloyds Repo.

506. Before turning to the detail of that I would note that the event generated an amusing and perceptive article by Peter McMahon in "The Scotsman" on 30 October 2008. He noted that proponents of a rival Scottish bid could not be written off:

> "[I]t would be deeply unfair to categorise someone of the calibre and pedigree of Jim Spowart as some kind of misty-eyed kilt-wearing extra from the Brigadoon School of Management and Business studies ."

But McMahon pondered why there was so little support for the proposal for a rival bid across Scottish boardrooms in general:

> "…. There are many who think they are letting their brave hearts rule their cool heads…. To put it at its most brutal, the argument is this: that HBOS is the dead parrot of banks. They claim that, in effect, HBOS is no more; it has ceased to be; it has expired, it has gone to meet its maker. You know the rest…"

He proceeded to comment on the prospects in the current economic climate for the areas of business on which HBOS focused, and the possibility of further nasty write-downs. He added:-

> "There is a further argument that all of the component parts of HBOS are now so heavily integrated that it would be impossible – or certainly very costly – to disaggregate them… The conclusion, from those who take this view, is that the takeover by Lloyds is the only game in town…"

507. I cite this article partly for the light relief it provides in an otherwise turgid factual account, and partly because it captures perfectly my own view (i) that it was only a minority who thought that Lloyds was buying a viable standalone bank; and (ii) that there was a good rationale for buying the whole rather than trying to pick off parts.

508. I should say that a survey of the press coverage of the Scottish interventions does not suggest to me that they squeezed out the Lloyds Repo story or its significance. For example a Newsnight Scotland broadcast on 10 November covered the Spowart intervention, challenged the idea that the nationalisation of HBOS was really the only serious alternative to the Acquisition (not a Scottish intervention) and that Lloyds' was the "only deal on the table", raised the issue of the Lloyds Repo and asked whether this surely meant that HBOS was weaker than everybody thought. A fair dissection and canvass of the key issues. The "Daily Telegraph" set the Burt/Mathiewson intervention in a well delineated context which included questions about the Lloyds Repo, whether Lloyds had agreed to take extra financing really destined for HBOS after the merger and the Government's willingness to nationalise HBOS.

509. But the real point of the digression is to refer to the text of the two letters which the Chancellor of the Exchequer wrote in the context of the rival bid. Taking the more general (written to the Chairman of the Treasury Select committee) the text stated:-

> "If for any reason the merger between HBOS and Lloyds TSB does not go ahead, the FSA would need to reassess both banks to determine the extent to which each would need to recapitalise."

Mr Hill QC suggested that this was an indication that, notwithstanding the comments of Mr Sants of the FSA but days earlier that the £7bn requirement for a standalone Lloyds was fixed, in truth the figure remained negotiable.

510. In my judgment this is not a true interpretation of the Chancellor's letter. What I believe the Chancellor was saying was that in the event that the Acquisition collapsed (which would itself be a disruptive event) then it could not be assumed that the current proposed level of recapitalisation would continue to be regarded as sufficient nor could it be assumed that the manner and level of Government participation in any recapitalisation would remain the same. The FSA, having made its assessment of the needs of Lloyds and of HBOS as "stand-alone" banks in current circumstances, would need to make a reassessment in those changed circumstances. My judgment is that the Government was careful to cultivate the element of uncertainty about what would happen to each component part of the Enlarged Group if the Acquisition did not complete, not least because it was anxious to support the Acquisition as a commercial solution to a problem that it would otherwise have to resolve through executive power. That resolution (what the OFT was to describe in its report on competition issues as "the more realistic counterfactual scenario") was Government intervention to prevent the failure of HBOS by bringing it at least into partial public ownership (if not full public ownership).

511. The other letter was to Mr Alex Salmond, then the Scottish First Minister. In it the Chancellor explained that when the recapitalisation scheme was triggered the boards of Lloyds and HBOS were minded to merge, and that it was in that expectation that the recapitalisation figures for each bank had been set; but that if for any reason the merger did not go ahead then the FSA would need to reassess *both* banks to determine the extent to which each would need to recapitalise. Once again, I do not think this can be read as an indication that Lloyds might (if it pressed) have been able to negotiate a figure lower than £7bn. The Chancellor was clearly warning Scottish interests that neither the HBOS share of the recapitalisation of the merged bank nor its provisional

requirement as a "standalone" bank would stand in the light of a failed merger: but that is all.

The Circular

512. The text of the Circular (and the figures and other details it contained) had been compiled under the supervision of Linklaters with material provided by members of the Lloyds specialist departments, reviewed by PwC, approved by the investment banks and scrutinised line-by-line by UKLA. As to the investment banks, each had confirmed to the FSA that nothing required to be disclosed under the Listing Rules had been omitted. As regards material deriving from HBOS there were letters of comfort from HBOS itself and from its auditors KPMG. But as the comfort letters made clear the ultimate responsibility for the contents of the Circular was left with the Lloyds Board.

513. As at the date of the Circular Lloyds was paying 108.4p for each HBOS share (a total of £5.9bn): and the Government had priced its underwriting of new HBOS shares under its recapitalisation arrangement at 113.6p. One analyst (Glass Lewis) calculated the effective implied premium being paid by Lloyds as less than 10%.

514. The Circular itself consists of 289 pages of closely typed text and tables, the purpose and significance of which is not always readily apparent. Although formally addressed to individual shareholders, much of it would be impenetrable to that audience: the individual shareholder was likely to focus on the Chairman's Letter and to leave much of what followed to the analysts.

515. After explaining the strategic background to the proposed merger ("a compelling opportunity to accelerate [Lloyds'] strategy and create the U.K.'s leading financial services group") and the Government's specific and comprehensive measures to ensure the stability of the UK financial system Sir Victor's letter continued thus:-

> "The [Lloyds] directors believe that [Lloyds'] and HBOS's participation in the Proposed Government Funding provides the capital necessary to complete the Acquisition in a timely fashion, with certainty and on terms that the [Lloyds'] Directors believe are the best available to [Lloyds] and HBOS in current market conditions.
>
> When combined with the new capital being raised by HBOS, the Proposed Government Funding is designed to provide the Enlarged Group with the capital strength and the funding capabilities to meet the short term challenges that current markets present and support the longer-term creation of shareholder value….. The [Lloyds] Directors believe that the combination of [Lloyds] and HBOS, including the required capital raising by both companies, is in the best interests of the Company and [Lloyds] Shareholders as a whole. The [Lloyds] Board believes the turbulence in current markets has presented a unique opportunity to pursue the Acquisition, and unanimously recommend that [Lloyds] Shareholders vote in favour of the Acquisition and the Resolutions associated with the Proposed Government Funding.

In considering the merits of the Acquisition, the [Lloyds] Directors have been mindful that the landscape of the UK banking industry has shifted materially in recent months. The [Lloyds] Directors do not believe it is appropriate to compare the Enlarged Group, including the impact of the Proposed Government Funding, with [Lloyds] as it currently stands but rather compare the Enlarged Group against the position [Lloyds] would be likely to be in should the Acquisition not become Effective.

If the Acquisition and Placing and Open Offer do not complete, HM Treasury has stated that it would expect [Lloyds] to take appropriate action to strengthen its capital position. The FSA has advised [Lloyds] that if the Acquisition were not to occur, it would require [Lloyds] to raise £7 billion of additional capital, made up of £5 billion of Core Tier 1 equity and £2 billion of Tier 1 instruments. Whilst [Lloyds] would be able to seek to raise such additional new capital in the public markets, there can be no certainty that [Lloyds] would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising, or as to whether any such fundraising would be on a pre-emptive basis .

The [Lloyds] Directors believe that the Enlarged Group would be more competitive and will have significantly greater opportunities to create sustainable shareholder value than Lloyds would on a standalone basis in what is now a materially more challenging market environment."

516. The Chairman's Letter returned the rationale for the Acquisition partway through. It described HBOS as having been "significantly affected by recent challenging market conditions", noting that the deteriorating economic environment had "negatively impacted its funding model". But it communicated the belief of the Lloyds Directors that HBOS remained "an excellent franchise with the potential to contribute substantial value to the Enlarged Group". After explaining the grounds for the belief in that potential the letter continued:-

> "The [Lloyds] directors believe that the Enlarged Group will also be more competitive and significantly better placed to create shareholder value in a rapidly evolving UK banking industry than [Lloyds] would on a standalone basis, primarily given the Enlarged Group's greater size and market presence. The Proposed Government Funding is designed to provide the Enlarged Group with significant capital strength and funding capabilities to meet the short-term challenges current markets present and support the longer-term prospects to create shareholder value."

517. Part II of the Circular set out, over 17 pages, the risks and uncertainties considered to be material to the performance of the Enlarged Group. I need mention only seven.

518. Risk factor 1.1 was a generic warning about the inherent risks arising from economic conditions and the difficulties that lay in the way of predicting and guarding against such risks amid a global financial crisis. It contained this warning:-

> "Lloyds has not yet been able to assess fully the level of fair value adjustments of the assets of the HBOS Group to be acquired in the Acquisition or other aspects of the HBOS business. If the fair valuation of the assets of the HBOS Group is materially less than anticipated, this could have a material and adverse impact on the financial condition and prospects of the Enlarged Group. "

519. Risk factor 1.3 noted that market conditions had resulted (and may in the future further result) in negative adjustments being made to the estimated fair value of the financial assets that Lloyds would acquire as part of the Acquisition (compared to their book value as at 30 June 2008, being the figures required to be used in the Circular). The consequences were said to be "a material adverse effect on operating results, financial conditions or prospects". There was a warning that, given the material deterioration in the value of financial assets since 30 June 2008 and the market outlook for the near future, the fair valuation of HBOS's assets would differ from the book value as at 30 June 2008. The Chairman's letter had already explained that, based on a review of non-public information provided by HBOS, Lloyds had made a preliminary assessment that net negative capital adjustments of no more than £10 billion after tax would need to be made to HBOS's financial position for Core Tier 1 capital purposes as a result of the Acquisition.

520. Risk factor 1.5 drew attention to the inherent risks concerning liquidity, particularly if current market conditions continued to reduce the availability of traditional sources of funding or the access to wholesale money markets became more limited (which might affect the ability of the Enlarged Group to meet its financial obligations as they fell due). In relation to HBOS it said:-

> "The HBOS Group has a funding profile that involves the need to refinance a significantly higher level of loan assets than that of [Lloyds]. Accordingly, the Enlarged Group's funding profile will involve a higher refinancing risk than for [Lloyds] on a standalone basis…. These risks can be exacerbated by many enterprise-specific factors, including an overreliance on a particular source of funding (including, for example, securitisations, covered bonds and short-term and overnight money markets), and changes in credit ratings, or market wide phenomena such as market dislocation and major disasters. There is also a risk that corporate and institutional counterparties may look to reduce aggregate credit exposures to the Enlarged Group…… In order to continue to meet their funding obligations and to maintain or grow their businesses generally [Lloyds] relies and the Enlarged Group will rely, on customer savings and transmission balances, as well as ongoing access to the

> wholesale lending markets and the Bank of England liquidity facilities and the UK Government's guarantee scheme …"

521. A later passage commented on the steps the Government had taken to ease the crisis in liquidity, and added:-

> "[Lloyds] expects that the Enlarged Group will substantially rely for the foreseeable future on the continued availability of Bank of England liquidity facilities as well as HM Treasury's guarantee scheme for short and medium term debt issuance. If the Bank of England liquidity facility, HM Treasury's guarantee scheme or other sources of short-term funding are not available after that period, [Lloyds] or the Enlarged Group could face serious liquidity constraints, which would have a material adverse impact on its solvency."

522. Risk factor 1.6 addressed the risk of insufficient capital resources to meet regulatory thresholds, warning:-

> "In addition to the impact of net negative capital adjustments, the Enlarged Group's Core Tier 1 ratio will be directly impacted by any shortfall in forecasted after-tax profit (which could result, most notably, from greater than anticipated asset impairments and adverse volatility relating to the issuance business). "

523. Risk factor 2.1 addressed the possibility that the Acquisition did not proceed. Its headline said:-

> "**In that case, [Lloyds] will be required to raise additional capital in an alternative manner. There is no certainty that it will be able to do so on acceptable terms or at all.**"

The supporting text said:-

> "The FSA has advised [Lloyds] that if the Acquisition were not to occur, it would require Lloyd's to raise £7 billion of additional capital, made up of £5 billion of Core Tier 1 equity and £2 billion of Tier 1 instruments. There can be no certainty that [Lloyds] would be able successfully to raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising and whether or not such capital raising would be on a pre-emptive basis. Thus, if the conditions to the Acquisition are not satisfied… [Lloyds] will be required to renegotiate the terms of either the Acquisition or the Placing and Open Offer or both with HM Treasury and the HBOS Group, and may be required to seek alternative means of raising funding. There can be no assurance as to whether [Lloyds] would be successful in raising alternative capital or as to the timetable or terms of an alternative capital raising or as to whether any such capital raising would be on a pre-emptive basis. If [Lloyds] is unable to find alternative

> sources of capital and sufficiently raise its capital… it may need to access HM Treasury's recapitalisation fund, if such fund is available."

The subject matter of this risk factor (what would happen if the Acquisition did not proceed) had been inserted at the request of the UKLA which then approved wording prepared by Lloyds' advisers.

524. Risk factor 3.3 warned then-current shareholders in Lloyds that their proportionate ownership and voting interest in Lloyds would be reduced if they did not exercise their pre-emption rights under the Open Offer. Risk factor 3.5 warned of the risk of further dilution in these terms:-

> "Further to the proposed issues of Open Offer Shares and Consideration Shares [Lloyds] has no current plans for an offering of [Lloyds] shares. However, it is possible that [Lloyds] may decide to offer additional [Lloyds] shares in the future either to raise capital or for other purposes. An additional offering… could have an adverse effect on the market price of [Lloyds] shares as a whole."

525. Finally, risk factor 1.14 addressed some of the consequences of accepting a Government capital injection, drawing attention to the undertakings that Lloyds had been required to give to avoid objections being taken to state aid. In part these related to sustaining particular areas of business (supporting mortgage lending and loans to SMEs); in part they related to levels of remuneration for senior management; in part they related to the obligation to submit a restructuring plan. The Circular warned that the content of some of the undertakings remained unclear and "could have a materially adverse effect" on operations.

526. The Circular then set out the terms of the Acquisition, the terms of the proposed share offering, the terms attaching to the Government recapitalisation, information on Lloyds, information on HBOS, historical financial information, a pro forma net asset statement of the Enlarged Group and the HBOS IMS. In a section entitled "Additional Information" (by which time the reader would have traversed 246 pages) there were observations about "Capital Resources and Liquidity". These summarised the response of governments and central banks to the "turbulent conditions" experienced by global financial markets during the course of that year, but warned that there was no guarantee that they would succeed. The passage continued

> "… Despite the relatively advantageous situation enjoyed by the Enlarged Group uncertainty facing the markets is such that management believe that no institution is immune from the effects of an extended closure of the wholesale markets without the support of the central bank and government. It is likely that in this context the Enlarged Group will continue to draw on the Special Liquidity Scheme and will take advantage of the guaranteed funding provided by HM Treasury…. The Enlarged Group is eligible to participate in [the Government guarantee

> scheme for senior funding, the extended Long-term Repo facility and the new Discount Window facility] and will use these tools as appropriate in future liquidity and funding management, particularly in an environment as currently experienced."

It then explained that because of the extraordinary uncertainty facing the banking industry and the availability of Government facilities the UKLA had agreed that a working capital statement for the next 12 months would not be required.

527. It is necessary to refer to 3 other items of Additional Information contained in of the Circular:

(a) The Lloyds directors accepted responsibility for the information contained in the Circular and said that to the best of the knowledge and belief of the Board (which had taken all reasonable care to ensure that such was the case) the information contained in the Circular was in accordance with the facts and did not omit anything likely to affect the import of such information.

(b) The Permanent Secretary to HM Treasury accepted responsibility for the information contained in the Circular relating to HM Treasury (including statements of expectation or intention), and confirmed that the information in the Circular for which he was responsible was in accordance with the facts and did not omit anything likely to affect the import of that information.

(c) There was confirmation that (with specified exceptions) there had been no significant change in the financial or trading position of either Lloyds or HBOS since 30 June 2008 (the date to which the last published interim financial information had been prepared). The specified exceptions drew attention to the fact that in the nine months to the end of September 2008 the profitability of HBOS had been impacted by higher impairments and negative fair value adjustments to the Treasury portfolio (and quantified them).

528. The Circular stated in plain and prominent terms:-

> "**The Lloyds TSB Board unanimously recommends that Lloyds TSB Shareholders vote in favour of the Resolutions to be put to the Lloyds TSB General Meeting as they intend to do in relation to their own individual shareholdings which amount in total to 1.316,034 Lloyds TSB Shares, representing approximately 0.02 per cent of the existing issued ordinary share capital of Lloyds TSB.**"

529. The issue of the Circular was followed on the same day by an investor presentation by Sir Victor, Mr Daniels and Mr Tookey (the "3 November 2008 Investor Presentation"). This was supported by a slide presentation which both stated that the directors of Lloyds accepted responsibility for the information it contained and had taken reasonable care to ensure its accuracy, and also warned that no reliance should be placed on it and that Lloyds' shareholders should rely on the Circular.

530. The 3 November 2008 Investor Presentation utilised a prepared script and prepared answers to anticipated questions. Mr Daniels spoke to the clear long-term value of the deal ("a compelling transaction") but noted near-term concerns in relation to capital, funding and impairments. As to the last he said that Lloyds had spent "some 5100 days on due diligence and synergy analysis" and felt that they had "fair valued the HBOS portfolios well". Mr Tookey spoke of the challenging market conditions but said that the bank had started to see some signs of stabilisation in global money markets, comfortably securing 3- and 6- month funding and successfully issuing a £400 million 10-year bond. Turning to the HBOS IMS he noted that HBOS impairments had continued to grow: a topic to which he returned in the context of capital issues.

> "When I initially announced the transaction I mentioned that we had only done limited due diligence, generally focused on our key areas of concern. Since that time, we have been able to conduct a thorough set of reviews; and as each review has been completed we have been able to get significantly more comfortable with the range of likely outcome in terms of the potential adjustments to capital. As this work has progressed, we have been able to narrow the range of possible outcomes quite significantly, and this now sits comfortably within our initial range."

Developing that he said:-

> "There will need to be some capital adjustments on acquisition of HBOS, which we believe will be no more than £10 billion. These adjustments include the deductions from the capital base of the enlarged group for HBOS's AFS reserves, and our estimate of the net fair value adjustments affecting capital that arise from the application of standard acquisition accounting principles. This has been assessed by applying market-based credit spreads to their various portfolios and the results have been carefully cross checked to the outcome of the thorough asset reviews, which we have just discussed. This gives us significant comfort….."

531. The reaction of analysts to the Acquisition as outlined in the Circular and the presentation was mixed, with an even spread between critical, neutral and supportive. Attention tended to focus on the HBOS IMS, describing the situation as "bad, but will get worse" or as "highlighting a broken franchise that can no longer stand on its own" or as showing HBOS "very badly beaten up as a standalone". The probable inability of HBOS to continue as an independent entity (should the Lloyds takeover fail) was a strong theme, with some form of nationalisation mooted as the probable outcome. Some commentators characterised the Acquisition as a rescue by Lloyds of HBOS from the

brink of insolvency (underwritten by a Government guarantee to waive competition issues). Several commented on the disclosure that there had been outflows of corporate and retail deposits in September and early October (prior to the Government "bailout"): the very fact of disclosure by HBOS showed that these were significant, but the absence of any measure left the market guessing exactly how significant.

532. The most important of the analyst reports was that prepared by RiskMetrics. It is appropriate to deal with it at this point, although in terms of narrative it falls naturally into the next section. In his written evidence Mr Ellerton (called by the Claimants) was inclined to dismiss the work of RiskMetrics as "a single research paper". In cross-examination he conceded that this under-estimated its significance: and he was right to do so. As cross-examination of some of the Claimants (and disclosure by the Claimants) established:-

(a) Some institutional shareholders in Lloyds had formal policies in place under which their shareholdings would be voted in accordance with the RiskMetrics recommendation unless the investment decision-maker decided otherwise (an unusual occurrence). An example of such an institution is NFU Mutual Insurance Society Ltd ("NFU") which owned or managed about 0.4% of Lloyds' shares. (It is the fourth largest of the Claimants). According to Mr Glover the "vast majority" of NFU votes were cast under the RiskMetrics "default" policy. (In addition, where NFU voted against a management recommendation that had to be explained in an annual report).

(b) Some institutional shareholders in Lloyds went further and in effect determined the exercise of the voting power automatically according to the view of RiskMetrics. An example is the voting policy of the Russell Investments Group (which is the third largest of the Claimants): the proxy administrator was directed in relation to mergers and acquisitions to vote *for* the merger unless Risk Metrics recommended against: and if for some reason the relevant merger had to be judged on a case-by-case basis then the proxy administrator was directed to vote *for* the merger if both management and RiskMetrics recommended it.

533. There is no suggestion that these institutional investors were atypical: indeed other of the Claimants (Northern Trust Corporation, CPP Investment Board) adopted the same approach. So this put the RiskMetrics' work (as Mr Ellerton put it) "in a different category to other analysts' reports".

534. The RiskMetrics analysis began with an attempt to understand the strategic rationale for the merger and to identify what the deal was bringing to Lloyds. First, cost synergies: these, subject to challenges, were viewed as "a net positive for the deal". Second, market dominance: this, setting improved margin spreads and higher fees

against a potential resurrection of the competition issues (currently being avoided) was regarded as "slightly positive for the merger". Third, funding: RiskMetrics advised:-

> "We believe funding is the most clear negative issue in this transaction, as Lloyds can't dilute the problem easily when incorporating HBOS into its balance sheet. In the end, though, the Treasury won't let the combined entity down in the future given its size, and the issue would be the cost to pay for the mismatch [between loans and deposits]."

Fourth, capital: here RiskMetrics took the view that a "standalone" Lloyds would have to raise £7bn capital, either from the government or exclusively from private investors (the latter being an open question). It had advised:-

> "In the end, the clear advantage of the merger vs the stand-alone option for Lloyds is that it is saving its shareholders a 5% dilution of its common stock, plus saving dividends on an additional £1 billion in preferred stock due to the FSA assessment of its capital needs. Lloyds could still raise capital from the government if that is less expensive, an alternative that also allows private investors to participate in the deal. We recognise though the uncertainty shareholders would face until such capital raising is done if the merger doesn't go through. Overall, the capital issues seems to favour the merger. "

535. After considering asset mix and size ("does not contribute to lower risk"), state influence ("don't have strong views on whether the merger leads to worse alternative versus the stand-alone option") and dividend policy ("a short to medium term concern") the conclusion reached was this:-

> "Lloyds is exposing itself to a balance sheet that doubles its own, with lower asset quality and a wholesale funding gap under adverse market conditions, while gaining in terms of synergies and market dominance. We believe that the UK government will stand behind the combined institution, and the same could be said of other big banks and a standalone Lloyds; this makes the funding issue a controllable one, albeit at a cost. The transaction also diminishes uncertainty on the terms for a capital injection, something that a standalone Lloyds would still have to face and that has the potential to dilute shareholders even further. On balance, we find that the combination of arguments makes a reasonable strategic rationale for the acquisition."

536. RiskMetrics then undertook a deal evaluation, and reached this conclusion:-

> "This transaction is more of a rescue than a normal acquisition. We are trying to assess value under binary conditions, where failure to meet wholesale debt maturities or a deposit run-off would eliminate all value immediately. HBOS was down a path to nationalisation, according to market commentators and the governor of the Bank of England… Whilst some may argue that

> the price/book ratio looks attractive at first glance, it seems that HBOS shares would go lower without the support from the merger. However, the merger presented itself with the capital injection, and Lloyds had to make the decision on the overall package. Valuation is slightly above that of similar transactions. But in any case, *we believe this is a deal where valuation takes a secondary consideration versus the strategic opportunities/challenges involved*." (Emphasis added).

537. The recommendation of RiskMetrics was expressed in these terms:-

> "The high level of uncertainty in the market raises many caveats to any analysis. We believe the merger adds challenges, but at the same time eliminates uncertainties in terms of capital in an environment where other banks are being severely punished. As such, we recommend shareholders vote FOR the acquisition."

538. RiskMetrics also produced an EGM Report containing specific advice as to voting on each resolution to be put to the Meeting. It too recommended a vote in favour of the Acquisition, but noted that the recommendation raised "governance issues" which clients might wish to examine. These governance issues related to the inability of Lloyds to pay a dividend whilst the Government's Preference Shares were outstanding, to the presence of two new independent directors post-acquisition to reflect but not to represent the Government's substantial shareholding (raising questions about commercial independence) and to the Risk Factors identified in the Circular. RiskMetrics advised that it had considered these issue and expressed the view

> "We consider that the company has adequately dealt with any potential governance issues in respect of diltution to existing shareholders, the conditions put on the proposed Government funding and risks and opportunities posed by the acquisition of HBOS."

539. The work of RiskMetrics is also useful in identifying who were the major shareholders in Lloyds and to extent to which institutions had holdings in both Lloyds and HBOS. The top five shareholders in Lloyds (according to the last available public filings) were

- Barclays Global Investors (UK) Ltd: 4.7%
- Legal & General Investment Management Ltd 4.43%
- State Street Global Advisors (UK) Ltd 2.98%
- AXA investment Managers UK Ltd 2.22%
- Scottish Widows Investment Partnership Ltd 2.17%

Barclays Global was the third largest investor in HBOS (with 4.54%). Legal & General was the second largest investor in HBOS (with 4.68%). State Street was the fifth largest investor in HBOS (with 2.62%). Scottish Widows was the fifteenth

largest investor in HBOS (with 1.25%). The 10 largest institutional shareholders in Lloyds (holding 27% of the bank) together owned 38% of HBOS.

The "Away-day"

540. With the Circular launched and the recommendation on the Acquisition made the Board convened on 6 November 2008 to receive a report on the reaction to the Circular and to consider (amongst other business) strategy and the medium term plan. As to the reaction to the Circular Mr Daniels reported that institutions were broadly supportive, but that their views were coloured by their relative holdings in Lloyds and in HBOS; that individual investors were less supportive, being more concerned with the risk presented by HBOS and by the dividend "block"; that rating agencies were undertaking a review for possible downgrade; and that analysts were broadly supportive (because of the potential benefits from synergies and market position) but had concerns about the UK economy. The agenda items relating to strategy and the medium term plan involved consideration of papers presented by Mr Foley and by Mr Tookey.

541. Although the attendance record suggests that Mr Foley attended only in relation to the issue of a bond programme the body of the Minutes (which I treat as more reliable) and the Agenda record him presenting his paper (for 45 minutes) and as "commenting on the possible length and depth of the downturn" and on "the implications for the business of the group". The terms of the Minutes themselves ("the directors questioned the use of mid-case assumptions and discussed whether the 1:25 scenario represented a more likely outcome") and the terms of Mr Tookey's notes of the meeting ("more scenarios, contingency plans. What do scenarios mean for the [businesses] and what changes do they make = 1:25") show that the board were not mere passive recipients of information but raised challenges.

542. Mr Foley began by analysing what he considered to be the cause of the present crisis and then conducted a comparative analysis of previous recessions. He stood by the analysis that he had undertaken in early October 2008, that a base case (that is, the "new base case") had a 35% probability, a mild recession also a 35% probability, and a "1 in 25" a 15% probability. When challenged he maintained the view that the "mid-case scenario" remained "the most likely outcome". By "mid-case" Mr Foley meant the mid-point on the spectrum between the "new base case" ("significant downturn") and the "credit crunch" scenario ("1 in 15" recession). That was the approach being adopted by Mr Tookey for his medium term plan. Notwithstanding that affirmation the Board asked for further work to be done on different scenarios.

543. It is important to emphasise that there can be no criticism of Mr Foley as regards this assessment of the position and prospects as at the end of October 2008. Mr Foley was (justly) a very highly respected economist, conservative in approach and thorough in analysis. He could not know, as he made his presentation, that the economy stood on the brink of a "1 in 60" or possibly a "1 in 200" recession. His forecasts as to the course of the recession were more conservative than those currently being adopted by BoE, the Treasury and the IMF. As Prof Gary Gorton of the Yale Business School wrote in his Introduction to "Misunderstanding Financial Crises: Why We Don't See Them Coming" (OUP 2012)

> "Many saw a crisis looming, but what no-one saw was the size of it, that it would be a global systemic crisis."

In his first report (paragraph 8.12) Mr Ellerton made the point (which I think is a fair one) that economists' forecasts tend to be lagging indicators. Events happen. There follows a period of analysis. Forecasts are then prepared. But between the events and the intellectual reaction to them markets are already moving, further events are occurring. Mr Foley could not escape that reality. On the other hand, there is no evidence to suggest that every competent director would interpret economic predictions as "lagging forecasts".

544. I would, whilst making clear that Mr Foley's assessment of the position at the end of October 2008 is not to be criticised, specifically and in the clearest terms exonerate Mr Foley of the charge made against him by the Claimants in open Court that "a certain amount of politics or strategy went into Mr Foley's thinking". I am clear that he gave to the board on each occasion what he thought was the most accurate forecast, and did so with independence and with professional integrity.

545. Mr Tookey had alerted the Board of his intention to discuss in some detail the liquidity profile of the Enlarged Group and the sources of finance (including SLS), and also regulatory capital adequacy (particularly in the context of paying off the preference shares). It is difficult to discern from the surviving slide presentation exactly what was said. But the thrust seems to have been that Lloyds itself had made impairment provisioning in accordance with the views of Ms Sergeant and Mr Roughton-Smith, that the HBOS plan for the same period used similar assumptions, that "fair value adjustments will protect group income from further HBOS impairments beyond their plan". Mr Tookey's notes indicate that he spoke (or intended to speak) about "fair value" issues (alongside which he had written "Be very careful"). The topics covered (or to be covered) were the issue of "unwind" and the impact of Mr Roughton-Smith's views. Certainly the board would have needed an explanation that FVAs assessed as at the date of completion would have an immediate impact upon capital (subject to adjustment as events unfolded) whereas forecast impairments would not impact upon capital until the impairments were recognised as losses.

Events before the EGM

546. On 9 November 2008 an article was published in the "Sunday Times" under the headline "Lloyds TSB's secret £10bn loan to HBOS". The article stated that Lloyds was secretly providing financial support to HBOS through £10 billion loan facility, but it did not develop the story. It instead moved on to a proposal by two Scottish businessmen (rivals to the Spowart bid that I have referred to above) that HBOS should kept independent with additional capital provided by the government because they felt that HBOS shareholders were getting a raw deal. (There were, incidentally, rumours of interest from Bank of China and the Spanish bank BBVA). The "Daily Telegraph" picked up the "Lloyds' loan" story on 10 November 2008, reporting that analysts considered that £10bn was a small figure compared to HBOS's balance sheet of some £700bn but a very large loan for a normal transaction in the interbank market. The Scottish bidders asked the FSA to investigate. Robert Peston at the BBC added his confirmation to the story, writing:-

> "I thought that the disclosure by the Sunday Times that [Lloyds] has lent £10bn to HBOS was highly significant (and, for the avoidance of doubt, Lloyds has lent its prey this tidy sum)"

He surmised that Lloyds had only been allowed to make the loan because the FSA believed the takeover by Lloyds to be beneficial. He described this as “extraordinary support” and a demonstration that the authorities did not believe that HBOS had a viable long-term business model. The story was taken up by other publications and media and I am satisfied must have received wide circulation amongst the institutional investment community and interested retail investors.

547. Although there was some comment that the Lloyds’ facility to HBOS had not been mentioned in the Circular the point was not explored and the story subsided. Mr Hill QC fairly pointed out that this was in part because the Lloyds’ news management machine swung into action. This promoted the view that there was no £10bn “loan” (an accurate statement since that was the ceiling on a particular facility and one which had never been fully drawn), that as part of “ordinary course” Lloyds provided interbank funds of various maturities, and that Lloyds was very comfortable that the Circular made appropriate disclosure of everything required. Whether this was (as Mr Hill QC charged) an attempt to dampen public attention or was (as Mr Parr preferred) a proper response to press speculation in the light of the Disclosure and Transparency Rules matters not. The fact is that the strong story had no statistically significant impact on the Lloyds or the HBOS share price.

548. On 14 November 2008 HBOS published its circular to its shareholders (the "HBOS Circular") recommending them to vote in favour of the Acquisition. It made no secret of the doubts attending HBOS’ access to funding or of what faced HBOS shareholders if the Acquisition did not proceed:-

> “There can be no certainty as to the sources of capital if the Resolutions are not passed. The HBOS Directors would expect the UK Government to take appropriate action consistent with the policy objectives set out in HM Treasury’s announcement of 8 October 2008 on Financial Support to the Banking Industry, which are to ensure the stability of the banking system, and to protect ordinary savers, depositors, businesses and borrowers. Such action may include the issuance to HM Treasury of HBOS Shares on a basis which could be more dilutive to HBOS shareholders than the Placing and Open Offer and the issuance to HM Treasury of other securities on terms less economically advantageous and more restrictive than the HMT Preference Shares or the loss of independent or private sector status for HBOS.”

This sent a clear message about the doubtful prospects for the long term viability of HBOS. The market understood it. Indeed the market consensus was that given its liquidity and capital needs HBOS simply was not viable as an independent entity with no external intervention. The question was one of timescale. The HBOS Circular revealed nothing new to the Lloyds’ board. No commentator suggested that the situation disclosed in the HBOS Circular was materially different from what had been revealed in the Lloyds’ Circular.

549. Lloyds and HBOS both published their prospectuses on 18 November 2008. Lloyds published its prospectus in respect of the proposed placing and open offer of 2,596,653,203 open offer shares at 173.3 pence per share (the "Lloyds Prospectus").

HBOS published its prospectus in respect of the proposed placing and open offer of 7,482,394,366 open offer shares at 113.6 pence per share (the "HBOS Prospectus").

550. The Lloyds Prospectus provided no additional material information over and above that disclosed in the Circular. The HBOS Prospectus is interesting in relation to its treatment of the HBOS funding needs. As regards those the HBOS Prospectus first described the global announcements of tools for the provision of liquidity to banks and how they had become an important feature of liquidity management solutions for banks and then said:-

> "There can be no assurance that these global measures will succeed in improving the funding and liquidity of the markets in which the major UK banks, including HBOS, operate. There is a range of different central bank funding arrangements in which HBOS is eligible to participate, both within the United Kingdom and overseas. As with many other banks, HBOS makes use of a number of these arrangements to assist with its funding and liquidity management. The general purpose of such arrangements is to allow a bank to pledge or enter into a repurchase agreement in respect of collateral for varying periods of time in exchange for Treasury Bills or cash funding. The HBOS Group expects that it will substantially rely for the foreseeable future on the continued availability of these government-sponsored arrangements, including central bank liquidity facilities such as those offered by the Bank of England as well as HM Treasury's guarantee scheme for short and medium term debt issuance. "

The Extraordinary General Meeting

551. On 19 November 2008 Lloyds held its EGM to vote on the Resolutions set out in the Circular. Sir Victor was in the chair. Mr Daniels, Mr Tookey, Ms Weir and Mr Tate (the Defendant Directors) were on the panel. So was Mr Kane (an executive director who is not a Defendant). Of the non-executive directors Lord Leith, Sir David Manning, Mr Scicluna, Mr Brown, Dr Berndt Mr Green and Mr du Plessis were also on the platform. The meeting provided an opportunity for the board to address shareholders and for shareholders to question the board.

552. In his address Sir Victor underscored the strategic significance of the Acquisition with its intention to create the leading financial services company in the United Kingdom, the need to raise additional capital at the behest of the Government, the necessity to do so by the issue of preference shares to the government (which was a lower risk and lower cost option compared with an attempt to use public markets), and an intention to achieve the repurchase of the preference shares during 2009 so as to enable the Enlarged Group to resume the payment of cash dividends. Mr Daniels spoke to the terms of action and told the meeting that based on the recent closing share price Lloyds was acquiring HBOS for approximately £4.9bn.

553. The second question from the floor asked the board to explain why it was in the interests of Lloyds' shareholders to take over "a very large failed bank": the later questioner addressing the same issue referred to HBOS as "a terminally diseased company". The reply was that the merger was the fulfilment of a long-standing ambition and would produce a stronger bank better able to create value for shareholders over the medium and long term. The third question from the floor asked about taking on the HBOS corporate lending portfolio. Mr Daniels replied that Lloyds was underweight in that area and that the Enlarged Group would have about the right exposure. He said:-

> "Very clearly we have done an awful lot of due diligence. We have spent over 5000 days looking at the synergies and examining the portfolio quality. We think that the series of fair value adjustments that we have taken reflects the value of the HBOS portfolio and we feel that the impairments going forward are manageable."

554. One shareholder described the Acquisition as a deal

> "…cooked up at a cocktail party, in collusion with a Prime Minister who was prepared to set aside a national law, a competition law, that had been designed for the common good…."

concluding with the observation that "most of us in fact think this deal stinks": which drew applause. Sir Victor addressed the factual inaccuracies embedded in the question. Another shareholder addressed the new capital requirements for a standalone Lloyds suggesting that the figure of £7 billion appeared to have been plucked out of thin air. Sir Victor replied by stating that that was the figure that the FSA had determined was appropriate, and that satisfying the government was a prerequisite for access to some government funding. A later questioner returned to the topic, asking why Lloyds had to raise £7bn as a "standalone" bank but only £5.5bn as part of the Enlarged Group, and why that £7bn was greater in proportion than the additional capital required by a stand-alone HBOS, and what steps the Lloyds board had taken to investigate raising additional capital on the market. Sir Victor responded that those were the figures required by the government, but if the £7 billion was not raised then the bank would not have access to the liquidity funding arrangements that the government has made available, that the view of investment bankers was that it would not be possible to raise the money privately and that if it had been then it would be very expensive.

555. Well into the meeting a shareholder asked about the media report of a Lloyds loan of £10 billion to HBOS, enquiring why it had not been highlighted to shareholders. Sir Victor responded by saying that loans between banks were part of everyday business, the lending always being on commercial terms, and were not disclosed as they were ordinary course of business lending.

556. Another shareholder characterised the Acquisition as "a takeover too far" and enquired what would happen "if the united group goes belly up in two years". Mr Daniels identified three concerns during the next two years. First, would capital be all right? Second what about funding? Third would impairments (loan losses) be worse, could they be handled? And in these terms:-

> "so we spent over 5000 man days, that is an incredible amount of effort. I don't think that there were many acquisitions in fact have had the luxury of having that much effort dedicated to it. And what we basically feel is that while those threats are very real and they should be concerns that we feel we can address them, we feel that we can manage them through the couple of years. I think we feel very strongly that the longer term outcome of being able to create the leading financial services organisation in the UK is very worthwhile. The synergies are very real and we think those three things that were worried about which are legitimate concerns that we can manage and we can do on an informed basis having spent the amount of time on diligence that was necessary."

557. After some rousingly critical speeches from the floor the Resolutions were put to the vote. On the Resolution to approve the Acquisition the total votes cast were 3,116,962,477. Of those 2,999,725,191 (95.98%) were cast in favour. The votes against were 125,237,286 (4.02%). Just to relate those figures to the present claim, it is thought (on the evidence one cannot form a reliable view because of potential double counting of legal and beneficial ownership) that the Claimants hold 312,732,812 shares. It is not clear how many of the Claimants attended the EGM. It is clear that some of the Claimants did so and did vote against the resolution (and so are already included in the 4.02% mentioned above): and that others attended and abstained. But if one takes the position most favourable to the Claimants on each variable and assumes that their holdings (at their maximum) were in their entirety voted against the resolution (as additional votes in opposition) the majority in favour of the Acquisition would have reduced to 82.19%.

558. The effect of the approval by shareholders of the Acquisition was to bind Lloyds to proceed unless (i) the Acquisition was rejected by HBOS shareholders or (ii) the Scheme of Arrangement, (being the mechanism chosen to effect the merger) was not approved by the Scottish Court. (I should here note that the Claimants had an argument that the Defendant directors should themselves have objected, or should have enabled Lloyds shareholders to object, to the sanction of the scheme). This was a consequence of the removal of the "material adverse change" provision with which I have dealt with above.

The descending gloom

559. Within days of the Lloyds EGM the storm clouds began to gather.

560. First, during the course of November 2008 it became apparent that GDP was declining rapidly, and that the recession was developing faster and threatening to go deeper than had been anticipated. This lead to two "inputs" from Lloyds' management.

   a) On 28 November 2008 Mr Foley produced a fresh paper on "Economic Scenarios for planning [HBOS] funding". This moved the probability of the "mid-case" scenario down to 15% (from 35%), retained the probability of the "credit crunch" "1 in 15" scenario at 35%, but

increased the probability of a “1 in 25” recession to 20%. So that was a shift in the risk profile. (There was an unallocated probability of 30% but it is not possible from the available material to work out what scenarios this covered: but amongst them may have been a scenario worse than “1 in 25”).

b) On 10 December 2008 Mr Roughton-Smith sent to Mr Tookey an updated Group Risk analysis. In the light of the material worsening of global macro-economic conditions since the preparation of the 29 October 2008 report (including material foreign exchange movements) Group Risk believed that impairments ought to be considered in the context of a “1 in 25” scenario. This did not alter the level of impairments embedded in the HBOS portfolio as assessed by Mr Roughton-Smith on that scenario: but it had led to HBOS itself to recognise that its forecast for Q4 2008 had significantly understated impairment levels, although not at that point to adjust its 2009 impairments forecast (which Mr Roughton-Smith thought “materially inadequate”).

561. Second, on 5 December 2008 the European Commission issued a new set of guidelines which distinguished between "unsound" and "fundamentally sound" banks in terms of the requirement to submit restructuring proposals. This opened the possibility of adjustment to existing recapitalisation schemes to incentivise lending by fundamentally sound banks to the real economy without restructuring and to require banks in receipt of state aid in consequence of their business model to submit restructuring plans. Mr Daniels discussed these proposals with members of the Tripartite: but in those discussions there was no suggestion that the Enlarged Group would be required to make significant divestments because Lloyds and HBOS had participated in the Government recapitalisation programme.

562. Third, on 10 December 2008 HBS disclosed to Lloyds an updated impairments forecast prior to its intended release to the market on 12 December 2008. I have noted the response of Mr Roughton-Smith to it. I must now note the response of Mr Tookey, who had to consider the potential impact on regulatory capital.

563. Mr Tookey advised the board in these terms:-

> “In the circular to shareholders we noted that based upon a preliminary assessment net negative capital adjustments of no more than £10bn after tax would need to be made upon acquisition; we also noted that the actual figure would depend upon market conditions at the date of the acquisition. This figure is principally comprised of an estimate of the fair value adjustments that will be required that have an impact upon regulatory capital. Fair value adjustments represent a point in time assessment of the value of the assets and liabilities and whilst there is some relationship, there is no direct link to future impairment losses. HBOS has undertaken a very limited update review in the last two days of the likely accounting fair value adjustments and they have concluded that the additional impairment losses incurred have had no significant effect upon

> the size of the adjustments that we are likely to have to make… Combining the effects of the extra impairment losses and the broadly consistent fair value adjustments, however, we do not currently expect to see a significant impact upon the net negative capital adjustments the Group is likely to have to make on acquisition."

When tendering that advice Mr Tookey was of the provisional view that the probable FVAs at completion would be of the order of £11bn.

564. The view that the latest impairment figures released by HBOS would have no significant impact upon the anticipated net negative capital adjustment was also that expressed to shareholders in the Supplementary Prospectus issued by Lloyds (in respect of its then current Open Offer) on 17 December 2008.

565. Notwithstanding the generally emollient nature of these statements it is plain that before the content of the HBOS trading statement (to be released on 12 December 2008) was known there had been a degree of consternation on the Lloyds side as to what might be the consequences of a really bad update, sufficient for someone to seek the advice of Mr Parr as to whether Lloyds could withdraw from the Acquisition in that event. His advice on 11 December 2008 was that it could not: and that even if the "materially adverse change" clause had remained a term of the Acquisition such a clause would not have availed Lloyds. But in the event the trading statement did not necessitate action.

566. Fourth, as part of an ongoing conversation with Sir Victor Mr Roughton-Smith updated him directly on the developing impairments position. His e-mail of 19 December 2008 made two key points. The first was that his own October 2008 figures remained unchanged whereas the HBOS impairment figures had risen from £1.7bn at the half year stage to £6bn in their latest trading update. As he put it "[HBOS] have gradually "smelt the coffee" and now agree with us – after very vociferously disagreeing with us initially". Looking further out, he stood by his October 2008 figures for anticipated impairments in 2009 both on a "1 in 15" and a "1 in 25" scenario but observed:-

> "However, the macro economic position has deteriorated materially since October and, especially given the nature of [HBOS'] portfolio, we believe that the one in 25 year figures are more appropriate rather than the one in 15 year basis case."

His observation that a deepening recession was hitting HBOS harder than Lloyds was in line with what Mr Roughton-Smith had been saying at the end of October 2008.

567. There was, however, one countervailing factor emerging. It related to the acquisition accounting treatment of HBOS' own debt in issuance. On the occasion of an acquisition the accounting standards (IFRS3 "Business Combinations") require that the assets and liabilities of the target should be reflected in the consolidated balance sheet as at the acquisition date at "fair value". "Fair value" is not face value of the debt, but that value adjusted by reference to movements in interest rates since issue and any movement in the issuer's credit spread. It may be recalled that a comparison between (i) the price that the acquirer is paying and (ii) the net fair value of the fair valued assets and the fair valued liabilities being acquired will produce a figure for "goodwill": and that an ability to capture "negative goodwill" has a favourable impact on regulatory capital.

568. When preparing the Circular the Lloyds specialist team thought that there was a "prudential filter" (GENPRU 1.3.9) which required them when conducting the "fair value" process to *exclude* the effect of a reduction in the face value of HBOS' own debt to fair value. But further consideration of the detailed accounting standards (led by UBS but with review by PwC) led to a revision of this view. The Lloyds specialist team came to think that it *was* appropriate to include the effect of a "fair value" adjustment to HBOS' own debt, thereby reducing its face value. This had a favourable effect on regulatory capital: the eventual benefit was about 100bps. When the point was put to the FSA (in January 2009) it agreed : the FSA had no objection to Lloyds "fair valuing" the HBOS debt on completion in calculating the consolidated group regulatory capital ratios. Thenceforth, market deterioration which had the effect of reducing the fair value of the net assets being acquired also had the effect of reducing the fair value of the liabilities of HBOS. The point was neatly put in an Enlarged Group Audit Committee paper of 10 December 2009 (from which I quote to illustrate the point, not to establish the figures):-

> "An extensive exercise has been undertaken to determine the fair value of the assets, liabilities and contingent liabilities of HBOS…. This exercise has concluded that the fair value of the acquired net assets and contingent liabilities of HBOS was £1.2bn greater than their carrying value at 16 January 2009. This seems counterintuitive given the credit risk concerns surrounding the HBOS loan book. However, a £15bn fair value reduction in HBOS's loan books was more than offset by the reduced value of HBOS's own debt in issue (c.£16bn) reflecting increased credit spreads. "

It should, however be observed, that this "fair value" adjustment was not permanent and would "unwind" over time because (unless the debt was bought in at a discount, as about £11bn of "own debt" was) the Enlarged Group would have to pay the debt back *at face value* at maturity.

569. In broad terms the situation was that the deteriorating macroeconomic position had increased the risks inherent in the Acquisition, but the potential consequences lay within the range of outcomes taken into account when recommending the transaction, and there was the possibility of some unanticipated "headroom" generated by the discovery that any increase in the £10bn net negative capital adjustment might be offset by the ability to "fair value" HBOS' own debt.

570. On 12 January 2009 the Court of Session approved the HBOS scheme of arrangement. The following day Lloyds issued 2,596,653,203 shares to HM Treasury under the placing and open offer (only 0.5% of the open offer shares being taken up by Lloyds shareholders under the "clawback" provisions): and HBOS also issued new HBOS shares under its placing and open offer. So far as Lloyds was concerned the pre-existing shareholders now owned 69.7% of Lloyds and the Government owned the balance of 30.3%. Then on 15 January 2009 Lloyds and HBOS both issued shares to HM Treasury as part of the recapitalisation scheme.

571. In preparation for completion Lloyds received from KPMG a letter of comfort which was itself supported by a letter from Mr Ellis of HBOS to KPMG: the effect of Mr Ellis' letter was to confirm an estimate of HBOS impairments for 2008 at £7.98bn. HBOS

also provided an "out-turn status report" and in the course of that estimated the HBOS impairments for 2008 to be £7.25bn. The Acquisition completed on 19 January 2009 with HBOS shares being delisted. On completion the pre-existing Lloyds shareholders now owned 36.5% of the Enlarged Group: the Government owned 43.5% and the former HBOS shareholders 20%.

572. Completion took place against a background of increasing gloom. That week Citigroup and Bank of America announced bad news. On the morning of 18 January 2009 Mr Daniels was warned by the FSA that a major UK bank would release bad news the following day. On the afternoon of 18 January 2009 the Chancellor informed Mr Daniels that the Government would be releasing unfavourable economic news on the Monday along with further measures to support bank lending in the light of the intensity of the downturn over the preceding two months. Amongst the unfavourable economic news was that the final quarter of 2008 had shown a decline in GDP of 1.5% (the sharpest quarterly contraction for 28 years). HBOS informed UBS and Merrill Lynch that all HBOS lending businesses were under extreme pressure with respect to impairments as the economy continued to deteriorate and at great pace, but stood by its impairment assessment (which as at 10 December 2008 was £7.25bn, and confirmed at that figure in the "out-turn status report" a month later). A few days after giving that indication it revised the estimate upwards to £7.6bn.

573. In the result, when Mr Tookey came to report to the board on 18 January 2009 what he considered the Core Tier 1 ratio for the Enlarged Group was likely to be post-Acquisition and post-recapitalisation he advised that it was 6.1% (at the bottom end of (but within) the announced target range of 6-7%). Since this was dependent upon the change in the treatment of the HBOS own debt for acquisition accounting purposes it was necessary to make an announcement to the market; and this was done.

574. It is appropriate at this point briefly to pick up the topic of HBOS funding and liquidity. With the merger with Lloyds assured (having been approved by the both the Lloyds and the HBOS shareholders) and the proceeds of the open offer and the recapitalisation in immediate prospect (and further boosted by the sale of the Bankwest business unit on 19 December 2008), HBOS began paying down the ELA. The process was eased by the fact that HBOS was able to securitise the collateral that supported the ELA into a form acceptable for mainstream SLS. By 16 January 2009 HBOS had repaid all ELA and was reliant on SLS and market funding (including debt issued under the credit guarantee programme).

575. As had been indicated to Mr Daniels, on 19 January 2009 the Treasury announced its "Government Asset Protection Scheme", explaining that it did so "with the global economic downturn intensifying in the past two months". Because the Enlarged Group did not ultimately avail itself of this facility it is unnecessary to descend to detail: but its rationale was to underpin asset values on the banks' books in order to encourage banks to lend into the real economy. Its importance in the present context is that it a clear indicator that the economic situation was significantly worse than had been anticipated in October and called for an additional response from the Tripartite over and above that provided during the Recapitalisation Weekend, which had been intended to "bullet-proof" UK banks.

576. Another part of that response was the running of further "stress tests" by the FSA to assess how balance sheets might be impacted by the more severe recession than had

been anticipated during the Recapitalisation Weekend. Obviously these "stress tests" were more severe than those applied in October 2008: the issue was whether the "buffers" applied in October 2008 remained sufficient to absorb the more severe shock, or whether banks should be required to raise more capital. Mr Tookey acknowledged that it was a reasonable prediction that the latter would be the eventual outcome (though in the case of Lloyds this was not actually confirmed until 21 February 2009).

577. The rapidity and the severity of the recession also caused the Lloyds Risk Oversight Committee to advise on 19 January 2009:

> "Our latest view on the economy is that we are effectively now in a 1-in-25 economic scenario with strong similarities to the 1-in-25 stress we have been deploying. "

578. It was in this context that HBOS (which post-Acquisition had a new board) issued a revised impairments forecast on 23 January 2009. The total impairments for 2008 were now estimated to be £9.3bn (in place of the original HBOS estimate of £3.7bn uplifted only a few days before first to £7.25bn and then to £7.6bn). This certainly reflected an acceleration in the anticipated impairments (bringing forward into 2008 impairments that had been anticipated to occur in 2009): but did not of itself indicate an overall increase in impairments. However, there was also an increase in the anticipated impairments for 2009: HBOS now estimated £10.2 bn (in place of an original figure of £4.2bn). As Mr Hill QC emphasised, these increased HBOS figures in fact remained more-or-less within Mr Roughton-Smith's 29 October 2008 range. In an assumed "1 in 15" scenario for 2008 Mr Roughton-Smith had estimated a top-of-the-range figure of between £8bn-£9bn. In an assumed "1 in 15" scenario for 2009 Mr Roughton-Smith had estimated impairments at £6.5bn-£10.1bn, and in an assumed "1 in 25" estimated impairments in the range of £10.25bn-£16.6bn. It is notable that no director is recorded as suggesting that the Acquisition had proceeded on the footing that Mr Roughton-Smith's views had been more benign: which I think tends to confirm that at the board meeting on 29 October 2018 Mr Tookey had conveyed the import of Mr Roughton-Smith's then-current estimates. Lloyds of course had not proceeded on the basis of Mr Roughton-Smith's most pessimistic impairments forecast (because of the low probability of its occurrence), but on the basis of the anticipated net negative capital adjustment of £10bn (informed by but not based on impairment forecasts). So the impact of these revisions upon Lloyds' assumed post-acquisition scenario had to be examined.

579. Mr Tookey did so in a report to the board on 23 January 2009: and Mr Roughton-Smith did so in an e-mail on 26 January 2009.

580. In his report Mr Tookey addressed what he termed "a heavily weakened economic outlook" which drove down anticipated profits significantly below the previous budget. In the case of HBOS the budgeted profit anticipated for 2009 as at October 2008 had been £2.1bn, but was now revised to a net loss of £2.3bn. The revision was attributable to a sharp rise in the HBOS impairments for 2009. This reduction in HBOS' anticipated 2009 profits (because of increased impairments) in fact formed the budgeted loss for the Enlarged Group. The impact of this loss on capital was dramatic. Assuming the least severe of the outcomes in a "1 in 25" scenario the Core Tier 1 capital ratio dropped to 5.2% during 2009 and on the most severe outcome "1 in 25" scenario to 4.1% even

allowing for partial mitigation by means of a FVA "unwind". So Mr Tookey warned the board that it must contemplate:-

> "Significant business critical activities on costs and impairment required over the coming months…Options for capital plan B's need to be evaluated".

581. By "capital plan B's" Mr Tookey was warning the board that management action (to effect disposals or to alter the business model to reduce RWAs, for example) or the raising of additional capital (though not necessarily by a means that would be dilutive to existing shareholders) would need to be considered. Mr Tookey observed in an e-mail to Mr Daniel:-

> "In the week and a bit of proper access good (very good) progress has been made but we don't have a complete picture yet. At the moment every stone being unturned (*sic*) is yielding problems and downsides. The HBOS 2008 numbers are slipping away from us, 2009 is racing away from us, and the fair value work (which I have always said is a rush for mid-Feb) is highly unlikely to save the day…the picture is not good and is deteriorating."

582. Mr Roughton-Smith's e-mail identified the same movements (though his actual figures are different), but he warned that since the economy had deteriorated significantly even since early December further revisions could be anticipated. He considered that the HBOS impairment figures for 2008 had risen from £3.7bn to £9.3bn and that the 2009 impairments had risen from £4.2bn to £10.2bn. He correctly pointed out that the aggregate of these increased figures was within his own October 2008 projected range (and, indeed, in the case of 2009 impairments at the bottom of that range). He emphasised in an e-mail to Ms Sergeant and Mr Tookey a couple of days later that "because of the rapidly deteriorating macroeconomic environment [these] downside risks have increased markedly even since December" and so he expected even these revised HBOS figures to be further amended and to move towards the upper end of his estimated range, which in this e-mail he said was £17.75-£25.9bn, being the total impairments for 2008 (on a "1 in 15") and 2009 (on a "1 in 25" basis).

583. Mr Roughton-Smith obviously continued to reflect on what had changed since his due diligence work in October 2008: and it is at this point convenient to refer to the conclusions that he reached towards the end of February 2009. These were:-

   a) That the last quarter of 2008 had seen a much more rapid deterioration (bringing forward into 2008 impairments anticipated for 2009);

   b) That 2009 itself would *at best* be a "1 in 25" and in some significant areas would be a "1 in 40+" recession;

   c) That post-acquisition access to file level information (not available pre-acquisition for standard M&A reasons of commerciality/client confidentiality) had revealed problems greater than anticipated.

The board meeting of 13 February 2009

584. A board meeting was scheduled for 13 February 2009. A number of steps were taken in preparation for it. First, Mr Roughton-Smith provided updated impairment figures to Ms Sergeant, who was to attend the meeting. He now assessed the 2008 HBOS impairment figure at £11.6 bn and the 2009 figure at £12.3bn, a total of £23.9bn. The 2008 impairment figure was above his October 2008 estimate: however the combined figure was now at the upper end of his 28 October 2008 range, but still within it.

585. Second, Mr Tookey prepared a Finance and Capital Update for the Board seeking to explain how and why financial projections had changed. This did not incorporate Mr Roughton-Smith's very latest figures, but presented a picture consistent with them. It took the Board through both the HBOS internal and the Lloyds external assessments of the HBOS impairments, pointing out that the latest HBOS internal 2008 impairments figure on its own (at £9.6bn) now exceeded the Lloyds October estimate. It informed the board that whereas at the time of the Announcement HBOS had a forecast profit before tax of £3.5bn and then on 18 January 2009 had forecast a loss of £5.9bn, now on 13 February 2009 it was anticipating a loss of £10.8bn, a decline driven to a great extent by revised (increased) impairments. He summarised the position for the board in these terms:-

> "- the economy has deteriorated materially - impacting both [Lloyds] and HBOS results
>
> - The economic deterioration is amplified by market dislocation as market prices have fallen
>
> - HBOS impairments have exceeded our own due diligence estimate based on a 1 in 15 downturn by £1.6bn
>
> - The capital position which will be reported to the market is still within range 6-7% - but benefits from a lower fair value charge as we have included HBOS debt"

586. There are three observations to make about that. First, as Mr Hill QC noted in cross-examining Mr Tookey, Mr Daniels and Mr du Plessis, whilst it was true that the actual HBOS impairments exceeded the Lloyds due diligence estimate, the Acquisition had been approved not on the basis of the Lloyds due diligence impairment assessment but upon the PwC assessment of the net negative capital adjustment required, which incorporated HBOS' estimates (the Lloyds own due diligence estimates serving only as cross-checks to the resulting conclusion). Second, the "capital position" at completion was now estimated to be 6.41% (and so within the target range). Third, the reference to the "benefit of a lower fair value charge" is a reference to fair valuing of HBOS' own debt: this underpinned the capital ratio at completion but would have an adverse impact on future capital ratios as it unwound.

587. Having completed his analysis of the current position Mr Tookey moved to predict the 2009 out-turn and to assess its impact on capital ratios. His central assessment was that the capital ratio would fall at the year-end to 5% (i.e. below the target range) even assuming the Enlarged Group set and achieved a targeted reduction in RWAs of £8bn. But on a slide entitled "Risks and Opportunities" Mr Tookey warned that adverse

conditions (in particular further impairments in 2009 over and above those then forecast) might bring the ratio down further. In fact, if the upper end of Mr Roughton-Smith's 2009 "1 in 25" impairment estimate was reached the Core Tier 1 ratio would be reduced to 4.1% (at which level the concern would not be limited to regulatory capital requirements but would extend to liquidity issues): the presentation slide did not so state.

588. Mr Tookey therefore addressed "capital mitigants", including the conversion of the Government's preference shares, use of the Government Asset Protection Scheme (though he thought successful execution to be uncertain), management of RWAs and capital management (including non-dilutive issuance). But the message he gave the Board was that "significant risks remain and active management was required".

589. In presenting his report Mr Tookey commented on how the disclosed out-turn related to the due diligence which had been undertaken in October 2008. He expressed the view that the key limiting factor had not been one of time, but of the relatively restricted access to underlying documentation that had been available.

590. At the board meeting on 13 February 2009 Mr Daniels began by reminding the directors that at the time of the negotiations with HBOS in the autumn of 2008 there had been a significant difference of view in relation to the risk profile of the HBOS business, the state of key portfolios and the likely near term profitability, and that after conducting its due diligence (albeit it with relatively restricted access to underlying documentation) Lloyds had formed a far more pessimistic view than HBOS of its anticipated 2008 out-turn). He related that to the current situation in this way:-

> "Since the 12th December announcement by HBOS it was clear that the likely 2008 HBOS outurn had deteriorated significantly as a result both of general economic conditions and the application of more conservative standards of prudence to the assessment of its banking books (more aligned to historic [Lloyds] standards."

This was a (correct) acknowledgement that the sudden, rapid and deep recession was not the sole reason for the emerging divergence between the anticipated and the actual.

591. This view was echoed by Mr Tookey who is recorded as explaining:-

> "Compared to the due diligence carried out by the Group the "excess" loss related both to the effect of further market deterioration as well as to the more prudent view of the quality of the HBOS lending books now being taken. In total the anticipated 18 months' experience of impairment **could** still be within the previously anticipated range. But in the 12 months to 31 December 2008 the experience was worse than ([Lloyds] had) expected." (Emphasis in original).

592. The board then considered and approved a draft trading statement for release to the market (which was done that day). This disclosed an anticipated loss before tax for HBOS of £10bn, explained in these terms:-

> "The key elements of the loss are the £4bn impact of market dislocation and approximately £7bn of impairments in the HBOS corporate division. The market dislocation has been driven by deterioration in asset quality and falling market valuations. The impairments are, principally as a result of applying a more conservative provisioning methodology consistent with that used by [Lloyds], and reflecting the acceleration in the deterioration in the economy, some £1.6bn higher than our expectations when we issued our shareholder circular at the beginning of November last year."

The trading statement confirmed that the Core Tier 1 capital ratio would be within the range of 6-6.5%, but acknowledged that this "include[d] the regulatory capital benefit of the fair-valuing …of HBOS own debt". The full results were promised for 27 February 2009.

593. The market reaction was swift. The market was stunned by the speed and scale of the deterioration at HBOS. Lloyds' shares fell about 30%. Ratings agencies reduced Lloyds' credit rating from Aaa to Aa3 (a notch below what Lloyds had anticipated would probably occur, but still on a par with Barclays). The Government's January 2009 investment of £17.7bn of new capital into the Enlarged Group lost £8.3bn of its value. Press speculation began that a further injection of Government capital would be required to "bail out" the Enlarged Group, possibly amounting to majority public ownership. Unsurprisingly Lloyds shareholders became restive.

Further capital raising

594. Before the announcement of the full results the Lloyds Audit Committee considered the figures and reported on them to a board meeting on 19 February 2009. Mr du Plessis (who chaired the Audit Committee) described it as "one of the worst moments of my professional life".

> "Some of the loans which the Committee were having to assess were structured in a very complex manner and we were required to make judgements about their provisioning against the background of uniquely challenging and rapidly deteriorating economic circumstances, the likes of which I had not come across previously during my years of being a chartered accountant and in corporate and board positions."

Mr Tookey had warned of the worse-than-anticipated outcome for 2008 (and the Audit Committee explored that by extensive questioning of KPMG), but for Mr du Plessis

> "..what was particularly worrying was going through this process and looking ahead to 2009 recognising the impact that the deteriorating conditions could have on the Enlarged Group's position."

595. That issue (amongst others) was addressed by Mr Tookey at the board meeting on 19 February 2009. The meeting itself was satisfied that the Acquisition remained a good long term deal, even though in the short term its revenue generating potential was going

to be eroded by the impairment issues: Mr Daniels felt that the Lloyds risk management skills would reduce the significance of those issues, and that in the meantime the Enlarged Group remained strongly capitalised. Mr Tookey reported that in terms of liquidity and funding the Enlarged Group was funded strongly, and although significantly reliant on the wholesale market (in relation to which conditions were now as tough as immediately post-Lehman) it was successfully taking steps to lengthen the maturity profile of that funding. In terms of capital Mr Tookey reported that the Enlarged Group was operating well ahead of its Individual Capital Guidance and its regulatory minima. He observed that although in a stressed scenario (such as a "1 in 25") the minimum Core Tier 1 ratio could drop to 4% external audiences (such as analysts and rating agencies) would probably have serious concerns at that level which could result in reduced liquidity availability. The present level was 6.3%, but he observed:-

> "It was acknowledged that further stresses could arise, most likely in the areas of impairments and adverse RWA movements. However, there were significant available mitigants to justify confidence that the Core Tier 1 ratio should remain in excess of 5% in the next few years."

Getting this message across to a market in turmoil and rife with speculation was recognised as a challenge.

596. But a key question for the board was what FVAs fell to be made at completion (for only at that date could they be ascertained) and how these compared to the £10bn predicted in the Circular in the very different economic circumstances of early November 2008. On 23 February 2009 Mr Tookey explained the latest provisional position to the board ("provisional" because the work would extend over months). The overall message was calming. In the Circular the shareholders had been told that net negative capital adjustments of £10bn after tax would be needed to HBOS' financial position. The figure now anticipated (taking into account not only FVAs but also other accounting adjustments such as the elimination of the AFS reserves) was £3.7bn, giving a Core Tier 1 ratio at completion of 6.4%: but this was because the Enlarged Group was going to claim a credit of £11.3bn post tax in respect of HBOS' own debt. The position looking forward was far less reassuring.

597. In preparation for the release of full-year figures Mr Tookey reported to the board on 26 February 2009 that further revisions to the base case meant that the anticipated year end Core Tier 1 ratio was 5.3% *on the assumption* that the Enlarged Group both participated in the GAPS scheme and converted the Government preference shares into Core Tier 1 "B" shares, and would fall below 4% in a severe (but possible) recession. In other words, further capital was needed. The need was reinforced by the results of the FSA further stress testing, which was much more severe than the October testing: the more severe stressing produced higher hypothetical losses which would require additional capital to absorb them. (It is important again to emphasise that the outcome of the stress test was not a forecast, but simply the result of applying assumptions). However, the need for *some* further capital would have arisen even without the stress tests both because of the severe downturn (which now approached a "1 in 40" rather than a "1 in 25", on its way to becoming a "1 in 60+") and because on detailed examination the HBOS portfolios were in much worse shape than had been thought (the

complex structure of some of the lending giving exposure to the same enterprise at multiple levels). Mr Tookey blamed the FSA: in an e-mail to Mr Tate he wrote:-

> "The FSA didn't understand HBOS, they just didn't get anywhere close to doing so. Had they understood it, the autumn injections would have been much higher, we would have seen that we could only buy it with a majority govt shareholding and we would have walked away from the deal."

(Just as an aside, in November 2015 the PRA and the FCA were to conclude in their report "The failure of HBOS plc" that indeed the FCA senior management had devoted too little attention and resource to supervising HBOS, placed too much trust in senior HBOS personnel and had not adequately monitored the risks facing the bank).

598. The need for further capital became imperative when in March 2009 the FSA formed the opinion that in its new stress scenario the Enlarged Group's Core Tier 1 ratio fell below 4% and required £24bn-£29bn to restore it to a level acceptable in those circumstances. The Enlarged Group initially proposed to meet this regulatory requirement by conversion of the Government's preference shares and by accessing the GAPS facility (notwithstanding that there would be a significant access fee). It is unnecessary for the purposes of this case to detail the negotiations and sufficient to note the outcome.

599. On 20 May 2009 the Enlarged group published a prospectus seeking to raise £4bn to redeem the Government's preference shares. To get the issue away it was necessary to offer 10,408,535,000 shares at 38.43p (a significant discount to the then market price of 70.5p per share). HM Treasury participated in this rights issue up to its 43.5% shareholding for an amount of £1.7 billion.

600. The necessity for this capital raise arose out of the formulation of the FSA's new stress scenarios. Mr Sharma (the Defendants' expert) explained the context:-

> "…the severity of the financial crisis was not foreseen by the Tripartite Authorities in October 2008 and consequently, in the light of the declining economic situation between October 2008 and March 2009, the economic reference points for the stress tests would inevitably have been more severe in March 2009 and those in October 2008…"

Thus what lay behind the raising of additional capital was not covering the "1 in 25" impairments that had been estimated by Mr Roughton-Smith, but meeting tougher stress tests.

601. Then on 3 November 2009 the Enlarged Group announced a capital restructuring to generate £21bn of Core Tier 1 capital (by a further £13.5bn rights issue and a series of offers to exchange non-Core Tier 1 subordinated instruments for Core Tier 1 notes). To get the rights issue away Lloyds had to offer 36,505,000,000 shares at 37p per share. The Government took up its rights to maintain its 43.5% interest in the Enlarged Group (thereby injecting another £5.9bn). Thus (as the Claimants' Skeleton Argument notes) over the 12 months following completion Lloyd's share capital had "ballooned" from just under 6 billion ordinary shares to almost 64 billion ordinary shares.

602. The November 2009 restructuring was called “Project Seaview”. The BoE indicated during the currency of Project Seaview that it intended to disclose to the market the fact that it had afforded ELA to HBOS from 1 October 2008 until 16 January 2009 to a maximum amount of £25.4bn. Mr Tookey sought to dissuade Mr Bailey of the BoE from doing so. Mr Hill QC sought to explore why this might have been, suggesting that it was because even in late 2009 Mr Tookey recognised that knowledge of ELA might make a difference to shareholders and to their perception of the Acquisition and of the Enlarged Group. Mr Tookey responded that he was simply

> “..keen to avoid media speculation about a historic event which actually has nothing to do with the current project…But one cannot control media speculation. The media… have a habit of creating mountains out of molehills, selling stories on the back of speculation, and that…can be unhelpful.”

Shortly put, if he could avoid media speculation then naturally it would be prudent to do so. To the same effect was the evidence of Mr Daniels, who spoke of a desire to avoid “superfluous noise”.

603. In the event, when the historic support was disclosed it was widely commented upon in the press; but there was no market reaction and no material impact on the share price.

Two other streams

604. Whilst the further capital raising was in train there were two others streams of activity.

605. First, the Treasury Select Committee examining the banking crisis took evidence during February 2009: and I have already referred to the evidence of Mr Daniels concerning the need for Lloyds to take Government capital in October 2008. He was also asked about the due diligence undertaken. His response was that Lloyds had put 5000 man days into the effort (a great part of which was done not by Lloyds staff but by accountants and investment bankers). Asked if he had had more time, how many man-hours he would have expected to put in he said:-

> “If we had unlimited access, which is not permitted by law….we probably would have put in somewhere around three to five times as much time as we put in.”

This is not in my view an acknowledgment that the due diligence actually carried out was deficient. It is important to note the condition (“If we had unlimited access….”). When (in January 2010) the Select Committee attempted to turn Mr Daniel’s words against him and to suggest that he had acknowledged that Lloyds had undertaken only one fifth of the due diligence required Mr Daniels was at pains to point that out:-

> “If you recall, my answer to your question of “Did you do enough due diligence?” was emphatically yes; … we did the maximum that we were permitted to under the law. In an *a posteriori* review by the board, supported by our external advisers… the Board remain[ed] fully satisfied that we did an excellent job on due diligence. You had asked the hypothetical question of, if there were no restrictions, would we have done

> more, and I think the answer was yes, of course, but that is a hypothetical question."

606. Second, as I have noted in December 2008 the European Commission had indicated that "fundamentally sound" banks could receive State aid without the need to submit a restructuring proposal. This led to discussions between the Government and the Commission and between the Government and the Enlarged Group about whether a restructuring plan was required. The view of those involved at the time was that Lloyds was a fundamentally sound bank, and that its taking over HBOS and subjecting HBOS to more conservative management was of itself a sufficient avoidance of "moral hazard". So even if a restructuring plan was required the Lloyds' business plan would suffice without significant divestment. But on 25 February 2009 the Commission reversed this policy and announced that the submission of a restructuring plan would be required whenever a bank had received State aid in excess of 2% of its RWAs, the question of whether a bank was or was not "fundamentally sound" going only to the extent of the compensatory measures required. By now the HBOS horrors had emerged, jeopardising the view that Lloyds was "fundamentally sound", and opening up the possibility of divestments being required. This undoubtedly coloured the consideration of the restructuring plan which the Enlarged Group submitted in July 2009. When eventually the Commission announced its decision in November 2009 it was to the effect that Lloyds had to dispose of the TSB franchise.

A retrospective

607. In January 2010 Mr Roughton-Smith produced a paper entitled "Review of the adequacy of the HBOS due diligence undertaken by [Lloyds] and the accuracy of the resulting 2008/9 impairments forecast". Its central observation is in these terms:-

> "The various HBOS impairments forecasts for aggregate 2008/9 are set out in the table below. These show that, even at 9 February 2009 - after intensive post Day 1 reviews by [Enlarged Group] teams – the due diligence forecast of 29 October 2008 was still remarkably accurate. It is worth noting that the accuracy of our due diligence based forecast (made in the depths of a severe recession) was very substantially greater than other banks forecasts of their own results. The actual HBOS impairments for 2008/9 of £29.6 billion are 14% greater than the £25.9 billion top end of our due diligence forecast range. This is because the recession suffered in 2009 was much deeper than the 1 in 25 year recession we had assumed in October 2008. The Economist magazine has stated (9 January 2010) that the UK recession is the longest and deepest since the Second World War. The recession has exhibited worst or close to worst simultaneous deterioration in many areas of the economy in the post-war period, including equity markets, interbank market, commercial property market and housing market. The recession has hit HBOS particularly hard because of its massive, highly leveraged exposure to commercial real estate both in the UK and overseas (Ireland, US Australia). We therefore consider the current recession to be a one in 60+ year event for HBOS. "

608. To pick one phrase out of that analysis for special comment, Mr Roughton-Smith drew attention to the "worst simultaneous deterioration". The sense I get from the evidence is that it was the speed of on-set and the all-embracing nature of the recession as much as its depth and length that caught the financial world unawares and generated the difficulties for the Enlarged Group. In October 2008 the IMF forecast that in 2009 UK GDP would dip by 0.1%. Within 6 months it had amended that to -4.1%. In its Pre-Budget Report in November 2008 the Treasury said that growth for 2009 was going to be negative at -0.75% to -1.25%: it was in fact 4.8% negative. As Sir Mervyn King was to acknowledge in the "2012 BBC Today Programme Lecture" even the Bank of England had not imagined the scale of the disaster that would occur when known risks crystallised. When reviewing judgments made in October/November 2008 the subsequent sense of shock at what happened thereafter is vital context.

609. This has been a long factual account: even so it has focused on only one aspect of the Acquisition. I have ignored the work done on the benefits of the Acquisition, the synergies, the plans for business integration, organisational issues and a mass of other issues on which material was produced for the board to absorb, process and make decisions on. That focus of course already differentiates my account from the contemporary reality. In my factual account I have tried not to "telegraph" the important points that would eventually emerge. But constraints of space mean that I have not wholly succeeded. With that account I can now address the two ways the case is put.

The recommendation case: the pleaded case

610. The Claimants allege (in paragraph 37 of the Claim) that the Defendant directors advised the Lloyds shareholders that the Acquisition was in their best interests and voluntarily undertook responsibility for the correctness of that advice. It is pleaded that in so doing the Defendant directors owed a common law duty to the shareholders (including the Claimants) to use reasonable skill and care when providing that advice and information to the Claimants, and to ensure that the advice so provided to the Claimants was reasoned and supported by information available to the directors: see paragraph 40 of the Claim. (Other phrases in the paragraph expand the duty to exercise care into a duty to provide complete information and not to mislead or conceal; but these seem to me duties of a different character from those arising from positive advice and better considered in the context of disclosure obligations).

611. The duty there pleaded is a duty owed as director, and one owed by each of the Defendants equally without distinction. It is not suggested that any individual Defendant Director (because of particular executive responsibilities or particular skill, knowledge or experience) had a duty of care different in scope or content from that of any other Defendant director which might make that individual Defendant liable in circumstances in which another Defendant would not be liable. The duties of Sir Victor as a non-executive director are not distinguished from those of Mr Daniels as an executive director. The duties of the Defendants are not distinguished from the duties of executive and non-executive directors who are not defendants. The Defendant Directors are treated as a single common body of persons. Paragraph 44 of the Claim pleads that in preparing the Circular (and the Announcement and the Revised Announcement)

> "the Defendants acted at all times in their capacity as directors of Lloyds and, therefore, as its agents. It follows that Lloyds is vicariously liable for the acts and omissions of the Defendants."

612. The duty pleaded in paragraph 40 of Claim is also a duty owed directly by each director to each individual shareholder. Each of the 5800 Claimants brings his or her own claim.

613. Paragraph 42 of the Claim pleads that the board (including the Defendant Directors) produced the Announcement, the Revised Announcement and the Circular which contained the advice about the Acquisition and the Recapitalisation of Lloyds which they intended would be read, analysed and relied on by Lloyds shareholders. Paragraph 43 pleads that the Defendant Directors also held press conferences and briefings for industry advisers at which information was provided and representations made. But it is not alleged that these press conferences and briefings were occasions for the giving of advice: rather, it is said that these were occasions for the provision of information which was to be the subject of analysis by the financial press, market analysts and Lloyds shareholders.

614. Paragraph 119 of the Claim pleads that the Defendants knew or ought to have known that the Acquisition was not a good deal for the shareholders of Lloyds and would not be in their best interests (for the reasons set out in the Particulars given of that allegation).

615. Paragraph 122 of the Claim then alleges that if the Directors had complied with their duty of care they would have corrected their recommendation so as to advise Lloyds shareholders that the Acquisition and the participation in the Recapitalisation on the terms and in the manner proposed was not in their best interests and was not a good deal for them: or alternatively would have declined to proceed with the Acquisition.

The recommendation case: the law

616. It is a cardinal principle of company law that the duties of directors are owed to the company and not to individual shareholders. It is the company that may bring an action for any breach of duty: if it does not, but an individual shareholder does wish to pursue the company's claim, then the individual shareholder must obtain permission to commence a derivative action on behalf of the company. The directors are therefore not vexed (nor the Courts burdened) by multiple actions by individual shareholders each seeking to prove his or her own formulation of an alleged breach of a duty owed directly to him or her and to establish his or her own individual loss. If (as is argued by the Claimants) the Acquisition was not a good deal and Lloyds paid £6bn for a worthless HBOS through the failure of the directors to exercise the degree of skill and care required of them by s.174 of the Companies Act 2006 ("the 2006 Act") in the performance of the duty imposed on them by s.172 of the 2006 Act to promote the success of the company for the benefit of its members as a whole, then that is something of which Lloyds can complain - either itself or through a shareholder acting on its behalf.

617. There are very limited exceptions to this cardinal principle. One group of exceptions relates to where on the particular facts a special fiduciary relationship arises between the directors and the shareholders sufficient to confer a direct right of action of the shareholder: Mummery LJ considered these in <u>Peskin v Anderson</u> [2000] EWCA Civ

326 at [34] and Nugee J commented upon them in this case in giving judgment on a successful strike-out application: [2015] EWHC 3220 (Ch) at [13]-[15]. This group of exceptions is not relevant here, for no special relationship is pleaded; the case is based on a general duty of a director. Another is where the duty is owed to the company, but the substance of the complaint is an infringement of a shareholder's rights under the articles (which are said to contain an implied term that fiduciary powers vested in the directors will only be exercised in a fiduciary way). That is not the case pleaded here. Another is the "sufficient information" disclosure duty in the context of seeking shareholder approval (which I consider later).

618. In the instant case the Defendants concede that the Director Defendants owed a common law duty to the Claimants to take reasonable care and skill to the extent that in the Circular they made any written statements and/or provided any recommendations in relation to the Acquisition and to participation in the Recapitalisation. I will call this "the conceded duty". The concession is made on the basis that the Circular contained a statement that the individually named directors had taken reasonable care to ensure that "the information contained in [the Circular] is in accordance with the facts and does not omit anything likely to affect the import of such information": and the Defendants do not quibble at the extension of the duty from the exercise of care in relation to the accuracy of "information" to the exercise of care in relation to the foundation for "opinions" expressed: see Mabanga v Ohir Energy plc [2012] EWHC 1589 (QB) at [30]. But the Defendants deny that the conceded duty applies to the Announcement or the Revised Announcement or to any statements made at meetings or in conference calls. I will first focus on the conceded duty within its agreed scope of application, and then turn to the areas of contention.

619. Because the matter proceeded by way of concession it was not subjected to rigorous analysis. But I must set out the matters that underpin my application of the concession. The Defendants submitted, and I accept, that the conceded duty as it applies to the Circular must be consonant with the duty of skill and care which the Defendant Directors undoubtedly owe to the Company in respect of the Acquisition. I do not think that the directors can fulfil their duty to the Company but yet be in breach of the conceded duty to an individual shareholder. As to the duty owed to the company, directors are bound (in compliance with s. 172 of the 2006 Act) to act in the way which they consider in good faith would be most likely to promote the success of the company *for the benefit of its members as a whole,* having regard (amongst other things) to the likely consequences of any decision in the long term.

620. There are two comments on that duty that I would make. First, the reference to the members "as a whole" is important because there will be many sectional interests within the general body of shareholders. Some will hold a share for its dividend yield, others for prospective capital growth; some because the company is stolidly unspectacular, others because it is ripe for reinvigoration; some because they are speculating in the short term, others because their investment horizon is five or more years. Directors must look at the members, and at their common interest in promoting the success of the company, even if the pursuit of that common interest may impact differently upon sectional interests.

621. Second, the Circular is addressed to "shareholders", and it is addressed to those who are on the register of shareholders at that time, because they are the members who will be voting. But when the Circular says that a transaction is "beneficial to shareholders"

it does not necessarily mean that it is beneficial to those who are on the register of shareholders at the record date. The "shareholders" there in contemplation are the continuing general body of shareholders over the forecast period. So, for example, a transaction which is immediately dilutive but is anticipated to be EPS accretive within a forecast period can be recommended as "beneficial". Mr Tookey in his evidence put it this way (when commenting on risk):-

> "….clearly, if you can obtain benefits in the short term then that's terrific, because the short term is more predictable than the long term. But if you can survive a rough patch and come out the other end able to enjoy the benefits of the enlarged group and its franchise, then that's fantastic. "

Thus, the conceded duty is owed to the direct recipients of the Circular (including purchasers of shares after the publication date); but is performed by reference to the interests of the continuing body of shareholders (being those affected by "the likely consequences of the decision in the long term"). The shareholders at the record date will exercise their votes according to their own investment horizon.

622. The discharge of the duty to the company and the performance of the conceded duty required the Defendant Directors, before making a decision and a recommendation, to undertake an analysis of the then current position of Lloyds and of HBOS as its target and to make a prediction about the likely consequences in the long term of any decision they might take about pursuing or rejecting a takeover. Both analysis and prediction involve a process of evaluation and the exercise of judgment. Lord Hatherley LC in The Overend & Gurney Co v Gibb (1871-1872) LR 5 HL 480 at 487 expressed the view that a Court (reviewing such a decision made by the directors) had to ask

> "...were [the directors] cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into?"

This decision may today be taken as establishing the irreducible objective standard of the reasonable ordinary businessman.

623. Ignoring the controversies which attended some decisions, it may safely be said that later authorities (Re City Equitable Fire Insurance Co [1925] Ch 407, Re D'Jaan of London (1993) BCC 646 and Re Barings [1998] BCC and [1999] 1BCLC 433 are well known landmark cases) made clear that something more than the standards of the ordinary reasonable businessman may be required by reason of the function performed by the director under scrutiny or because of the general knowledge skill and experience which that director has. As regards the duty of skill and care that a director owes *to the company*, the principles derived from these cases have now been given a statutory basis in s.172 and s.174 of the 2006 Act: and in my judgment that provides the template for the application of any common law duty of care directly owed *to a shareholder* (including the conceded duty). As I have said, any direct duty to an individual shareholder must be consonant with the duty owed to the company.

624. One must, because of the terms of the 2006 Act, treat a present-day application of earlier authorities with some care. But some of the points of principle they address (if not their application in the decisions themselves) remain valuable. I have found the following of assistance.

625. First, in Re City Equitable Fire Romer J observed (at p.426) that the functions that a director is required to perform will vary with the size and nature of the company and the way that its internal affairs are organised.

> "The position of director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of the insurance director, and the due duties of a director of one insurance company may differ from those of the director of another. In one company, for instance, matters may normally be attended to by the manager or other members of staff that in another company are attended to by the directors themselves. The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the managers, the accountants and the rest of the staff. The manner in which the work of the company is to be distributed between the board of directors and the staff is in truth a business matter to be decided on business lines… In order therefore to ascertain the duties that a person appointed to the board of an established company undertakes to perform, it is necessary to consider not only the nature of the company's business, but also the manner in which the work of the company is in fact distributed between the directors and the other officials of the company, provided always that this distribution is a reasonable one in the circumstances, and is not inconsistent with any express provisions of the articles of association."

Where the judge is speaking of the "functions" or the "duties" of a director I think he is there speaking both of the tasks which have to be performed and the skills that have to be used in the discharge of those tasks.

626. Second, having taken as his starting point the standard of the ordinary reasonable businessman identified in Re Overend & Gurney, Romer J (at 427) further observed that a director need not exhibit in the performance of his duties a greater degree of skill and care than may reasonably be expected from a person of his knowledge and experience. In so doing he was not, as I think, saying that something less than an ordinary degree of prudence might in some circumstances be acceptable: he was rather saying that the functions undertaken by the director (themselves affected by the nature of the company of which he was a director) might require something more than the ordinary degree of prudence but could never exceed the degree of skill that might reasonably be expected from a person having the knowledge and experience of the director in question. So the director of a life insurance company does not guarantee that he has the skill of an actuary or a physician, but is expected to have the degree of skill that might reasonably be expected of someone who has undertaken to discharge the functions of a director of a life insurance company. It is in that sense that I think his words must today (in the light of the statutory codification) be read.

627. Third, Romer J observed that a director is not liable for mere errors of judgment (an expression oft-repeated). By this I understand him to mean that where the opinions of reasonably informed and competent directors might differ over, for example, some entrepreneurial decision, the mere fact that a director makes what proves to be clearly the wrong choice does not make him liable for the consequences. When embarking upon a transaction a director does not guarantee or warrant the success of the venture. Risk is an inherent part of any venture (whether it is called "entrepreneurial" or not). A director is called upon (in the light of the material and the time available) to assess and make a judgment upon that risk in determining the future course of the company. Where a director honestly holds the belief that a particular course is in the best interests of the company then a complainant must show that the director's belief is one which no reasonable director in the same circumstances could have entertained.

628. Fourth, Romer J observed that where the exigencies of business mean that some matters are properly left to an official then a director is, in the absence of grounds for concern, justified in trusting that official to perform such duties properly, citing from the speech of Lord Davey in Dovey v Cory [1901] AC 477 at 492:-

> "I think the respondent was bound to give his attention to and exercise his judgment as a man of business on the matters which were brought before the board at the meetings which he attended… But I think he was entitled to rely upon the judgment, information and advice, of the chairman and general manager as to whose integrity, skill and competence he had no reason for suspicion."

With the gloss (i) that today there is a recognised duty to monitor employees upon whom significant reliance is placed and to ensure that there are in place appropriate supervisory and review systems; and (ii) that the reliance must in the particular circumstances be consistent with the discharge of the duty of reasonable skill and care by the director, I consider that the principle holds good.

629. Fifth, the same principle applies to the taking of expert advice. In general, a director who takes and then acts upon expert advice has gone a long way to performing his duties with reasonable skill and care. But the taking and acceptance of advice is not a substitute for the exercise of reasonable skill and care: it is only part of the discharge of that duty.

630. Ms Davies QC cited Green v Walkling [2008] BCC 256 at [37]-[38] as a statement of the principle: and amongst the authorities adduced was an extract from the 3rd edition of Professor Keay's book on *Directors' Duties* in these terms:-

> "8.130 As Professor Brenda Hannigan points out [sc. in her work *Company Law* at 309], the risk involved in permitting directors to rely on professional advice without question is that directors will instruct advisers in all matters and shift the risk of liability. So, a distinction has to be made between reliance that is merited and blind dependence. The bottom line is: was it reasonable, given all of the facts, for the directors to depend totally on the advice of the professional? In answering that question the director and his or her experience and qualifications, as well as

> the kind of company in which the director holds office, are relevant issues to be taken into account….
>
> 8.131 …it would also seem necessary for directors to ask appropriate and timely questions of their advisers rather than just accepting everything they are told without question…Of course it might become an issue in any given case about the kind and depth of the questions asked by the directors….”

I agree.

631. Sixth, in testing whether a director has been negligent the question is not simply what the Court thinks it would be reasonable for the director to have done; rather it is what the evidence before the Court establishes were the courses open to reasonably competent directors (the burden lying on a complainant to establish that the course of which complaint is made is not amongst them). Thus, in Re Brazilian Rubber Plantations and Estates Ltd [1911] 1 Ch 425 Neville J had to consider whether directors acted without reasonable prudence in adopting a contract on the information they possessed and said (at 37)

> “I entirely concur in the view that this must not be tested by considering what the Court itself would think reasonable.”

632. In support of this proposition the Defendants cited several cases (Sansom v Metcalfe Hambleton [1998] PNLR 542 at 549; Pantelli Associates Ltd v Corporate City Developments No.2 Ltd [2011] PNLR 12 at [17] and Caribbean Steel Co Ltd v Price Waterhouse [2013] UKPC 18 at [39] and [46]) as authority for the proposition that the Courts should be slow to find that professionals acted negligently without expert evidence on the question. I accept the point. That said, I do not think the Court would have much difficulty in answering the question posed in Overend & Gurney (*supra*) without the aid of expert evidence, where the degree of negligence is glaring and obvious (as in Roberts v Frohlich [2011] EWHC (Ch) 257, a case of recklessness and wilful blindness rather than a nuanced case of negligence). Nor would it where there is simply no rational basis at all for the act in question.

633. In the instant case the question to be answered is this:-

> “Could a reasonably competent chairman or executive director of a large bank reasonably reach the view (on the available material and within the timeframe required) that the Acquisition was beneficial to Lloyds and its shareholders? Or would any such director so placed of necessity have reached the view that the Acquisition was not beneficial?”

634. I answer that question below. For the present I observe that in framing the test in that way I am quite deliberately characterising the Defendants by reference to the functions they discharged at board level (even though the pleaded case does not itself identify any distinguishing features which placed the chairman or executive directors in a position of advantage over non-executive directors, and not every executive director is named as a defendant). I do so to avoid the risk of pitching the threshold of competence too low: and when I refer to “a reasonably competent director” that is shorthand for “a

reasonably competent director discharging executive or chairmanship functions" (even though the pleaded case does not emphasise these characteristics).

635. Before answering the question I must consider whether the conceded duty ought also to apply to the Announcement and to the Revised Announcement. I am not sure why this matters, since if the Defendant Directors are in breach of duty in relation to the Circular the fact that they were also in breach of a duty arising out of the Announcement or the Revised Announcement would seem to add nothing to the actual loss and damage case pleaded: and if they are not in breach of duty in relation to the recommendation in the Circular, the fact that they had made the same recommendation earlier, albeit at that time (hypothetically) negligently, would seem immaterial on the actual loss and damage case pleaded. The point was argued, so I will address it.

636. For the Claimants Mr Hill QC submits that this is a straightforward application of familiar principles in relation to the recoverability of economic loss. He argued that Court adopts a tripartite approach (each element of which can be used as a cross-check on the other, and which will usually lead to the same answer):

a) On the application of an objective test, did the Defendant directors assume responsibility towards the Claimants? If so, did the Claimants rely upon that assumption of responsibility?

b) Applying the threefold test in Caparo Industries v Dickman [1992] AC 605 (i) was loss a foreseeable consequence of the actions of the Defendant directors in relation to the Announcement? (ii) is the relationship between the Claimants and the Defendant directors sufficiently proximate? (iii) is it fair, just and reasonable to impose a duty of care on the Defendant directors towards the Claimants?

c) Would the imposition of liability upon the Defendant directors for economic loss suffered by the Claimants after the Announcement be no more than a small extension of a situation already covered by authority? Or would finding the existence of a duty of care in such a case effect a significant extension to the law of negligence?

637. Mr Hill QC argued that upon application of those principles it was clear that the Defendant Directors were responsible for assessing the Acquisition and ultimately providing a recommendation to Lloyds shareholders; that they ought to have known that Lloyds shareholders would rely on public statements made by the Lloyds board as to the merits of the Acquisition; that the existence of such a duty was contemplated by Linklaters in advice tendered to the Board on 3 October 2008 about potential liabilities to HBOS shareholders (and liability to Lloyds shareholders was an *a fortiori* case); and that the existence of such a duty was consistent with the regulatory regime (for Rule 19.1 of the City Code - the 8th edition of which applied - provided that each document issued or statement made during the course of an offer must be prepared with the highest standards of care and accuracy and the information given must be adequately and fairly presented). He made the forensic point that until July 2017 the Defendant Directors had admitted the existence of such a duty, but that they then withdrew the admission: however, he did not cite any case close to the facts of the present case which he invited me to say established such a liability and to which the present case would be a small extension.

638. I do not accept that in relation to the Announcement the Defendant Directors personally owed a common law duty of care to each Lloyds shareholder. Like the relevant tests themselves, my reasons overlap and interact.

639. First, I do not think the facts objectively disclose any assumption of responsibility. The key concept underpinning company law is that the company is a separate person distinct from its directors. So, an announcement to the market made by a company is not to be treated *ipso facto* as an announcement by its individual directors. The cardinal principle of company law is that directors owe their duties to the company but not (subject to established exceptions) to individual shareholders. The imposition of a direct duty of care owed by each director to each shareholder in relation to the contents of an announcement runs counter to those fundamental principles and requires strong justification. Mr Hill QC cited no case in support of the assertion (in paragraph 276 of the Claimants' Closing) that the imposition of such a duty did not involve any extension to the law of negligence. To my mind, it is a big leap to make directors personally liable for an announcement to the market made by a company (even if that announcement records, as inevitably it will in a takeover context, that the directors believe the deal worth doing). I think that before the Defendant directors are to be treated as having objectively assumed personal responsibility to each recipient of the Announcement for the contents of that Announcement it would be necessary to establish something more than their routine involvement in its production. I have reached this view from a consideration of first principles: but as will be apparent from the language I have used I have clarified my thoughts by re-reading Williams v Natural Life Products [1998] 1 WLR 830.

640. Second, Ms Davies QC submits, and I accept, that the purpose of the Announcement was not to enable individual directors to provide advice to each Lloyds shareholder about whether they should retain or sell their holding or about whether they should support or vote against a future intended transaction, but for the company to make an announcement to the market in compliance with the regulatory regime. The Announcement expressly said that it had been prepared for the purposes of complying with the Listing Rules, the rules of the London Stock Exchange and the City Code.

641. The Listing Rules operate under part VI of the Financial Services and Markets Act 2000 ("FSMA"). Listing Rule 10.5.1(1) required Lloyds to issue an announcement to the market about the Acquisition because its shares were traded on the LSE's main market for listed securities. They also required (by LR 10.5.1(2)) Lloyds to send an explanatory circular to Lloyds shareholders: and the Acquisition had to be conditional upon the approval of the Lloyds shareholders in the light of that circular. So, the object of the Announcement itself was not to tender advice to Lloyds shareholders (that being the function of the Circular) but for Lloyds to provide basic information to the market.

642. The rules of the LSE (as they stood in 2008) required Lloyds to comply with the Listing Rules.

643. The City Code on Takeovers and Mergers (to which Lloyds was subject) operates under Part 28 of the 2006 Act. Rule 2.2 required Lloyds to make a public announcement of the offer once a firm intention to make an offer was notified to the HBOS board and/or when, following an approach by Lloyds, HBOS was the subject of rumour and speculation. The purpose of such an announcement was to forestall insider trading, to promote the integrity of financial markets and to ensure that shareholders in HBOS in

the same class received equal treatment. So, the Announcement was by Lloyds and HBOS saying that they had reached agreement on the terms of a recommended acquisition, and it set out the then-proposed terms. Rule 19.1 of the Code required the Announcement (as a document issued during the course of the offer) to be prepared with the highest standards of care and accuracy, and for the information given to be adequately and fairly represented. That ensured that the purpose of the announcement to the market (the protection of its integrity) was achieved.

644. Any breaches of these regulatory duties would not be directly actionable by Lloyds shareholders. In relation to compliance with the City Code the position is covered by sections 955 and 956 of the 2006 Act. In relation to the Listing Rules the position is covered by s.150(1) and s.150(4) of FSMA, the latter Act being the subject of analysis by Teare J in <u>Hall v Cable and Wireless plc</u> [2011] BCC 543.

645. Mr Hill QC submitted that to say that (i) because the purpose of the Announcement was compliance with a regulatory regime *therefore* (ii) it cannot give rise to a duty of care on the part of the directors, is a *non sequitur*. I agree. But as Oliver Wendell Holmes famously observed (*The Common Law*, 1881) "the life of the law has not been logic; it has been experience". In my view commercial experience tells us that a regulatory announcement by a company providing information to the market at the very outset of a transaction is something distinctly and immediately recognisably different from the personal assumption of responsibility by an individual director for the provision of advice to an individual shareholder about how eventually to respond to the transaction. Whether we identify this difference as a matter of "proximity" (that in a standard market announcement there are no special circumstances such as would create a special relationship between the individual director and the individual shareholder) or of policy (that it is not "fair, just and reasonable" to impose on an individual director the liabilities of an adviser when his or her company has provided information to the market) does not matter.

646. Mr Hill QC also submitted that if the Announcement was not intended to provide advice by the directors to Lloyds shareholders about how they should exercise proprietary rights attaching to their shares so as to perform their corporate governance function then the Defendants have failed to identify what the purpose was. I do not agree. As I understood the Defendants' case it was that the function of the Announcement was for predator and target (i.e. Lloyds and HBOS) to inform the market generally of the existence of the proposed agreed takeover and of its terms so as to forestall the opportunity to conduct any "insider dealing" in the shares of Lloyds or of HBOS. The offer was plainly endorsed by both boards, and the market was so informed. That is my view of the function of the Announcement. In the light of the information provided in the Announcement some existing Lloyds shareholders might want to sell their shares (as at least one of the Claimants did), others to keep them: others in the market might want to buy Lloyds shares (as the evidence shows some did) or (as others did) HBOS shares. But the Announcement was not advising any of these groups to take any course at that point.

647. Third, the Announcement could not, on its own terms, reasonably be taken to recommend any course of action to any Lloyds shareholder or (as it was put in the Claimants' Written Opening) "to give a steer to Lloyds shareholders on how they should vote in relation to the Acquisition". It specifically stated that it did not constitute the solicitation of any approval and it contained clear, strong advice to Lloyds

shareholders (i) to read the forthcoming formal documentation relating to the Acquisition when it became available and (ii) to make any response in relation to the Acquisition *only* on the basis of the information contained in that formal documentation. The Announcement cannot therefore be taken as demonstrating an assumption by individual directors of responsibility for the foundation of any recommendations which it is said the Announcement may contain.

648. Mr Hill QC submitted that the terms of the Announcement did not purport to disclaim responsibility for the accuracy or proper basis of statements in the Announcement: and if they did, then the impact of those statements operated subject to the Unfair Contract Terms Act 1977 ("UCTA"), and in particular s.2(2) and s.11(3). I agree with the first proposition: and disagree with the second.

649. In my judgment the statement that the Announcement was not a solicitation (by anybody) for approval of the transaction, and the statement that any response to the proposed transaction about which the Announcement provided information should only be taken on the basis of a forthcoming formal document, were statements about the "basis" on which the information was being provided to the market by Lloyds: and those statements go to the issue of whether it is "fair, just or reasonable" to impose on individual directors a duty of care to individual shareholders.

650. In IFE Fund SA v Goldman Sachs [2006] EWHC 2887 Goldman Sachs supplied market information derived from third parties but said that it should not form the basis of any contract (stating that they did not accept responsibility for its accuracy). Toulson J held (addressing the matter as one of substance and not of form) that in a pre-contractual context such words went to the scope of the representations being made and could not properly be characterised as an attempt to exclude liability for misrepresentation: and that in a tortious context the words could not be taken as excluding liability for negligence, but more fundamentally went to the issue as to whether there was a relationship such as would make it just and reasonable to impose a duty of care at all.

651. In JP Morgan Chase Bank v Springwell Navigation [2008] EWHC 1186 (Comm) Gloster J captured the essence of the distinction: she explained that terms which simply define the basis on which (in that case) services were to be rendered did not fall within the scope of UCTA because they did not exclude a liability for negligence but prevented the obligation arising in the first place. In my judgment that is what the words used in the Announcement (immediately after the summary and before the setting out of the detail of the Announcement) do: they explain that the information provided, including the information that as at the date of the Announcement both boards thought the transaction good for their respective shareholders, was not a solicitation for approval, that such approval would have to be sought, that that would be done in formal document, and that recipients of the formal document should act only on the basis of what it contained.

652. So Mr Hill QC is right when he says the Announcement does not contain any words of disclaimer. That is because it does not purport to "give a steer" to Lloyds shareholders (or to HBOS shareholders or to anybody else) which might create a liability that would have to be disclaimed. But his submission that UCTA applies is wrong: because the relevant words are explaining the "basis" on which the information is provided.

653. Of course, the matter must be looked at as one of substance and not of form. Christopher Clarke J made this clear in Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland [2010] EWHC 1392 when he said (at [314]-[315]) that the key question was whether the relevant clause "attempts to rewrite history or parts company with reality":-

> "..to tell the man in the street that the car you are selling him is perfect and then agree that the basis of your contract is that no representations have been made or relied on, may be nothing more than an attempt retrospectively to alter the character and effect of what has gone before, and in substance an attempt to exclude or restrict liability. "

654. In my judgment the statements (following the introductory words of the Announcement and preceding the meat of the Announcement) that the Announcement was not a solicitation for approval of the transaction, and that a formal document would be produced upon which alone reliance should be placed, was not an attempt to re-write history nor a parting with reality. This was the first disclosure to the market at large of the outline of an evolving transaction. There is in my judgment absolutely nothing wrong in explaining to market participants (who would include then-current Lloyds shareholders):-

> "This is a summary. Much more is coming. We think you should wait until you get the whole picture before taking action."

655. Fourth, although Mr Hill QC advanced the argument only in relation to Lloyds shareholders it is hard to see upon what basis liability can arise in relation to some only of the addressees of the Announcement. The Announcement was to the market at large: it was not aimed at Lloyds shareholders. If the Announcement functioned as advice and recommendation as to action then it is difficult to see why it was not advice to all addressees, potential purchasers of Lloyds or HBOS shares or current holders of HBOS shares as well as current holders of Lloyds shares. But that would be to create a liability to a large and indeterminate class, a contra-indication to the imposition of a duty.

656. Finally, Ms Davies QC draws attention to the fact that in a similar regulatory regime (concerning "investment-focused" disclosures to the market) section 90A of FSMA provides that an investor who has suffered loss as a result of reliance on misleading published information when buying, selling, or holding securities (other than information in listing particulars) may recover compensation from the company if the directors knew or were reckless as to whether the statement was untrue or misleading or were dishonestly concealing a material fact. There the statutory regime both identifies the circumstances of recovery and also the nature of the conduct that establishes liability. By contrast in what have been called "governance-based disclosures" (see *Gullifer & Payne "Corporate Finance Law" 2nd ed* para. 11.4.1.1) Parliament has not provided for recovery.

657. This is not a strong point: but it suggests a cautious approach to the imposition of liability. In my judgment, in the context of governance-focused and investment-focused regulatory regimes Parliament has decided what should be done and how, and what the consequences of not doing it should be (and upon what basis). Given that regulatory context some caution is therefore required of a Court before (i) recharacterizing the action of making the Announcement (by treating the provision of information as the

giving of advice) so as (ii) to impose upon others (namely, individual directors - and it is difficult to draw here a distinction between the Defendant Directors and other board members - rather than the company) (iii) actionable obligations to some only of the addressees (namely Lloyds shareholders not the market generally). I do not see that the making of a market announcement by the company creates between individual directors and individual shareholders that "special relationship" that is normally required for the imposition of liability.

658. For these reasons I hold that the individual directors did not tender any advice to any individual Lloyds shareholder, nor did they come under any liability to an individual Lloyds shareholder in respect of statements made in the Announcement. This does not mean that individual directors could with impunity make false or misleading statements to the market. Each director was bound to act honestly and not deceitfully towards the market, and each director owed a duty to Lloyds to exercise reasonable skill and care in deciding what should be released to the market and in what terms.

659. I take the same view in relation to the Revised Announcement. This announced to the market both the revised terms of the Acquisition and the recapitalisation. It confirmed that "the Board of [Lloyds] intends to recommend that [Lloyds] shareholders vote in favour of the necessary resolutions" and affirmed that "[Lloyds] believes that the acquisition of HBOS will create a compelling business combination offering substantial benefits". It stated (though not as prominently as in the Announcement)

> "[Lloyds] strongly advises [Lloyds shareholders] to read the formal documentation relating to the Acquisition when it becomes available because it will contain important information relating to the Acquisition. Any response in relation to the Acquisition should be made only on the basis of the information contained in the formal documentation relating to the Acquisition. This announcement does not constitute a prospectus or prospectus equivalent document. "

The recommendation case: key holding

660. As part of the context of my decision I re-emphasise the need to exclude hindsight, neatly underlined in the following exchange between Mr Hill QC and Sir Victor:-

> "Mr Hill QC: …this is a deal on which, quite simply, shareholders have suffered?
>
> Sir Victor: I think that the question you have to ask is whether this was a deal which, when it was considered at the time, was in the best interests of shareholders. "

661. If the relevant question is posed, then in my judgment 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

taken. I do not think that such a director so placed would of necessity have concluded that the Acquisition ought not to proceed.

662. In framing the test I have laid some emphasis on the executive role of the selected Defendants: but it deserves to be noted that highly regarded and widely experienced senior *non-executive* directors shared the view of Sir Victor and of the named executive directors (not all executive directors being defendants). Ms Davies QC submitted that what the Claimants had to prove was that each of 15 members of the unanimous board took a decision which no reasonably competent director could have taken which she said was "self-evidently an extremely high hurdle". Of course, that is right if no distinction is drawn between executive and non-executive directors: but even if a distinction is drawn the fact that the entire board approved the proposal is a factor of great weight (unless one can point to some specific advantage conferred by an executive role).

The recommendation case: opinion evidence

663. As to the standards to be expected of a reasonably competent executive director in making a recommendation to shareholders the Claimants did not adduce expert evidence from a serving or retired executive director of a large bank or similar enterprise, or from an academic at an established business school to prove accepted practice. Although the heart of this case is about the assessment of risk, they did not seek to establish that there was some commonly adopted procedure for risk assessment (such as according a numeric value to the likelihood of occurrence and to the impact of occurrence and computing a risk factor) which a competent board would have adopted but which the Lloyd's board did not, and which (if adopted) would have demonstrated that the selected course was outside commonly accepted parameters.

664. The Claimants relied upon the evidence of Mr Ellerton, presented from the standpoint of an equity analyst without investment banking or main board acquisition experience in the large enterprise context. Mr Ellerton's report, naturally enough, did not approach matters from the perspective of the reasonably competent executive director. He stated in oral evidence that he had not really been asked to consider the reasonableness of the actions of the Lloyd's board. But he had said in paragraph 9.46 of his first report:-

> "In my opinion, [Lloyds] had the information that it required by 13th October to acknowledge that the acquisition, whatever its strategic attractions, was too risky to be in the best interests of its shareholders."

On his approach to such matters he was cross-examined: first, on his approach in general; second, on his opinion that the transaction was too risky; and third on his opinion that the Lloyds directors were negligent in relying upon figures produced by HBOS.

665. The first passage went thus (with insignificant material omitted):

> "Q: … When you were expressing your views as to the assessment of the acquisition in your reports…. you understand that it wasn't relevant whether you personally disagreed with the

assessment, but the relevant question is whether the assessment was one no reasonable person could have made?

A: Yes ….

Q: So therefore it's relevant at each stage to consider whether or not the view that was taken by the Lloyds directors was a reasonable one?

A: Given all the information that was available to them, yes.

Q: Because you see…. we don't read in your report any acknowledgement of that approach. You, at various points, express views and criticisms, without assessing the question of whether or not the view that was taken by the Lloyds board was one that a director in the position of the Lloyds board could reasonably have taken at the time.

A: Well, I wasn't asked directly to address the operation of the board….

Q: You were seeking to do your best, were you, to put yourself in the position of the Lloyds board at the time the decision was actually being taken, by reference to all the information that was available to the Lloyds board at that time?

A: … I can't honestly say that I wrote my report from the position of the Lloyds board…

Q: … What you did – isn't this right – is look at all the material that is now available and express your personal views as to whether, by reference to the benefit of that information, you personally would have reached a different decision?

A: Yes, but I think that doesn't exclude whether the board would have also …. made a reasonable decision, based on the information that I had, given that they have that information too.

Q: Well, as we've discussed a number of times, with any judgement there is a range of reasonable responses or decisions to be taken, aren't there?

A: There are indeed, yes.

Q: And within that range – it comes back to our sort of fan chart of possibilities – you can have a range of outcomes, all of which are reasonable..?

A: Yes.

Q: And what it doesn't appear from your report that you are seeking to do is to look specifically at the question whether the

> decisions taken by the Lloyds board were or were not within that range of reasonable decisions?
>
> A: Right…I didn't write my report from the perspective of a fan chart of probabilities or possibilities available to the board. No, I didn't.
>
> Q: …You didn't write your report…by reference to the range of reasonable responses of the board either?
>
> A: No"

666. The second passage (which directly addressed the recommendation) went thus:

> "Q: You've just said that you don't believe the transaction should have been recommended because the risk was too great: yes?
>
> A: Yes.
>
> Q: What I want to understand from you is whether you are seeking to suggest that no reasonable board of directors in the Lloyds board's position could have recommended the transaction to the Lloyds shareholders, bringing us back to this range of views.
>
> A: Are we back to the fan chart?
>
> Q: Yes.
>
> A: You know, I guess we are in the middle of that fan chart.
>
> Q: So it was a reasonable view, but not one you agree with?
>
> A: That's – you know, it was – Yes, I would agree with that. "

667. In my judgment that was an honest and brave answer, consistent with the qualifications Mr Ellerton felt bound to make on other occasions during his cross-examination to the views expressed in his reports (relating to the original bid price, to market reaction to the disclosure of ELA or of the Lloyds support loan, and to the assessment of the impact of impairments upon regulatory capital ratios). His re-examination did not restore the validity and reliability of his written reports.

668. The third passage (which addressed the basis on which the Lloyds board had approached the likelihood of maintaining a 6% Core Tier 1 ratio) was in these terms:-

> "Q: Just again focusing on the 6% minimum Core Tier 1 ratio for a moment, are you seeking to suggest that it was unreasonable, in the sense of something that no reasonably competent board….of Lloyds could have regarded it as appropriate for the purposes of assessing the 6% to use the combination of the HBOS central forecast, the Lloyds central

> forecast, which were assessed in the HBOS Working Capital Memorandum to be broadly aligned, subject to the adjustment for corporate insolvencies, and the inclusion of fair value adjustments of £8.7bn……
>
> A: I think we have to go back to the fan chart of reasonable….I think that was close to…the bottom of any reasonable interpretation of what can be done as possible….I think it was at the very bottom end of, you know, the reasonableness spectrum….
>
> Q: But I think it follows from what you've just said that you do accept it was within the reasonableness spectrum?
>
> A: No, I think I am saying it is at the bottom end of any reasonable….it doesn't strike me as a competent decision by the board to have done that"

669. The Claimants have failed to adduce expert evidence establishing that Sir Victor and the Defendant Directors were negligent in recommending the Acquisition to the Lloyds shareholders. The evidence they did adduce pointed in the opposite direction. The Claimants therefore set about seeking to establish that this was not a case of nuanced decision-making, but was well outside any margin of appreciation that might be allowed. It was a case of self-evident irrationality where the circumstances were of such a character, so plain, so manifest that no person with an ordinary degree of prudence would have recommended the Acquisition. The submission was that this was a case in which critical information was not subjected to any proper degree of evaluation, and where the consequences were neither scrutinised nor catered for. On the state of the expert evidence I doubt that this course is open. But since so much effort has been expended and after so many thousands of pages of expert evidence filed and so lengthy a trial it would be unjust to the Claimants not to address it.

The recommendation case: the "irrationality" argument

670. The argument was powerfully presented. It had six main themes.

671. First, HBOS simply had no value and the notion of a share exchange was wholly mistaken.

672. Second, the transaction was excessively risky for shareholders, but the risks were ignored. The due diligence work undertaken by Lloyds (itself inadequate) had produced impairment estimates which indicated a material capital shortfall for the Enlarged Group on a "1 in 15" basis (at a time when a "1 in 25" scenario was in fact highly realistic). Any capital raise would by destructive to shareholders and wipe out any putative benefits generated by the Acquisition. The Defendant Directors ignored this Lloyds' internal work and instead relied on work produced by HBOS.

673. Third, the risk of a capital raise sat on top of funding risks that assumed that the markets would not revert to their previous frozen state.

674. Fourth, estimates of future performance were at risk from a potential restructuring plan the extent of which was wholly uncertain but which (it was said) the board acknowledged might require a break-up or significant down-sizing of the Enlarged Group.

675. Fifth, in deciding upon the course to be adopted the Defendant Directors made the flawed assumption that a £7bn capital raise would be required by a "standalone" Lloyds .

676. Sixth, the use by HBOS of ELA and the provision of the Lloyds loan were secret and were likely to cause a catastrophic market reaction if revealed.

677. I will look at each of those elements in turn (save for the last, which I will consider in the context of the disclosure case).

The recommendation case: absence of value

678. In a nutshell, this case was that because HBOS was in receipt of ELA this proved that it was a bust enterprise which (if it continued at all) could only continue on the basis of full nationalisation which would inevitably obliterate all shareholder value. On this analysis the HBOS shareholders had as from 1 October 2008 no negotiating position at all and no reasonably competent Lloyds directors could recommend a takeover that involved any share exchange with them. (A variant of this argument was that HBOS lacked value because of the level of impairments: I consider that in the next section).

679. In part this case was advanced on the basis of commercial logic ("Receipt of ELA inevitably means a bank is worthless"): in part it was based on the expert evidence of Mr MacGregor.

680. Quite plainly the Lloyds board did not think that HBOS was worthless. Was there a rational basis for thinking on 3 November 2008 (the date of the Circular) and on 19 November 2008 (the date of the EGM) that it had value?

681. First, in my view receipt of ELA does not *of itself* render a bank entirely worthless (as the example of RBS demonstrates). I accept that receipt of ELA eventually followed by full nationalisation under the Banking Powers (Special Provisions) Act 2008 might do so, as was ultimately established in relation to Northern Rock in July 2009 when the Court of Appeal decided SRM Global Master Fund LP v Treasury Commissioners [2009] EWCA Civ 788. But even there, before the announcement of that decision I consider that a reasonable director contemplating the possible consequences of a full nationalisation of HBOS might reasonably have held the view that upon nationalisation the government was acquiring assets of significant value to which its advance of ELA had made no contribution and for which it would have to compensate the owners (the shareholders). So reasonable directors, considering an acquisition of HBOS in November 2008 against a backdrop of potential partial or full nationalisation could in my judgment reasonably take the view that the use by HBOS of ELA did not deprive HBOS of *all* value.

682. The essence of the Claimants' argument was that receipt of ELA demonstrates cashflow insolvency. Insolvency means that HBOS was not a going concern. This means it had only a "breakup value". A "break up" sale would have led to the disposal of

(unattractive) assets on a value destructive basis such that there would have been a deficiency and no value for HBOS shareholders. Between 2008 and 2011 HBOS had impairment losses of £52.8bn (largely on its book as it stood in October 2008) which exceeded the value of its assets at June 2008.

683. I do not accept this argument. Because of the business model of banks ("borrow short, lend long") there will be frequent mismatches which are covered by an injection of liquidity by the central bank: and support systems exist for the purpose of funding banks through periods of illiquidity. Illiquidity is not the same as insolvency. The state of insolvency requires more than illiquidity on a "snap-shot" view. The Tripartite would not have advanced ELA if HBOS was insolvent (as opposed to temporarily illiquid) and it would not have permitted insolvency to occur. It would have met cashflow needs as they arose until such time as HBOS established a permanent and credible basis for future viability, which might have taken the form of a partially nationalised HBOS in which there would have continued to be a body of (diluted) HBOS shareholders (as Mr MacGregor and Mr Williams agree). If for strategic reasons Lloyds wanted HBOS, then Lloyds had to put an offer to such shareholders of more than nothing.

684. Second, in assessing commercial logic one must in my judgment be careful to identify the precise "value" question. We are not here concerned with an abstract and acontextual valuation question: the issue is – did HBOS have value *to Lloyds*? The Claimants' expert Mr MacGregor recognised this when he wrote in his report that "it is possible that HBOS had a value on the Acquisition by [Lloyds] which it did not have on a standalone basis": and confirmed that view in cross-examination. Mr Ellerton for his part regarded it as "obvious" that the transaction could have value for Lloyds even if by some other measure HBOS was worth nothing. That offer had to be put in November 2008, before it could be known that over the next 3 years such a deep recession would occur that impairments on the loan book as it stood in October 2008 would not be covered by the earnings it generated and would wipe out its value.

685. Lloyds was not simply acquiring HBOS' net assets, but an established network of operating branded businesses with their own customer bases operating in areas both consistent with and complementary to Lloyds' own businesses, businesses which in normal times competition restrictions would prevent it acquiring. Such a move (and the attribution of value to these economic benefits) did not lack a rational basis nor was it a glaring and obvious commercial misjudgement. To put it another way, Lloyds shareholders were not being asked to buy HBOS shares: they were being invited to share in the "upside" of an Enlarged Group, and there was a rational basis for thinking that there was an "upside".

686. Third, I am unable to accept the view of Mr MacGregor that the only reasonable assessment of the value of HBOS to Lloyds was that it was worthless. My first reason is that Mr MacGregor acknowledged that he had not actually undertaken a valuation of HBOS, and that his opinion was founded (i) on the proposition that there was insufficient information available to the directors when they decided to proceed on 13 October 2008 and (ii) on the assumption that in the absence of sufficient information the default position was that HBOS was without value. I do not accept the proposition that because some of its elements are difficult to value a business has no value.

687. My second reason is that Mr MacGregor did prepare an illustrative table to support his argument. It began with HBOS's net assets as disclosed in its interim results in June

2008. This was (as Mr MacGregor eventually acknowledged) the wrong starting point. By October 2008 this was out-of-date because the HBOS rights issue was a post-balance sheet event. This net asset disclosure plus the rights issue (plus the capital to be injected over the Recapitalisation Weekend) gave HBOS net assets of £33.6bn. From this Mr MacGregor deducted impairments and FVAs as estimated on 10 October 2008 (rather than impairments and FVA as estimated on, say, 29 October 2008). He did so on a pre-tax basis: PwC (along with the investment banks) worked on a post-tax basis, but Mr MacGregor did not explain why they could not (as competent practitioners) do so and why only his approach was permissible. He also made his deductions on the basis that these impairments and adjustments were certain to occur, rather than by reference to any probability of occurrence. He also assumed that there would be no off-setting income arising during the period over which the impairments arose. He then allowed nothing for the net present value of conservatively estimated synergies of £1.5bn per annum. Lloyds internally was putting the NPV of these synergies at £10bn and the market externally at some £7.5bn-£9bn: and Mr MacGregor acknowledged that if he had undertaken the exercise using his discount rates he would have come out at £8bn-£10bn. Having summarised Mr MacGregor's approach, the short point I want to make is that in order to sustain his opinion that HBOS had no value Mr MacGregor has had to make a number of adverse assumptions or decisions ("adverse" in the sense that they have as their object the reduction in the value of HBOS). But Mr MacGregor gave no evidence that reasonable directors would of necessity have assumed all the worst scenarios and ignored all the benefits: and I can see no reason why they should do so. Indeed, if one amended Mr MacGregor's own table to take into account the fresh capital raised and to allow a low figure for synergies one soon reaches a positive value of £4.1bn.

688. My third reason is that external valuations made available to the Lloyds board did not suggest that HBOS had no value at all, and on their face those valuations were not so deficient as to be unworthy of consideration (even if individually none was of itself wholly reliable).

689. UBS produced a valuation on 30 October 2008 (as part of a 60-page model). It relied on the accuracy and completeness of material that was publicly available (including a range of broker estimates) or had been provided by Mr Pietruska and his team (on a "realistic" scenario), or by HBOS (on a "realistic" and a "pessimistic" scenario). The different methodologies produced a wide range of values, largely because in times of stress methodologies which rely on stock prices will diverge from those that do not. But all were positive i.e. HBOS was worth something between £4.6bn (price/tangible book value) and £44.1bn (historical market capitalisation). The wide range of course tells its own story about the reliability of any individual valuation: but the general picture was that HBOS was not valueless. It is the unchallenged personal view of Mr McGregor (for the Claimants) that this extensive UBS model with its multiple inputs and methodologies is not based on sufficient work and analysis to provide a reliable valuation of HBOS: but he cannot and does not say that every director of reasonable competence would have entirely ignored and placed no reliance upon it, for it used entirely conventional valuation methods current within the analyst community.

690. Furthermore, valuations were also undertaken by Merrill Lynch using different methodologies: these ranged from £15.5bn (price/Core Tier 1 ratio) to £24.5bn (NAV). (As a reality check, and logically not relevant to the assessment which the board had to

make at the time, in its post-Acquisition audited accounts for 2009 Lloyds put a fair value on HBOS on acquisition of just under £19bn).

691. The Preamble to the Financial Reporting Council's "Combined Code on Corporate Governance" published in June 2008 stated:-

> "Good governance should facilitate efficient, effective and entrepreneurial management that can deliver shareholder value over the longer term."

It continues in its first supporting principle to state:-

> "The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed."

These objectives and principles do not require a board necessarily to assume the worst about and to ignore the potential benefits of a given transaction and so to determine the company's course. I agree with Dr Berndt's insightful comment that 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. I think Mr Tate was making the same point when he drew a distinction between taking a figure (such as an impairment estimate) as a "hard number" that "drives" the transaction and treating it as a number that has to be "taken into account" in reaching "a reasonable number taking into account the extremes". I would note that by way of contrast with Mr MacGregor, Mr Ellerton was disposed to accept that there was a whole spectrum of views about what was a reasonable price for HBOS at the time of the Announcement, and that that spectrum included the original offer price. So, it has not been established to my satisfaction that the only fair and balanced view on a proper assessment of the risks in November 2008 was that HBOS had no value at all, such that a share exchange should not have been contemplated.

The recommendation case: inadequate due diligence

692. It was common ground that adequate due diligence had to be undertaken (i) in order to assess the quality of HBOS's assets and the risks in deterioration of its balance sheet; (ii) because this was a reverse takeover where the quality of the HBOS balance sheet would have a large effect upon the health of the Enlarged Group even when subjected to the more rigorous Lloyds' management techniques; and (iii) the HBOS assets were by nature particularly vulnerable in a severe economic downturn (because of the higher lending risks HBOS was prepared to run especially in the property and construction sectors of the economy). As one shareholder perceptively noted, Lloyds was acquiring a portfolio of loans it would not itself have made.

693. Lloyds was able to gain greater access to HBOS's books than would normally be the case. First, because the £10bn facility enabled it to obtain detailed access to any collateral offered on each draw down (albeit that this may not have been representative since the best collateral would have been used in the SLS process). Second, because Lloyds had to prepare a prospectus for the open offer to be made by the Enlarged Group. It was, however, still subject to constraints imposed by the demands of client

confidentiality, competition issues and the need to fit within a takeover timetable. Absent those constraints another four weeks could have been spent on due diligence. As it was, it was conducted with a period from 6 October 2008 to 28 October 2008.

694. It is the Claimants' case that what was done was inadequate, and insufficient to ground a decision by the board. Mr Hill QC submitted that Mr Roughton-Smith, whilst giving figures to the board which he indicated could not be realistically improved without a great deal of intensive and time consuming additional work had (i) informed the board that it *was* possible to improve the due diligence output by undertaking a detailed examination of a statistically significant sample of individual loan files over several weeks with external expertise brought in; and (ii) internally expressed the view (in material not seen by the board) that what was required for greater robustness was a datatape analysis. He submitted that that is what should have been done, and that it was down to the board to negotiate for more access, not simply to accept that constraints of confidentiality, competition and time meant that there were unquantifiable risks to the transaction i.e. that there were limitations but that what had been done was the best in the circumstances.

695. I do not accept this submission. Looking at what was made available to the board, Mr Roughton-Smith's paper of 29 October 2008 was based on what he described as "satisfactory access" albeit "restricted", resulting in a "robust" forecast range. Of the corporate book he said that an attempt to achieve any significant improvement in the forecast range would take several weeks with a large team (assuming HBOS withdrew its confidentiality and competition objections); and that such work would be unlikely to achieve its purpose because of inherent uncertainties in the economic environment and the nature of the HBOS portfolio. Of the retail book, he said that account-level analysis would take weeks and was unlikely to lead to an alteration in the present forecast. Of Treasury assets he said that a statistically significant sample had been analysed and that further work was unlikely to produce more precise results. Of the international portfolio (which included Australian and Irish business) Mr Roughton-Smith acknowledged that a greater level of comfort could be obtained by a deal-level review, but noted that that would raise confidentiality and commerciality concerns: he made no recommendation that further work be undertaken. In relation to the private equity and joint venture portfolios he said that the robustness of the calculations could be improved but that the anticipated output itself would not be materially different because of the existing forecast write-offs. There is nothing in the report itself which signals that Mr Roughton-Smith's team had done what had been asked of them but that the board should not rely on it.

696. Looking at a wider picture, there was no evidence adduced that it was an established practice in bank takeovers to conduct granular asset-level "due diligence" extending over a couple of months. In the absence of such an established practice the Claimants must demonstrate that in this individual case no director of reasonable competence could have accepted the "due diligence" output that was proffered by Mr Roughton-Smith and that every such director, of necessity, would either have sought to extend the takeover timetable or would have withdrawn from the transaction. But there is no evidence (expert or otherwise) to that effect and I am not satisfied that there was only one answer to the dilemma faced by the board. With expense and delay more could have been done, but perhaps to little advantage. But the board was at a point where Mr Roughton-Smith was able to provide "due diligence" output with some confidence, and

where Citi, Merrill Lynch and UBS (having conducted the necessary "10b-5" exercises) were prepared to lend their names to the Circular. 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.

697. I should address one specific point made. In his expert evidence Mr Ellerton notes that Mr Roughton-Smith's assessment of impairments on the international portfolio for H2 2008 and 2009 was £1.3bn at the top of the range, whereas for 2009 alone the actual impairments came out at £5.3bn (representing 9% of the total international loan book and 25% of the total impairments for 2009): and he comments that the assets that were subject to the lowest level of review proved to be the most toxic of all. This was not a pleaded point. The suggestion that the actual outcome as at December 2009 could have been predicted in October 2008 is a false one. There was no examination of the question whether, if an asset level review had been undertaken in 2008, then an impairment estimate above £1.3bn and closer to £5.3bn would probably have been reached. The point was a distraction.

The recommendation case: impairments

698. The key issue here is whether Mr Roughton-Smith's impairment figures prepared on 28 October 2008 and reported to the board meeting on 29 October 2008 manifestly indicated a capital shortfall that would be destructive of value to shareholders.

699. At trial a dispute emerged about whether Mr Roughton-Smith's 29 October 2008 figures (which were undoubtedly "an estimate") represented the outcome of a stress test or a forecast of what would happen in the real world. When the disaster began to emerge in early 2009 people certainly looked back on the "1 in 15" figures and treated them as if they were and always had been a prediction which was then being fulfilled. This is "confirmation bias" in operation. It does not really help with how the figures were in fact seen or might properly have been seen between 29 October and 3 November 2008.

700. Mr Roughton-Smith's figures were undoubtedly the product of the application of assumptions (a "credit crunch" slightly worse in nature than that which occurred in the 1990's) to raw material: they were thus the outcome of a "stress test". He was instructed to use a "1 in 15" scenario, which he constructed. He was not instructed to predict the actual impairment outturn making whatever assumptions he wanted. But in practice this "1 in 15" scenario came to represent the central case for assessing the Acquisition (although for budget and planning purposes Lloyds continued to adopt the softer "mid-case" scenario identified at the end of the first week in October 2008). I do not think that this was a matter of conscious choice. I think it was a tacit acceptance that the anticipated trend of events was beginning to align with the sort of assumptions made in the "1 in 15" scenario coupled with caveats beginning to emerge in relation to the "mid-case" scenario (articulated by Mr Foley around 15 October 2008). But the fact that the "1 in 15" came to be treated as the central case when approaching the Acquisition did not mean that it was to be treated as certain to occur or even that it was the probable outcome (though Mr Tate certainly thought that it was the "probable" outcome, and Ms Weir a "reasonable probability"). It remained a "probability" scenario. Account could still properly be taken of the degree of probability of its occurrence: and as to that the board could properly look to Mr Foley, the Chief Economist.

701. With that issue out of the way I can begin with what was common ground between Mr Ellerton (the Claimants' expert) and Mr Williams (the Defendants' expert). This was that if the Lloyds directors had been aware of a significant risk that Lloyds would need to raise more capital within the 12 months following the EGM then this would have been material to the shareholders. Mr William's was of the opinion that if that *was* the view reached by the board then the Circular would have had to explain why such an anticipated capital raise did not form part of the Acquisition proposals being put to the EGM. Plainly it did not: neither the directors nor PwC nor the investment banks thought that there was a significant risk of a further capital raise.

702. Mr Ellerton's view (as expressed in his Second Report) was that the Lloyds board were complacent in their analysis of capital and should have incorporated a high margin of safety into their assessments of capital to counter the possibility (or even probability) of forecasting error (assuming that any error necessarily lay in the direction of over-optimism). He thought that there was "a significant risk" (which he did not quantify) that if the top end of the range of Mr Roughton-Smith's impairments and FVAs on the "1 in 15" scenario was reached then the Core Tier 1 ratio would have been below the bottom of the 6-7% target range which Lloyds had set for the Enlarged Group (possibly at 4.4%): and that if the top end of the range on the "1 in 25" scenario had been reached then the Core Tier 1 ratio of the Enlarged Group would have been as low as 3.4%. In neither event could management action (retention of earnings, disposals, reduction in RWAs etc) have repaired the capital base.

703. This view (expressed in paragraph 37 of Mr Ellerton's letter of 15 September 2017 and ultimately set out as an area of disagreement in the Joint Statement dated 29 September 2017) was based on close analysis of Mr Roughton-Smith's memorandum of 29 October 2008, the UBS "Financial Effects Model" (dated 30 October 2008) and the PwC Working Capital Report (and in particular the working capital model produced by the Lloyds specialist team and PwC working together).

704. By doing some relatively simple maths it could be seen that Mr Roughton-Smith's Memorandum had put the "impairment and FVA" range from £16.9bn (for the low "1 in 15") to £28.8bn (for the high "1 in 25").

705. The PwC report had assumed "fair value adjustments" (i.e. reductions in the carrying value of loans to be acquired) of £8.7bn on a base case and £10.3bn on a downside case (assuming no "unwinds"). On those assumptions (which Mr Ellerton personally thought were optimistic) it had modelled a capital summary for the Enlarged Group (on "base" and "downside" scenarios). The capital summary showed a Core Tier 1 ratio at above 6% for the next 12-month period on a base case, but below 6% (and falling to 5.1%) during the next 12-month period on the downside. In both scenarios there remained a very substantial "buffer" over the 4% minimum Core Tier 1 ratio (which permitted an additional £6.9bn of impairments or FVAs to be taken).

706. Capital adjustments are not the same as impairments: but the figures can be and were here used to provide a rough cross-check. In his letter of 15 September 2017 Mr Ellerton embarked upon a reconciliation (to correct an analysis that he had undertaken in his second report). Drawing figures from the UBS Capital Model and the PwC Working Capital Report, identifying component parts of those figures, attributing some of those figures to separate periods, and adjusting comparisons to cope with pre-tax and post-tax treatments, Mr Ellerton opined that the PwC report failed by some margin to factor

in the last Roughton-Smith figures. He also expressed the view that the assumptions upon which the PwC projections had been based were themselves unrealistic. What Mr Ellerton is doing is taking the "top-down" analysis of PwC and inserting into it the "bottom-up" analysis of the Lloyds risk team (what Mr Tookey called a process of "lift, drop and swap").

707. One gets a flavour of the analysis from Mr Ellerton's commentary upon that part of the PwC Working Capital Report which addresses the base case (where, in fairness to Mr Ellerton, he has taken the raw figures for his computations from figures in Mr Tookey's witness statement which are extracted from underlying documents):-

> "Moving to the base case, the sum of £14.2 billion is incorporated into the Price Waterhouse forecast. (Note that this is a maximum £14.2 billion since a portion of the FVA unwinds in 2009). This number is broken down as to £4.2 billion for HBOS full year 2008, £4.2 billion for 2009 and £5.8 billion for the impairment component of the FVA.... What I should say here is that the assumption of an unchanged impairment charge in 2009 was completely unrealistic and the scenario is made even more unrealistic and optimistic by the assumption that the £5.8 billion impairment component within the FVA would begin to unwind in 2009. The range identified by Lloyds for HBOS impairments for 2008 and 2009 was £14 billion-£19.4 billion. I get this range by taking the £10.8 billion-£15.4 billion referenced above (i.e. £9.5 billion-£14.1 billion and £1.3 billion for H1 2008 impairments) and adding to £3.2 billion-£4 billion of items reclassified from the FVA analysis. The difference between the top end of the range £19.4 billion and the number actually used in the Price Waterhouse scenario £14.2 billion was £5.2 billion pre-tax, equivalent to £3.74 billion after tax. The £3.74 billion, had it been incorporated into the projections, would have lowered the Core Tier1 ratio by 0.72 percentage points, from the low of 6.1% identified in the Price Waterhouse report base case to 5.38%. At this level I consider that the Enlarged Group would have been required to raise £5.8 billion to bring the Core Tier 1 ratio back up to 6.5% ."

He later went on to record that he would also challenge the underlying tax assumptions. I emphasise that in citing this passage I am simply seeking to convey a flavour of the analysis, not with a view to subjecting the figures to critical deconstruction. But this illustrates the analysis that Mr Ellerton suggests that a reasonably competent director should have undertaken to test the opinions being offered to him or her.

708. Mr Ellerton concluded:-

> "In my opinion, given a range of £16.9bn to £28.8bn for H2 2008 and 2009 impairments and the information I refer to above in the course of Q&A, analysts would thereafter have been able to make calculations as to what the Core Tier 1 capital of the Enlarged Group was likely to be if the full range of impairments and fair value adjustments were taken into account (which are

> the calculations set out in my spreadsheet). From this analysts would have been able to see that the Core Tier 1 range set for the Enlarged Group of 6% to 7% was likely to be unachievable either on the 1:15 or 1:25 scenario."

709. Mr Williams (the Defendants' expert) was of opinion that Mr Ellerton had undertaken a rather complicated reassessment of the detailed financial analysis work undertaken by Lloyds and its professional advisers at the time. He believed that in doing so Mr Ellerton had made a number of high-level and ambitious assumptions and had distorted the outcome. Thus, in his commentary Mr Ellerton assumed that the Core Tier 1 capital ratio to be maintained by the board was 6.5% (the mid-point of the range announced to the market) rather than 6% (the regulatory threshold). But he conceded that the board might reasonably have looked to the 6% figure when assessing the Acquisition. Further, Mr Ellerton always took the highest figure in a range to be the material outcome and assumed that capital had to maintained at a level to cope with the extreme worst case scenario. Again, Mr Ellerton certainly had distorted the outcome by, for example, assuming that an entire year's impairments fell to be taken in a single month (rather than accruing month by month over the year); and further assuming that the month in which they fell to be taken was the one month in which for other reasons the capital ratio was at its most stretched.

710. This approach I think lay at the heart of his evidence. Faced with a range of impairment values it was Mr William's view that the range should be considered in the context of the merits of the Acquisition as a whole. Mr Ellerton's criticism of that approach was:-

> "...the high end of each range was a possible outcome from the same set of macroeconomic assumptions and the important judgment was where within that range or those ranges it was appropriate to assess the merits of the acquisition. Lloyds' board apparently took the view to proceed with an approach that was at the low end of the range."

So put, the judgment then turns of the probability of low-end figures versus the probability of high-end figures (not ignoring the possibility that a low probability/high impact event must be factored in).

711. Mr Williams undertook an analysis in which he spread the top end of Mr Roughton-Smith's "1 in 15" range equally across the year and found that the Core Tier 1 ratio dropped only to 5.72% (a margin he thought could be covered by management action and would not necessitate a dilutive capital raise). He gave evidence (which I accept) that in the M&A market in 2009 in which he was a participant there remained a market, not a distressed market, for non-core quality assets in which reasonable prices reflective of pre-crisis levels could be achieved. The Enlarged Group had non-strategic interests in St James's Place, Sainsbury's Bank, Insight, Clerical Medical and Heidelberger Leben (which Mr Tookey thought would raise £2.6bn in tier 1 capital). In closing Ms Davies QC pointed out that actual disposals in the period from 18 September 2008 to 13 February 2009 had on the evidence of the documents made a positive contribution to the Core Tier 1 ratio of 0.36%.

712. But making proper allowance for that, Mr Ellerton may still have a point. Amongst the mass of available material there are to be found figures which can be used to support

Mr Ellerton's opinion: and Mr Williams acknowledged that if the directors had embarked on the same process as Mr Ellerton and reached the same conclusions on those figures then they should not have recommended the Acquisition.

713. Mr Hill QC demonstrated that if you apply intense focus to the impact of impairments upon regulatory capital requirements (as Lloyds had to do when the catastrophe emerged in early 2009 and Mr Tookey prepared his "capital waterfall") it is possible to find the relevant figures and to undertake the requisite arithmetic to effect a reconciliation of the "top down" and the "bottom up" approaches. Mr Tookey (as did Ms Weir and Dr Berndt) strongly resisted the propriety of lifting figures prepared on one set of assumptions and dropping them into a set of figures prepared on another. I am not convinced by this objection because (i) the assumptions, although different in detail, are meant to reflect overall the same macro-economic scenario; and (ii) the purpose of the exercise is to provide a cross-check and the PwC working capital model had incorporated some material from Mr Roughton-Smith's impairments workings. So, I do not entirely dismiss Mr Ellerton's view based upon this technique.

714. But the fact that an expert equity analyst who has worked on the papers for upwards of six months and with a particular focus can (at the second attempt and after intense debate with a co-professional) identify an analysis which demonstrates a specific risk which he can characterise as "significant" does not prove that any reasonably competent company director would necessarily have done so during a board meeting at which the figures were produced, or in the short interval before publication of the Circular or in the period before the EGM. That is why Mr Ellerton was quite right to make the concessions he did during cross-examination.

715. The risk of a capital raise may be summarised in this way. Each of the Defendant directors acknowledged that if the Core Tier 1 ratio dipped below 6% then (i) that would be acceptable only on an interim basis and (ii) the board would have to formulate and submit to the FSA a plan to restore the ratio within an appropriate timeframe. (On reading my notes and studying the transcripts it has become apparent to me that the questions did not frame the scenario within which the Core Tier 1 ratio dipped. Did it fall below 6% in ordinary economic conditions? Or in a "credit crunch"? or in a deep "1 in 25" recession. That affects how long "interim" is and what is the "timeframe"). It was Mr Ellerton's view that even before the regulatory minimum ratios were approached the market would have forced Lloyds to raise more capital. In my judgment this overstates the position. I accept this opinion to the extent that if the market saw or anticipated a downward trend in the Core Tier 1 ratio such that the regulatory threshold (and the bottom end of Lloyds' stated target range) was going to be breached, then in the absence of a clear and coherent management action plan it would not tolerate that position for long but would begin to price in a capital raise. The period of tolerance would be influenced by the attitude of the Tripartite. In a period of real systemic stress the Tripartite was prepared to accept a Core Tier 1 ratio of 4% and would be unlikely to require a restoration of the 2% "buffer" by any means or according to any timescale that increased the stress within the financial system: so the "interim" was variable.

716. One has to put the hypothetical assessment of that risk in the transaction into the actual context in which the decision fell to be made *by the board*. By referring to "context" I am trying to escape from the artificiality of looking at a single question and a single piece of information as deserving of especial focus and attention amongst the mass of material generated as background for the decision itself. In emphasising "the board" I

am trying to distinguish between what might be done by the individual directors in receipt of reports and what might have been done by the employees of Lloyds, the specialist management teams charged with particular areas of responsibility and with the obligation to prepare reports for the board. In identifying the relevant context I will begin with material addressing the risks in the transaction.

717. First, the Lloyds board had the benefit of the PwC Working Capital Report. PwC plainly understood the regulatory requirements: and they had been party to discussions with the FSA. The scenarios in which those requirements were tested were (i) for Lloyds a "1 in 15" and a "1 in 25" scenario; and (ii) for HBOS a central case and a "stagflation" scenario. A reader of the PwC Report would see it recorded that Lloyds and HBOS had each obtained the agreement of the FSA that each scenario was appropriate. The PwC retainer required PwC to report to the board if any material assumption was unrealistic: and the board could expect PwC to have performed its retainer in that regard and would note the absence of any criticism of the assumptions.

718. The material used in those scenarios derived (i) from Lloyds as regards its "1 in 15" and "1 in 25" scenarios ; and (ii) originally from HBOS in relation to its central and "stagflation" scenarios. Mr Williams (the Defendants' expert) gave evidence (which I see no reason to doubt) that this was a conventional starting point. It was, however, only a starting point. The HBOS material was reviewed by its auditors KPMG. So as Mr Tookey put it in evidence:

> "They're operating under HBOS figures prepared by HBOS management, reviewed by their executive committee, their board, challenged by KPMG, a Big Four accounting firm, the economic conditions set – approved by the regulator, discussed and realigned as to corporate insolvencies…with our own team."

719. As the quotation discloses, the initial outcome was nonetheless thought by the Lloyds specialist team to be optimistic and it was therefore modified by PwC by making a fair value adjustment of £8.7bn post-tax relief (relating to the loan portfolio and the AFS reserve) on the base case and £10.3bn (to incorporate a "mark to market" adjustment) on the "stagflation" scenario. These adjustments and their rationale were set out in the text of the report: a director reading the report would have seen it recorded that Lloyds and HBOS management and economists had compared their respective economic assumptions and made the necessary adjustments. The reader would know that PwC would report upon any unrealistic assumption in that regard also: and would observe that the report did not so state. A competent director would see from the report that the Core Tier 1 ratio was forecast (i) to remain above 6% on the base case throughout the forecast period; (ii) to be below 6% in the stressed downside scenario returning (even in the absence of any management action) to 5.9% by March 2010; and (iii) to maintain a substantial buffer at all times over the 4% Core Tier 1 ratio acceptable in a severe stress (equivalent to further impairments of £6.9bn). Such a director would not ignore the warning that the economic assumptions on which these forecasts were based might worsen so that there was a residual risk of a worse outcome. But there would be nothing on the face of the report itself to suggest to someone lacking Mr Ellerton's skills and experience that PwC and the Lloyds specialist team had failed in some way to adjust fully for any optimism in the underlying HBOS forecasts.

720. Second, the board had the benefit of Mr Roughton-Smith's latest impairments figures upon which there was a robust discussion in the presence of Ms Sergeant, to whom Mr Roughton-Smith reported and who had been working with PwC on their Working Capital report. There is no suggestion that in the course of that discussion Ms Sergeant (who was cautious, independent, critical of aspects of the transaction and highly-attuned to risk issues) indicated to the board that any assumptions in the PwC report were optimistic or that Mr Roughton-Smith's latest figures invalidated the cross-checking that had hitherto taken place. The board was entitled to place reliance upon the views of Ms Sergeant as they understood them to be. Mr Tookey would have informed the board of his opinion that the latest "1 in 25" figures could be accommodated within the existing net negative capital adjustment and the available "headroom" before the 4% Core Tier 1 ratio was breached. The board was entitled to place reliance upon him and his team. The directors would, of course, know that any drop towards the 4% threshold would mean that a dilutive capital raise was indicated: and they would have to form a view about the likelihood of the occurrence of the downside scenario.

721. Third, as to macro-economic predictions the directors knew that Mr Foley's central forecast for budgeting and planning purposes was a "mid-case" scenario; and that for the purposes of providing a context for the Acquisition his forecast was that a "1 in 15" or better (e.g. "midcase") scenario had a 70% probability and that a "1 in 25" had a 15-20% probability. It is plain from the course of the "away-day" in early November 2008 that the directors did not regard the 15-20% probability of a "1 in 25" as beyond question and wanted further work done on it for planning purposes: but it provided them with a "ballpark" figure. Mr Ellerton acknowledged that it was not unreasonable for the Lloyds directors to take into account the views of their chief economist in making assumptions about the future performance of the economy though he qualified that by saying:-

> "…I think it would have been reasonable to suggest that they should have incorporated flex within their economic forecasts, given the fact that they were going to take over a bank that was twice [Lloyds] own size, and given their knowledge that that bank had a much more risky loan portfolio that themselves, and given their knowledge that the economy was going to determine, to a large extent, the impairments that HBOS was likely to suffer. *So I personally believe* that it was reasonable for the directors to insist or to incorporate a significant margin for error in terms of forecasts, rather than relying on a spot forecast at a moment in time." [Emphasis supplied].

If Mr Ellerton is only saying that the directors should have paid heed to the warning which the PwC report itself contained, then I agree. If he is saying that the directors should have allowed something beyond that warning and over and above the cautious assumptions embodied in the Lloyds model itself (it will be recalled that the FSA thought Mr Roughton-Smith's "1 in 25" was more like a "1 in 60") exemplified by the upper ranges of Group Risk's figures, then I can understand that to be Mr Ellerton's personal opinion: but I see nothing in the evidence to suggest that every competent director would have taken that view or that such an additional margin was the only rational approach.

722. Indeed, in an attempt to reinforce the point about the caution already built into the Lloyds' assumptions Ms Davies QC put to Mr Ellerton that the "1 in 15" scenario was already conservative compared with consensus forecasts. Mr Ellerton would concede that it was "somewhat worse" than the consensus and was "faintly conservative" but "was reasonable". So, if what was needed was "flex" or a margin for error in the forecasts, the Lloyds approach built that in.

723. Fourth, the Lloyds board received a Working Capital Report on HBOS prepared by KPMG (its auditors) accompanied by a comfort letter as to the sufficiency of working capital. It is, of course, right that KPMG were the auditors to HBOS and were working on figures provided by HBOS. But that does not of itself mean (and the evidence certainly did not establish) that upon that account the figures should be ignored by any competent Lloyds director. This Working Capital Report was part of the "due diligence" package arranged by highly experienced solicitors who had ensured that KPMG acknowledged a direct duty to the Lloyds' board. It was not suggested to any Defendant director that there was something on the face of the KPMG Report which indicated that its contents were suspect or that would have alerted any competent director to the need for further enquiry.

724. Fifth, the Lloyds board received the advice of Citigroup, Merrill Lynch and UBS (with some specialist input from Lazards). Of course, the sponsor banks put their names to the Circular recommending the Acquisition to the Lloyds shareholders (and of itself that could properly weigh with the directors). But the precise point under consideration here is whether every competent director would have appreciated from the terms of the investment banks' advice that there was a significant risk of a dilutive capital raise in the 12 months following the completion of the Acquisition. To expand upon "the terms of the investment banks' advice": given that the advice given by each of the banks did not flag up any such risk, the question is really whether a competent director should have appreciated that the omission of such advice resulted from a deficit in information or analysis or the making of some unrealistic assumption by the banks (such as Mr Ellerton suggests occurred). The investment banks were addressees of PwC's report and were retained to review it. No feature of their work was identified as alerting any competent director to some inadequacy of information, some shortcoming in analysis or the adoption of some unrealistic assumption.

725. Sixth, the Lloyds board knew that the FSA had (only three weeks before) undertaken a deliberately conservative analysis of the additional capital requirements of the Enlarged Group in order to render it "bullet-proof" and had settled on a figure of £17bn which (as part of the recapitalisation process) the Enlarged Group was going to raise. Mr Ellerton was in his written reports disposed to dismiss the FSA as having "no competence or expertise in macroeconomic forecasting"; but in cross-examination he withdrew the assertion. He agreed that the objective of the FSA was to "bullet-proof" HBOS on the "base" case:

> "Q: ..can we agree it would have made no sense at all for the FSA to set a capital level for the enlarged group which would leave the enlarged group with a core tier 1 ratio of less than 6% in the FSA's view as to the most likely development of the economy?
>
> A: Yes, I would agree with that….

> He was more equivocal in relation to the "downside", though he did acknowledge that £17bn additional capital for the Enlarged Group was the correct outcome of the FSA's stress tests.

726. What Mr Ellerton maintained was that the FSA stress tests were wrong; that the FSA had made a series of miscalculations when assessing the risk of HBOS; and that the only reasonable approach for the Lloyds board to adopt was to assume a more severe downside impact on HBOS in a severe stress than had the FSA. These "miscalculations" had occurred notwithstanding that the FSA had the benefit of using BoE macro-economic input, had extended supervisory experience of the HBOS balance sheet over many years and had the benefit of a review of its proposals by Credit Suisse on behalf of the Treasury.

727. His argument appeared to be (i) that exactly what assumptions had been made by the FSA on a "downside" case and how they had applied those assumptions to the HBOS balance sheet were not known; (ii) if there was no evidence to suggest or no reason to think that the FSA view was wrong then it would be reasonable for the directors to accept the sufficiency of the output of the FSA stress test; (iii) Lloyds had done some due diligence (on treasury assets, venture capital and loan portfolios) which showed the quality of the HBOS balance sheet to be risky and exposed in a downturn; (iv) the directors should have regarded this internal work as evidence that the FSA view was wrong.

728. I do not view this as a tenable position. How the FSA had viewed the quality of the HBOS balance sheet or assessed its degree of exposure in a downturn was not known. The Lloyds internal assessment of parts of the HBOS assets base could not demonstrate shortcomings in that unknown approach. The Lloyds board would have no reason to think that the FSA and the Treasury had got their estimates wrong. It was later to transpire that that those reviewing events in the light of knowledge of what transpired formed the view that the FSA may indeed have fallen short in its work: but there was no way that a bank director of reasonable competence could have known that at the time.

729. The FSA, which was focussed on the stressed scenario and preserving the 4% threshold, made known its view that an additional £17bn of capital would produce a Core Tier 1 ratio of 4.6% in a deep recession. I cannot see the basis for suggesting that every reasonably competent director would have been compelled to discount this view of what was needed to "bullet-proof" HBOS. I find that it was within the range of reasonable responses of a competent director to take that view into account.

730. Before summing up I should address one discrete point raised in the Re-Re-Amended Reply. In relation to the capital to be raised by Lloyds as part of the Enlarged Group under the Recapitalisation Weekend programme the Claimants say that the £5.5bn to be raised by Lloyds:

> "..was an amount merely "allocated" to Lloyds and most if not all of which would be required to absorb the losses HBOS was projected to incur."

The evidence adduced to prove this plea is that of Mr MacGregor. He examined where the additional capital raised by the Enlarged Group had been deployed down to the end

of 2009 and concluded that it had been almost entirely absorbed by HBOS losses. This does not assist.

731. The question is: what risks anticipated (in the assumed stress scenario) in October 2009 needed to be covered by additional capital? The fact that some risks to Lloyds as part of the Enlarged Group did not eventuate whereas rather greater risks eventuated for HBOS than had been anticipated (so that the resources of the Enlarged Group ended up supporting HBOS not Lloyds) would not prove that the initial allocation was wrong: and certainly could not establish that any director of reasonable competence would see that the Tripartite had manifestly failed to "bullet proof" HBOS (whether as a "standalone" bank or as part of the Enlarged Group). So, something more is required than knowledge of what ultimately happened; that "something more" is lacking. So I can put that point on one side.

732. Looking at the matter generally, Mr Ellerton thought that the directors should have had a greater concern for the protection of their shareholders and a lesser focus on accretion and should have been more sceptical about the assumptions being made. Many might agree with him. But that indicates an error of judgment; it does not establish negligence. The question is not whether many competent directors would have disagreed with the course taken by the Lloyds board: it is whether no reasonably competent director could have shared the view of the Lloyds board, so that their recommendation of the Acquisition to the Lloyds shareholders lay outside the range of responses reasonably open to competent directors.

733. To collect together Mr Ellerton's points, using his words, would every director of reasonable competence have said:-

> "All our advisers have got this wrong. The investment bankers have produced a one-dimensional model , focusing on a narrow range of metrics rather than providing us with a holistic view They have made frankly optimistic, indeed very optimistic, earnings forecasts which are barely consistent with a realistic case, and with an entirely misplaced emphasis on EPS accretion. Furthermore, PwC have produced a Working Capital Report which models a "downturn" scenario that is really more in keeping with a base case. Macro-economic forecasters (including our own Mr Foley) have got it wrong as well: we are at an inflexion point in the economy here. The Tripartite have also got it wrong, because although they think they have "bullet-proofed" all banks they have left us under-capitalised for what is coming. Whatever they all say, we think that things are going to get so bad that there is a real risk we are going to run out of capital appropriate to the forthcoming market conditions and we will be forced into a dilutive capital raise so large that it will destroy any synergy benefits."

The evidence does not establish that an affirmative answer must be given to that question: and pure rationality does not point only in that direction. Making my own assessment I find and hold that neither a chairman nor an executive director of a large bank would have been bound to take that view.

734. They were not required to do again the work which they had retained advisers to undertake. The advice given to them was not obviously irrational. There was nothing in its terms to indicate some manifestly false assumption, some glaring lacuna in its factual foundation, some obvious error of analysis. There was nothing in the terms of the advice which would have compelled every reasonable director to the view that the likely level of impairments over the next twelve months was such that there was so significant a risk of a dilutive capital raise that the Acquisition could not be described as beneficial to the Lloyds shareholders over the forecast period.

735. Before concluding this section I should refer to one other criticism which is intimately connected to the question of a dilutive capital raise but was at times advanced as a separate ground for criticism. This was that the view taken by the board and conveyed to the shareholders was that the Acquisition was recommended as EPS accretive having regard to the projected earnings (enhanced by the synergies) and the projected capital base. The point taken was that a dilutive capital raise would undermine projected EPS accretion.

736. The point is obvious. I have held that it was not unreasonable (in October/November 2008) to work on the basis that a dilutive capital raise was not a significant risk. But I should briefly examine the EPS question. With one caveat, it was common ground between experts that it was reasonable for the Lloyds board to take into account forecast EPS and, indeed, that it was "a critical metric" or "a key focus for assessing the merits of the acquisition" (as the Defendants' own expert evidence stated). The one caveat was that at one point Mr MacGregor seemed to suggest that in October 2008 *no* forecasting operation should have been undertaken. Given that the evidence of Mr Deetz demonstrated that of 245 banking sector analysts' reports in October 2008 85% utilised earnings forecasts I regard that as an untenable view.

737. The criticism of the Claimants' experts was (i) that the forecast EPS was "unreliable" or "speculative"; and (ii) in assessing how accretive the forecast EPS was the directors used the wrong comparator.

738. The first criticism is essentially true of all forecasts in some measure: so what the Claimants need to establish is that the EPS forecasts were so unreliable and so speculative that no reasonably competent director would have given them significant weight. I have already made a general point about that.

739. The forecast EPS figures reported to the board had been prepared by Mr Pietruska's Group Strategy and Corporate Development Team at Lloyds working alongside UBS. UBS created a model that relied upon the reasonableness and achievability of the Teams' figures. The forecasts were prepared on the basis of the "mid-case" scenario which Lloyds was using for its planning and budgeting purposes. The object of the model was to create a realistic scenario and a pessimistic scenario each of which took into account synergies, merger costs and "dis-synergies", impairment charges, FVAs and write-backs. The work continued up until 30 October 2008 with the later figures showing greater EPS accretion than earlier projections.

740. Mr Ellerton is of the opinion that Mr Pietruska's team erred in their forecasts because (i) a comparison between the HBOS earnings forecast in the UBS model and the HBOS earnings forecast in its Group Plan suggests that the impairments figure used in the UBS model is below Mr Roughton-Smith's latest figure for HBOS 2009 impairments on a

"1 in 15" basis; (ii) if you add impairments to forecast underlying profits for 2009 Mr Pietruska's team seems to have forecast underlying profits of £7.002bn whereas the PwC Working Capital report assumes underlying profits of £6.702bn; (iii) the accretion calculation assumes that a fair value "unwind" can be incorporated into the underlying profits whereas "analysts and investors would have backed the fair value unwind out" as non-intrinsic to the calculation of the underlying earnings accretion.

741. These criticisms were made only 1 month before the (delayed) trial in answer to targeted probing of the reasoning in Mr Ellerton's expert report. Even assuming each of the points to be right, the question is whether they would have been apparent to a reasonably competent director undertaking a general consideration of the advice received from the Lloyds' specialists and UBS upon likely EPS accretion. I would answer that question in the negative, on the evidence adduced as to the practice of competent directors, and upon my own assessment.

742. The forecast EPS accretion does not kick in until 2010. Concern over 2009 impairments or the accuracy of 2009 underlying profit forecasts would have no impact upon 2010 EPS unless events in 2009 had compelled a dilutive capital raise: that "broad picture" was what the board had to look at. But in the absence of any amber warnings apparent on the face of the advice a competent director was not obliged to embark upon some deep-drilling exercise into the factual or conceptual basis of the advice, but was entitled to treat it as the product of competent specialist employees properly discharging their functions and of competent advisers discharging the obligations of their retainer.

743. In any event I do not think the criticisms can be (or were in the end) maintained. The forecast earnings were below HBOS' last estimates, and below its actual earnings in the two years preceding the Lehman's crisis. They assumed a downturn and a gradual recovery (though in the event the downturn was much greater and the recovery period much longer than was anticipated in October 2008). Mr MacGregor did not identify any particularly incautious assessment: indeed, he accepted in cross-examination that he had not sought to investigate the reasonableness of the assumptions behind the earnings forecasts. The underlying material did not compel the assumption of a dilutive capital raise. Whilst "fair value unwinds" might have been an issue in the calculation of "cash EPS", such "unwinds" were not relevant to the task on which UBS embarked.

744. I accept the evidence of the Defendants' expert Mr Deetz (which struck me as moderate, balanced and firm under thorough cross-examination):-

> "[The UBS model] presents a realistic case, that realistic case is within the demonstrated earnings capacity of this company historically pre-crisis and it shows a view as to how the crisis is going to turn around and get back to normal. Is that the only view? No, but it's certainly reasonable to look at that view and consider it and that's all I've testified to."

745. There is one other angle briefly to consider. An opinion that a transaction is expected to be "earnings accretive" requires a consideration not only of projected earnings per share but also but also of a comparative measure: the projected earnings are better than some other scenario. The scenario modelled for comparative purposes was a "standalone" Lloyds required to raise additional capital of £7bn. I have explained elsewhere why I consider that to have been an entirely realistic scenario to create. But

I would note that in fact Lloyds did model an alternative scenario in which only additional capital of £5.5bn was required: this model still showed the Acquisition as accretive by 21%.

The recommendation case: funding

746. The Lloyds' management team itself had given the board a clear warning that if markets collapsed again to the chronic state which had been recently experienced then the Enlarged Group could not survive without access to additional government funding. The PwC Working Capital Report had warned the board that assessments of reasonable downside scenarios had to be made with considerable caution taking account of the recent extreme stress conditions affecting the wholesale markets. Were these funding risks so significant that the Acquisition was too risky to be embarked upon?

747. As PwC stated in their report (and as was the case) Lloyds had secured from the Tripartite a promise that (assuming the Enlarged Group had adequate collateral about which there seems no doubt) the Government would make available mainstream funding of £75bn under the debt guarantee scheme and up to £110bn under the mainstream SLS/Long Term Repo scheme. This exceeded by a substantial margin what was required in the "downside" scenarios then in contemplation. The board was also provided with a formal letter from BoE that the funding plan for the Enlarged Group which Lloyds had presented was "viable": that was the objective view of a key regulator.

748. As to the residual risk, the board had received "off the record" comfort that the Government would continue "to support the banking system". In my view this might reasonably be taken as a signal that the Government would, if the markets returned to virtual closure, do "whatever was necessary". As a matter of logic it seems to me that if the Tripartite had modified the criteria for access to mainstream funding and had extended ELA to HBOS in order to avoid the risk of systemic failure, then it was not going to run the risk of systemic failure by refusing to do the same for the Enlarged Group in what were *ex hypothesi* challenging circumstances arising from the insufficiency of its earlier steps.

749. If one looks at the forecast funding requirement and the forecast funding availability and the outlook as it appeared in October 2008 and asks:-

> "Are the funding circumstances of such a character, are the risks of inability to fund so manifest that no director of reasonable competence and ordinary prudence could recommend the Acquisition?"

it seems to me that the answer is "No". Funding issues would not compel a reasonable director placed as the Defendant directors were placed to reject the Acquisition. The directors had adequately covered the central risks and got as much as any set of directors could get in relation to the residual risks which (whilst they undoubtedly remained) were as at late October to mid-November 2008 remote.

The recommendation case: restructuring

750. A thumbnail sketch of the board's objective in pursuing the Acquisition was provided by Mr Daniels in these terms:-

> "Lloyds was acquiring more with HBOS than just its net tangible assets less the impairments that we forecast. It was also acquiring substantial synergies in the region of £1.5 billion per annum, as well as significant market share across multiple product areas and existing brand value. All of those factors taken into account meant that Lloyds was not acquiring a net liability in HBOS."

751. The Claimants make no complaint about the estimate of the synergies. Indeed (i) the market regarded it as an understatement of what was likely to be achievable (ii) the internally produced "stretch" case went up to £2.3bn and (iii) the internally produced "base" case was over £1.8bn-worth of synergies, but Lloyds announced only £1.5bn (leaving "headroom" of at least £300m). The estimate was the product of some 28,000 hours of work by Lloyds and by Deloitte, verified by PwC. It was a modest and well-grounded target. But the Claimants expert Mr MacGregor nonetheless expressed the view that the directors could not have been sure of how much of the value of the synergies would actually be realised for three reasons. First, because of "dis-synergies". Second because of a risk of restructuring. Third, because on a takeover the marriage value of synergies should be shared between predator and target. In my judgment none of these "deficits" would have caused every reasonably competent director to regard the anticipated synergies as so at risk that they should be left out of account in assessing the overall risk-benefit analysis the Acquisition.

752. First, "dis-synergies". A merger does not produce only benefits. A branch closure can cause a loss of customers, for example. For that reason "dis-synergies" must be estimated. Mr MacGregor acknowledged that the Lloyds estimate was expressed net of revenue dis-synergies: but he expressed the expert opinion that such a "dis-synergies" were frequently understated. In my judgment the point goes nowhere because (i) Mr MacGregor could not point to any area of apparent understatement of "dis-synergies" in the present case (however frequent their occurrence in other cases); (ii) Mr MacGregor made no attempt to analyse whether any potential understatement of the "dis-synergies" was already allowed for in the modesty of the "synergy" target; (iii) Mr MacGregor acknowledged that any difference between the Lloyds' "dis-synergy" estimate and the external advisers' "dis-synergy" estimate was immaterial; and (iv) even the maximum "dis-synergy" estimate of £59 million was itself immaterial in the context of £1.5 billion of anticipated synergies.

753. Second, restructuring. Mr MacGregor made the perfectly fair point that the value of cost synergies could be undermined if the Enlarged Group were required to make significant divestment as part of any restructuring plan approved by the European Commission. The board was not blind to this risk. It was warned on 24 October 2008 that the requirement to submit a restructuring plan could potentially require a breakup or significant downsizing of the Enlarged Group which might negate some of the merger benefits. The task for the board was (i) to estimate the significance of that risk to the achievement of the cost synergies and (ii) to assess what risk the non-achievement of the cost synergies posed to the benefit of the transaction as a whole.

754. I find that the Lloyds management and board were given the impression ("reasonable assurances" as Mr Tate put it) by the Tripartite that the takeover itself coupled with the integration plans and the disposal proposals inherent in it would very probably meet any restructuring requirements that might be imposed by the European Commission. The evidence of Ms Weir was particularly clear:-

> "I would not have gone ahead had I felt there to be a significant risk of elimination of the synergies as a result of a restructuring proposal. So the fact that therefore I was happy to support going ahead meant that I didn't. I believed that – and I remember this – the actions that we were taking were, should be considered to be sufficient, and I believe I believed that on the basis of the conversations (I didn't have but others had and reported) with the government."

755. I further find that this was the tenor of the advice which they received from Linklaters. Immediately after the Recapitalisation Weekend (when State aid was provided to troubled banks) the European Commission had issued its announcement as to the treatment of such aid, drawing a distinction between banks that were "illiquid but otherwise fundamentally sound" and other banks. Linklaters wrestled with what this might mean and what might be required, and sought clarity from Slaughter & May on behalf of the Treasury. Pulling everything together they were able to advise:-

> "Restructuring for the recap scheme is less articulated. It will mean the cessation of loss-making businesses and in all likelihood for HBOS the merger plus synergy plans. Beyond that is currently unclear…."

756. The Claimants do not seek to say what sort of divestment programme a reasonably competent board should have foreseen, or to quantify what impact such a programme would potentially have had upon the achievement of the anticipated synergies. Their case is simply that mere existence of a risk of some sort of divestment programme should have deflected the board from recommending the transaction to Lloyds shareholders.

757. In my judgment the evidence does not establish (nor does the logic of events compel the conclusion) that any director of reasonable competence would in November 2008 have assessed the prospect of a divestment and restructuring plan such as that which the European Commission eventually required in November 2009 as a real risk, sufficient to jeopardise the achievement of the objectives of the Acquisition. In my judgment the board did an entirely reasonable thing in assuming that the risk of a significant divestment programme was not sufficient to deflect them from the transaction, but then identifying and articulating the risk in the Circular (as risk factor 1.14).

758. As a footnote (irrelevant to the foregoing decision, but of interest) the anticipated synergies were comfortably exceeded notwithstanding the unanticipated restructuring.

759. Third, sharing the "marriage value" of synergies. Mr MacGregor's point was not easy to follow. In his report he argued that since synergies were generated by the combination of predator and target and since all shareholders would share in the

enlarged business it was appropriate to ignore synergies. If this is the approach that should have been adopted by any director of reasonable competence, then it is truly extraordinary that it was not an approach espoused by any of the specialist accountants or investment bankers involved in the transaction at the time or canvassed by any of the analysts who examined and commented upon it. I do not think that there is anything in this point, as in the end Mr MacGregor seemed to accept.

The recommendation case: the "standalone" comparator

760. The argument of Mr Ellerton and of Mr MacGregor here was one that was deployed in several contexts. The board should not have proceeded on the footing that the alternative to the Acquisition was a "standalone" Lloyds required to raise £7bn additional capital. The true alternative was a "standalone" Lloyds required to raise £1bn or £3bn, or £4bn or £5.5bn additional capital. So in deciding where the balance of advantage lay the Defendant directors negligently used an unduly and impermissibly pessimistic comparator.

761. I regard as untenable the proposition that no director of reasonable competence could have thought that Lloyds would probably need to raise £7bn in additional capital. It was a plainly stated requirement of the FSA to which, in the circumstances, Lloyds was bound to submit during the Recapitalisation Weekend (even though the board could not understand the basis for it and were livid at its imposition). Once the market was informed that this was the regulators' requirement there was a very significant risk that the funding market would react badly to a refusal by Lloyds to comply. Non-compliance was (as Ms Weir put it) "unthinkable".

762. Nothing that happened after the decision to proceed with the Acquisition and before the publication of the Circular affects that view. The requirement to raise £7bn additional capital was confirmed even as the directors were considering the terms of the Circular. An attempt by the directors to convey to the shareholders that perhaps less than £7bn would be acceptable ("at least £5.5bn") was given the cold shoulder by the FSA. The judgment that there was no realistic prospect of persuading the FSA to reduce the assessed figure and that effort was best directed to negotiating how the assessed figure might be raised otherwise than through the issue of preference shares was, in my view, well within the range of judgments that could properly be made by competent directors. How to best use limited time and resources are decisions that have to be made in "real time"; and it will be a rare case in which it is possible to say that every director of reasonable competence would have spent less time pursuing Objective A and more time pursuing Objective B, less time in working out the detail of the strategic decision that had actually been taken and more time in working on a rejected alternative. As Mr Tookey put it:-

> "Our focus was on what it was. It's not practical now to go back and try and digest the judgements that we made as to where we put the limited time and resources that we had at the time to try and secure a deal in the timetable that we wanted to."

Accepting the reality that a "standalone" Lloyds would be required to raise £7bn was a proper basis upon which the construct a comparative scenario.

The recommendation case: a summing up

763. The board (as is evident from the 12 October 2008 board minutes) correctly understood that the choice they faced over the Recapitalisation Weekend was whether to proceed with the Acquisition on revised terms and to accept the capital package of £17.5bn (of which they had to raise £5.5bn), or abandon the Acquisition and proceed as a "standalone" raising £7bn. The clear advice was that raising £5.5bn was less dilutive than raising £7bn. The former course entailed the risks inherent in acquiring HBOS. It cannot be said that the Defendants were ignorant of those risks: for they approved a Circular which set out the risks. It cannot be said that the Defendants chose to ignore the risks when they were presented with them; for the directors plainly considered them. In particular, the board recognised that the transaction was vulnerable to impairment issues. As Mr Daniels put it:

> "What we have to do is to…choose a scenario that we believe is probable and then look at a downside. And if the probability of that downside reaches a significant level, then what we have to do is talk about the risks that are attendant to that."

That is what the directors did; and the complaint must be that they weighed the risks inadequately. The expert evidence does not establish any such inadequacy by reference to the standards to be expected of reasonably competent directors at the time. The evidence of the events themselves does not demonstrate the existence of circumstances of such a character, so plain and so manifest that any competent director of ordinary prudence would be bound to decline to recommend the Acquisition notwithstanding the tenor of the advice received. With the benefit of hindsight one can see a strong case that there was a misjudgement. As Mr Daniels put it:

> "...we knew about the sensitivity but we didn't expect the deterioration to be as rapid or as severe."

But in that inaccurate prediction the individual directors who are Defendants were in the good company of the Lloyds Chief Economist, the Government, the IMF and many others, and the forecast was not careless. As Mr du Plessis said:

> "I still believe that things had changed so much in those months that there is absolutely no way that I could have understood by the end of October or that any reasonable director by the end of October could have imagined the world as it would look months later, by the middle of February."

764. Now that we know what happened we can see that a (possibly) over-capitalised "standalone" Lloyds with a small market share and a conservative book *might* have weathered that particular storm better than the Enlarged Group. But as Mr Ellerton rightly conceded, and as an examination of the advice received and the circumstances in which it was tendered reveals, the choice actually made by the individual Defendant directors at the time lay within a range of reasonable choices.

765. Thus, the recommendation case fails.

The disclosure case: main themes

766. There are three separate strands to the disclosure case:-

(a) That the individual Defendant directors are in breach of a common law duty of care that each owed in relation to responses given by directors and management at presentations concerning the Acquisition ("the presentation case"):

(b) That the individual Defendant directors are in breach of a common law duty of care in relation to misstatements in the Circular ("the misstatement case"): and

(c) That the individual Defendant directors are in breach of the equitable duty to make sufficient disclosure to shareholders of information material to the decision they were being asked to make ("the sufficient information case").

767. The foundation of the presentation case is that each of the Defendant Directors owed to each Lloyds shareholder a common law duty to ensure that the information provided to them was complete and did not contain any material omissions. The core duty is pleaded in paragraph 40 of the Claim. It is said to apply in relation to the Announcement, the Revised Announcement, and to presentations made on the 18 September 2008, 13 October 2008 and 3 November 2008. The representations and omissions relied on cover many pages of pleading and are categorised in paragraph 94 of the Claim as relating to the level of due diligence conducted, HBOS's liquidity position, HBOS's capital strength, the value of HBOS, the Lloyds £7 billion capital raise and representations about competition.

768. I have already addressed (in the context of the recommendation case) whether the individual Defendant Directors owed a duty of care to each Lloyds shareholder in relation to the Announcement and the Revised Announcement. For the reasons I there gave I do not consider that the individual directors owed a duty of care in relation to alleged misstatements or omissions in the Announcement or the Revised Announcement.

769. In relation to statements made at a presentation I do not consider that the case that an individual director owes each individual shareholder a duty of care (as opposed to an obligation of honesty) in respect of statements made by that director (or in the presence of that director) to journalists or analysts can be, or is, made out. That is so for the following reasons:-

i) For a director to be personally responsible for a statement made on behalf of the company at a presentation something more is required than that he is a director and made the statement (but no such additional element was pleaded or addressed in cross-examination).

ii) In the instant case the statement or misstatement was not made to the person to whom the duty was allegedly owed. I do not doubt that there may be some cases in which a statement made to a third party can give the claimant a cause of action. They will be cases in which the maker of the statement has the individual claimant in view and knows that his statement will enable the addressee to discharge some duty to the claimant: an example may be a pharmacologist who tells a doctor about the side-effects of a drug so that the doctor can treat a patient. But that is not this case: I was shown no case close to the present, where the statement is made to a journalist or analyst to assist that recipient in the preparation of freely-written commentary, which might be favourable or unfavourable, but which might be read by an interested public (some of whom would be Lloyds shareholders).

iii) The Claimants' case relies on the key proposition that each individual director is to be taken to have implicitly approved or adopted every statement made by any other director or member of the management team at a presentation (because at no time did any individual director seek to correct a statement made by any participant). Even if this proposition is confined in its scope to directors who were present on the occasion when the statement is made by Director A, silence on the Part of Director B does not mean implicit approval or adoption of Director A's statement. Director A may have particular knowledge which enables him to make the statement, and Director B's silence may arise out of lack of knowledge. At one point in the presentation on 3rd November 2008 the assembled analysts were told that a total of 5100 man-hours had been spent on "due diligence and synergies"; later in answer to another question there was reference to the 5100 hours spent "on due diligence". Ms Weir probably did not have the knowledge to intervene and say that the hours spent on "due diligence" (strictly defined) appeared to be 1397. Why should she be liable for any degree of inaccuracy in the second reference to 5100 hours?

iv) Given the careful terms of the Announcement and the Revised Announcement I do not regard the assertion, that statements made at the presentations on 18 September 2008 and 13 October 2008 were intended to be mediated (through commentary) to Lloyds shareholders and relied on by them, to be maintainable. There was the clearest communication that reliance should only be placed on the contents of the Circular read as a whole.

v) Given the terms of the Circular and its elaboration of the relevant risk factors (and also the assumption of responsibility it contained) I do not consider that statements made at 3rd November 2008 presentation by individual directors could reasonably be taken by any Lloyds shareholder as qualifying or

adding to statements in the Circular, particularly in the light of the warning given on 3rd November 2008.

vi) It has not been demonstrated how the alleged misstatements were translated into the commentary on the Circular, and in particular how the 3rd November 2008 presentation resulted in more favourable commentary than was justified by the terms of the Circular itself. All one knows is that some press coverage was favourable (e.g. "Eric Daniels….looks like he is getting HBOS for a song..." said the Telegraph on 4th November 2008); and some was distinctly unfavourable (e.g. Premier Wealth Management advised Lloyds shareholders on 8th November 2008 to vote against the deal because Lloyds was a strong proposition and HBOS would dilute the offering and strength since it was a mortgage lender with a poor and devaluing book). I was not shown anything of substance in this debate which showed any influential commentator's analysis was significantly altered by anything said at a presentation.

vii) The Claimants evidence does not show that any decision of any shareholder turned on or was significantly influenced by any answer given at any presentation.

770. I acknowledge (as Mr Hill QC pressed) that Rule 19.1 of the City Code provides:-

> "Each document or advertisement issued, *or statement made*, during the course of an offer must be prepared with the highest standards of care and accuracy and the information given must be adequately and fairly presented." (Emphasis supplied).

This Rule, of course, does not confer a direct right of action by a shareholder in relation to any alleged breach: s.955 and s.956 Companies Act 2006. But nor does it reflect any existing common law duty actionable at the suit of any individual recipient of the document or hearer of the statement. It is a provision that enables the relevant regulators to take appropriate steps to enforce regulatory discipline.

771. If I had considered that a duty of care was owed in relation to statements made at a presentation I would not have found there to be any breach. In summary, as to the 18 September 2008 and 13 October 2008 presentations it was clear at the time that they were intended to communicate the outline of then-current negotiations and investigations and were based on the then-current state of knowledge of the participants: and it was clear that in order to progress the transaction a Circular containing all relevant information would have to be published. Those presentations did not purport to be full and complete accounts and it is not sensible to seek to identify "omissions" from them e.g. in relation to the HBOS funding arrangements (both generally and as regards interbank arrangements with Lloyds), or in relation to assessing the prospects for HBOS if then-current funding arrangements were to alter.

772. As to alleged "misstatements" there is a general pattern of the Claimants seizing upon particular words, isolating them from their context, and then asserting that they are false. Thus, Mr Daniels said on 18 September 2008

"We have a robust capital and liquidity position. "

The Claimants assert that it was incorrect to say that the capital or liquidity position of HBOS was "robust". But set in their context these words properly understood meant that there was a robust capital position for the Enlarged Group but that even so the Lloyds directors were not satisfied with it and would look to enhance it further. There was no element of misstatement. Nor was there any element of falsity in those statements in which the directors and management expressed favourable views about or confidence in the Acquisition: those views were honestly held and (as I have explored in connection with the "recommendation case") reasonably grounded.

773. As regards the presentation on 3rd November 2008 if I had considered that a duty of care was owed in relation to statements made at it then I would not have found there to be any breach.

774. Statements about the excellence of the transaction expressed genuinely held and reasonably grounded views. The Claimants suggest that HBOS was a net liability: they say that the net assets as at 30 June 2008 (according to the HBOS interim statement) were £21.3bn but that the top of Mr Roughton-Smith's impairments and FVAs was £22.3bn so rendering the HBOS shares valueless. But it is clear that the Lloyds board (i) honestly believed HBOS had a value which justified the offer price; (ii) had reasonable grounds for so thinking in that the proposed comparison is too crude (because it does not address the value of HBOS *to Lloyds*, as the Claimants' expert Mr McGregor recognises, since it overlooks the synergies generated by the merger, the brand values gained and the market dominance achieved); and (iii) were supported in their view by Citigroup, Lazard, Merrill Lynch and UBS whose valuations (depending on the methodology adopted) ranged from £8.5bn to £40bn (ignoring extreme outliers).

775. The Claimants allege that at the November presentation the directors stated that they had accurately "fair valued" the HBOS loan portfolio and had conducted "thorough and detailed assessments" and that these statements were false. These statements were in my judgment true. Of course, it is always the case that given unlimited time and unrestricted access more could be done: but it is undoubtedly the case (i) that the work that was done was undertaken by a high-quality team and was thorough and detailed; (ii) that (as Mr Roughton-Smith made plain in his final pre-publication report) inherent uncertainties in the data and in the art of prediction meant that it was unlikely that further work could narrow the range of outcomes; and that (iii) that (partly in consequence of the security arrangements relating to the £10bn facility) Linklaters were of the view that the extent of due diligence was greater than might normally have been achieved (a view expressed in a memorandum dated 29 October 2008 which was no doubt much in mind on 3 November 2008). As a summary the statements were correct. The fact that detailed qualification might have been made in relation, for example, to the Australian and Irish business of HBOS, does not render the general statement made untrue.

776. The Claimants complain about the explanation Mr Tookey gave to an enquiry about the disparity between the need for Lloyds to raise £5.5bn of new capital if the Acquisition proceeded but £7bn of new capital if it did not. The answer identified the absence of synergy benefits in the latter case as a distinguishing feature. The answer that Mr Tookey gave accurately expressed his understanding which was itself based on

discussions over the Recapitalisation Weekend. Mr Tookey was reliant upon the explanation given by the Tripartite, and he faithfully communicated it.

777. The Claimants complain about the response given to the suggestion from an analyst that perhaps £30bn might represent the loss expectation on the HBOS book (above even the highest of Mr Roughton-Smith's figures). Mr Tookey's response had been the HBOS loan book had been fully stressed, and that that "bottom up" analysis compared with a "top down" analysis based on credit spreads, which comparison led the Board to the belief that no more than a £10bn net capital adjustment was required. This was not an answer to the analyst's question about the Lloyds' forward-looking cumulative loss expectation for HBOS. But avoiding a question does not itself constitute concealment of some truth allegedly hidden in the framing of the question: and the actual answer given was a fair and accurate summary of the process undertaken by Lloyds and the conclusion it had reached.

778. I turn to the Circular itself: and I can conveniently deal with the common law duty of care (the "misstatement" case) and the equitable duty of disclosure (the "sufficient information" case) together.

779. The law on which the "misstatement" case is based is not controversial:-

a) The Circular contained a statement that the individually named directors had taken reasonable care to ensure that "the information contained in [the Circular] is in accordance with the facts and does not omit anything likely to affect the import of such information": the Defendant Directors concede that this gives rise to the relevant duty of care.

b) The terms of any express representation must be construed by reference to what a reasonable person would have understood them to mean when placed in the context of the whole document in which they are found: (IFE Fund SA v Goldman Sachs International [2007] 1 Ll. Rep 264 at [50] and Mabanga v Ophir Energy plc [2012] EWHC 1589 (QB) at [27]).

c) The claimant addressee himself or herself must have understood the representation in *that* sense.

d) It is implicit in a statement of belief that the stated belief was honestly held by the representor; and in a statement of opinion by a representor whose knowledge of the matter exceeds that of the addressee it may (depending on the full context) be implicit that the representor has (or believes he has) reasonable grounds for the opinion expressed: Mabanga (supra) at [30].

e) Where a claimant asserts that there was an implicit representation then the Court has to consider what a reasonable person would have understood was being implicitly represented by the words in their context: IFE Fund SA v Goldman Sachs [2007] 1 Ll. Rep 264 at [50].

f) The statement must be false.

g) The representor ought reasonably to have known it to be false and so made it carelessly.

h) That (as is here conceded in relation to the Circular) the representor should have intended or reasonably foreseen that the statement would be relied upon by the addressee.

i) The claimant addressee must in fact have relied upon the statement.

j) By doing so the claimant addressee must have suffered loss.

780. The law on which the “sufficient information” case was grounded was also largely uncontroversial:-

a) The shareholders must be given sufficient information to make informed decisions about the proposals to be put to them at shareholders meetings. The authority cited by the Claimants for this proposition (Re RAC Motoring Services Ltd [2000] 1 BCLC 307 at 326) was actually a case about whether the notice of the meeting correctly conveyed the business to be transacted at the meeting; but in deciding that issue Neuberger J drew on wider statements of principle that undoubtedly support the duty asserted. The Defendants concede the existence of this duty.

b) The performance of the duty is measured against the requirement of reasonableness or fairness in the circumstances having regard to the interests of the company as a whole; the object being to provide *sufficient* information (not such a surfeit as to obscure the real issue, or so little as to constitute a misrepresentation by omission). That is a summary of a passage from Residues Trading & Treatment v Southern Resources Ltd (1988) 14 ACLR 375 at 377 (cited with approval in the RAC Case). As Hart J put it in CAS Nominees v Nottingham Forest FC [2002] 1BCLC 613 at [72]:

> “The circular to shareholders must give a fair, candid and reasonable explanation of the purpose for which the meeting is called.”

The Defendants concede the correctness of this.

c) The “sufficient information” duty requires the directors to set out fairly and candidly (and, the Defendant Directors concede, in comprehensible terms) matters within their knowledge: the proper performance of the duty does not require the Circular to set out what the responsible directors might have discovered had they initiated reviews or enquiries.

d) The Claimants submitted that this meant that the Circular ought necessarily to have included *any* material in the directors’ possession which had a bearing on their *own* view of the Acquisition. Mr Hill QC relied on some words of Lord Chelmsford in Central Railway of

Venezuela v Kisch [1867] LR 2 HL 99 concerning a prospectus where (at p.113) the Lord Chancellor said that shareholders must be given the same opportunity of judging everything which had a material bearing on the character of the transaction as the promoters themselves had.

e) The Defendant Directors did not accept that interpretation: Ms Davies QC's argument (though she did not put it in these precise terms) was that the very formulation of the duty shows that the directors have to exercise judgment about what (out of all they know) to include in the Circular in order to create a commercially informative document that aids comprehension and avoids confusion.

f) I accept the submission of Ms Davies QC: I hold that fair, candid and reasonable disclosure does not require the complete disclosure of everything which went into the decision-making process of the directors, nor yet every single piece of information that might affect shareholder voting. I have found most helpful the observation of Maugham J in Re Dorman Long & Co Ltd [1934] Ch 635 (a case directly addressing the contents of an explanatory scheme circular) at p.665:-

> "The practice being to send out an explanatory circular… it is in my opinion the duty of the Court very carefully to scrutinise the circular when the matters involved are matters of considerable difficulty and doubt. In a case of great complexity it is true that not every relevant fact can be stated. I apprehend that if the circular were to assume such a length as to state all the relevant facts in the [petition] it will be so lengthy as to defeat its own object. It is not saying, however, that the creditors or the members of the class concerned ought not to expect such a statement of the main facts as will enable them to exercise their judgement on the proposed scheme. I am prepared to believe that there are cases where even this is impracticable…"

g) The source of the duty is equity: see Re Smiths of Smithfield Ltd [2003] BCC 769 at [46]. The consequences of a breach of such a duty will not necessarily be the same as those of a breach of a duty at common law. In general, if an insufficiency of information is established then that will raise this question: "Is there any reasonable ground for supposing that such imperfections as may be found in the Circular have had the result that the majority who have approved the transaction have done so under some misapprehension of the position?" (The formulation of the question draws on the words of Clauson J in Re ICI [1936] Ch 587 at 618). The "sufficient information" duty is directed at testing the validity of the decision of the meeting: a breach of it will normally lead to directions as to the convening of a fresh meeting, not to the generation of claims for compensation by individual shareholders.

The issue before the shareholders.

781. Mr Hill QC submitted that the Lloyds shareholders were being invited to buy HBOS as a going concern and therefore any information relevant to its status as a going concern needed to be disclosed. I do not think that that accurately identifies the focus of the Acquisition. 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. Accordingly, the information that was material to the decision before them related to the impact that the incorporation of HBOS would have upon the Lloyds business. When I speak of "the Lloyds business" I mean (as Sir Victor pointed out in the Chairman's letter) not the Lloyds business as it had been before the Recapitalisation Weekend but the Lloyds operation as it emerged from the Recapitalisation Weekend with the choice of either completing the Acquisition or of pursuing a standalone future.

782. Mr Williams (the Defendant Directors' investment banking expert) expressed the opinion that Lloyds shareholders needed to be provided with sufficient information to form a decision on whether or not to vote in favour of the transaction that would create the Enlarged Group. I agree. He went on to say:-

> " Therefore, for the board of Lloyds and for the shareholders in Lloyds as they considered how to vote on the acquisition, the precise manner in which HBOS had managed its funding prior to acquisition was not of particular importance. The nature of the basis for the funding of HBOS post acquisition was anticipated to be different: it would be part of an enlarged group, with significant new capital injected. Rather, the critical point – which was well disclosed and discussed in the shareholder documents – was that the board was satisfied that the combined group would be able to fund itself following completion. "

I agree that the basic emphasis of this passage is right: but the question of whether the key duty (to put fairly and candidly before the shareholders the purpose of the meeting) nonetheless required disclosure of a matter perhaps of itself of no particular importance is one that requires careful consideration. Pre-completion funding was not entirely irrelevant. It was at the least an indicator of the sort of risks Lloyds was importing into the funding requirements of the Enlarged Group: and it gave a clue as to how far down the road HBOS had travelled away from viability as an independent "standalone" bank. To put the essential point in picturesque language: if the Lloyds Black Horse was joined by a spavined nag, how well would they work in harness? (I am not suggesting that HBOS was "a spavined nag").

The allegations made

783. There are, I think, seven key allegations in the "misstatement" and "sufficient information" case. The first is that at page 9 of the Circular in the Chairman's Letter Sir Victor said that the Lloyds Directors believed that the combination of Lloyds and HBOS was in the best interests of the company and the Lloyds shareholders as a whole. This may be taken as a sufficient example of a category of individual representations scattered throughout the Circular which express the view that the merger was beneficial, would offer synergies and savings and would contribute to shareholder value.

784. The second is that on the same page Sir Victor said that the FSA had advised Lloyds that if the Acquisition were not to occur then it would require Lloyds to raise £7 billion of additional capital and that "whilst Lloyds would be able to seek to raise such additional new capital in the public markets, there can be no certainty that [Lloyds] would be able to successfully raise such capital or as to the terms on which such capital could be raised, including the terms of any participation by HM Treasury in any such capital raising". This may be taken as an example of similar statements in the body of the Circular.

785. The third is that at page 22 of the Chairman's letter it was said that Lloyds had made the preliminary assessment based on June 2008 figures that net negative capital adjustments of no more than £10bn would need to be made to HBOS's financial position for Core Tier 1 capital purposes as a result of the Acquisition, the effect of which would mean that the Enlarged Group would have a Core Tier 1 ratio in excess of 7%. This may be taken as an example of similar statements made elsewhere in the Circular.

786. The fourth concerns working capital. Page 247 of the Circular contained an explanation that the UKLA had agreed that a statement regarding the adequacy of working capital for the next 12 months was not required. There was however a statement at page 273 that HBOS' "robust capital position….further enhanced by the injection of capital and liquidity facilitated by the UK Government" reinforced the ability of the Enlarged Group to meet challenges. The Claimants say that this was a representation that the £17bn of additional capital to be raised by HBOS would be sufficient to absorb the expected impairments of HBOS and enable the Enlarged Group to trade for 12 months with raising further capital. They say further that it was a representation that the £5.5bn was allocated to Lloyds on the basis of the balance sheet and business requirements of Lloyds rather than to cover the losses that HBOS had suffered and would continue to suffer (see the Claim at para.100(4)).

787. The fifth is that at page 247 of the Circular the Lloyds' directors asserted that the provision of liquidity and funding support to the banks "currently consists of the Special Liquidity Scheme… and a guarantee on short and medium term debt issuance by HM Treasury". There was no commentary as to how HBOS fitted within this model, and this meant that there was no disclosure that HBOS also currently used ELA.

788. The sixth is that at pages 254 and 259 of the Circular the Lloyds' directors set out the contracts material to Lloyds and to the HBOS group respectively: but the Circular did not mention the £10 billion loan facility agreement with Lloyds. The Circular in that form was approved by the FSA. The Claimants say that that approval was motivated by a desire on the part of FSA to enable HBOS to avoid formal insolvency and nationalisation (which would have been hugely damaging to the banking industry) by pressurising the Lloyds shareholders into voting in favour of the Acquisition: and that such conduct did not relieve the Defendant Directors of the obligations they owed to the Lloyds shareholders.

789. The seventh concerns the restructuring plan. The Circular in Risk Factor 1.14 drew attention to the risks presented by the decision of the European Commission of 13 October 2008 concerning State Aid (mediated through recapitalisation schemes) and the threat to competition, and it noted the requirement to submit a restructuring plan within six months. But the Claimants say that this did not disclose the potential impact

on the synergy and other merger benefits from which the commercial logic of the deal stemmed.

790. At page 52 of the Circular the Lloyds board (under the rubric "Other jurisdictions") said that the Circular had been prepared for the purposes of complying with English law, the Listing Rules and the City Code, and that the information disclosed might not be the same if the document had been prepared according to the laws of some other jurisdiction. The Claimants treated this as an express representation that the document *did* comply with English law, the Listing Rules and the City Code. They then sought to identify various breaches of the Listing Rules and the City Code. I do not consider that this endeavour added anything other than needless complexity. My attention was not drawn to any alleged breach of the Rules or the Code that was not otherwise an alleged breach of some duty at law or in equity. The one effect it might have is this. It represents (as the Claimants would have it) that there has been compliance with English law. If there was a breach of the equitable duty to provide sufficient information then that breach would also amount to a breach at common law of this "representation". I do not think this adds anything to the Claimants' case. It does not in any event pass through the "causation" filter identified next. I shall not consider this head further.

The relevant core allegations

791. In identifying the core misstatements or insufficiencies I have attempted to distil allegations that are spread over many pages. But it is possible to apply one further filter. Not all of these alleged misstatements or insufficiencies are said to have had operative effect i.e. to have been relied on and/or to have caused loss.

792. Paragraph 122(1) of the Claim pleads that the Defendant Directors ought (i) to have advised the Lloyds shareholders that the Acquisition was not in their best interests; and (ii) to have disclosed to the Lloyds shareholders HBOS' use of ELA and the Lloyds Repo, the level of HBOS impairments anticipated by Lloyds, the fact that the £7bn additional capital required of a standalone Lloyds could not be justified, and the fact that the additional capital to be raised by Lloyds under the arrangements made over the Recapitalisation Weekend was not required by Lloyds but only to finance anticipated HBOS losses. Paragraph 123 pleads that if these events had occurred then by one route or another the Acquisition would not have proceeded and the losses said to have been occasioned to the Claimants would not have occurred. No other misstatements or deficiencies are said to have had operative effect. I shall therefore concentrate on the paragraph 122 allegations (though in fairness I shall seek to address additional complaints that might be regarded as supportive of the pleaded operative wrong).

A beneficial transaction

793. As I have said before in the course of this judgment there is no doubt that the Lloyds board honestly held the unanimous view that the Acquisition was in the interests of Lloyds as a whole and genuinely believed that there were facts which reasonably justified that view: and in my judgment (as I have explained) they in fact had reasonable grounds for holding the view that the Acquisition was likely to be beneficial. Their assessment contained a misjudgement, about the rapidity and depth of the impending recession and about the likelihood of its occurrence. Indeed, at the time some analysts made that very point. When asked to comment on the Circular Adrian Frost of Artemis said that he thought Lloyds were complacent on their economic view, too "middle of

the road" and tending toward a shallow, minor recession. Others also thought that banks generally were too optimistic on the outlook for the economy. But that misjudgement did not involve carelessness. There was a respectable body of opinion, of which Mr Foley was part, which shared the outlook of the Lloyds' board. So the main thrust, that this expression of view involved a misstatement, is not made out.

794. As part of the presentation of the benefits of the Acquisition the Circular stated (in the Chairman's letter at p.16) that the implementation of costs synergies and other operational efficiencies would deliver pre-tax costs savings greater than £1.5bn by then end of 2011. A figure of £1.9bn was sustainable on the material available, but Mr Tookey spoke only to the lower figure – perhaps out of caution, and perhaps to avoid drawing attention to potential competition issues. The Chairman's letter then said (at p.18) that it was expected that the Acquisition would lead to accretion in Lloyds' "cash earnings per share" of 20%. It explained that "cash earnings per share" excluded write-downs on intangibles and FVAs but did include the benefit of costs synergies. In their statement of case the Claimants criticised this as misleading because the computations leading to the 20% figure in fact did include FVAs: but their witnesses could not maintain the criticism under cross-examination. In his presentation of the Claimants' case Mr Hill QC went further and suggested that the cash EPS figure would in fact be dilutive (rather than accretive): but the comparison he drew was with Lloyds as it was before the Recapitalisation Weekend, not with a "standalone" Lloyds recapitalised by an injection of £7bn additional capital (the comparison actually made in the Circular). So, neither of the points about misstating the EPS enhancement was made out.

795. The cost synergies estimated by Mr Tookey (and backed up by extensive due diligence work, necessarily time consuming because of the branch-level analysis that had to be undertaken) were real. The value of the synergies would be shared between the population of shareholders as it existed when the costs benefits came through in the course of trading, reflected in earnings per share. But in terms of the net present value of the anticipated synergies the then-current Lloyds shareholders gained 15.2p to 32.9p per share. The suggestion that they benefited from enhanced EPS was sound. The proposition was not oversold to Lloyds shareholders in the Circular.

796. I digress to make one point about reliance. The complaints about EPS representations are, I think, illustrative of a process that appears to have been undertaken in the preparation of the Claimants' case. What appears to have happened is that a trawl has been undertaken of the 286 pages of the Circular to identify statements which (in isolation and upon one reading) might *in the abstract* be taken to be misleading or insufficient, without any grounding in what anyone actually read (80% of the Claimants did not read the Circular) or in what sense they understood it or to what extent they relied upon it. Thus, of the 5800 Claimants only two say that they paid any attention to the statements about EPS (which in the event were not misstatements at all): and many of the Claimants voted against the Acquisition in any event. The Claimants' evidence does not properly engage with the need to prove reliance.

797. To fill this evidential gap the Claimants invite the Court to infer that those who did not read the Circular *did* read press and analysts' commentary (which in turn relied on statements in the Circular) and so indirectly relied on the Circular. The difficulty with that approach is that whilst analysts (like institutional shareholders) undoubtedly took into account what was in the Circular, what needs to be demonstrated to establish indirect reliance is that the journalistic or analytic output on which the shareholder

ultimately "relied" was substantially shaped by identified raw material in the Circular and not by journalistic comment. The analyst who says she notes from the Circular anticipated synergies of £1.5bn per year but thinks that this understates the position and would expect to see £2bn per year is not "relying" on statements in the Circular. The journalist who notes anticipated cash EPS accretion of 20% but thinks that the economic outlook is more gloomy than Lloyds acknowledges and that profits will be lower is not "relying" on statements in the Circular. To make good this part of the case the Claimants would have to establish which journalists "relied" upon statements about EPS and which Claimants "relied" on those journalistic reproductions of the EPS statements. I see this as a real difficulty in the way of the "misstatement" case which has not been properly addressed (in the context of EPS or elsewhere).

798. One further aspect of the representations about the benefits of the deal of which the Claimants make complaint is that the views of the benefits of the transaction were based on inadequate due diligence. If there were deficits in the due diligence undertaken such that any competent board would have seen the need to qualify its recommendation then undoubtedly the Circular ought to have disclosed that.

799. Mr Daniels had publicly expressed the view that the Lloyds board "felt very good about the purchase" and having done due diligence "we now have much, much better certainty around the HBOS portfolio and feel very good about the deal". When it came to the Circular there were no qualifications as to the extent of due diligence undertaken, which the Claimants say gave false confidence to the recommendation made because (they say) the actual due diligence was riddled with defects and inadequate in the context of the reverse take-over by Lloyds of a much larger enterprise with a significantly higher risk profile.

800. I do not accept that the evidence establishes that every director of reasonable competence would have adjudged the due diligence undertaken as inadequate or that the "deficiencies" required disclosure in the Circular.

801. By 14 October 2008 the Group Risk team had completed its work on the retail, corporate and international portfolios to which it had access. It did not say that it was unable to draw any reliable conclusions. It produced a range of values narrower than its earlier estimates and said that further precision could only be achieved by an asset-by-asset review that would require weeks of intensive work that was not considered to be worthwhile. However, Mr Roughton-Smith did thereafter identify further work that could be done within the constraints imposed by competitive considerations and was able to exploit the need for the investment banks to give "10b-5 clearance" (on 27 and 27 October). That led to his paper tabled for the board meeting on 29 October 2008 which I have examined above. One of its objects was to set out for the board the "level of comfort around [its] conclusions". Its terms were not such as to alert any director of reasonable competence not to rely on the specialist work done.

802. Further, Linklaters advised the board on 29 October 2008 that neither they nor Allen & Overy/Freshfields would be able to give "10b-5" sign-off to satisfy American regulators unless they felt that all material issues discovered on due diligence were adequately reflected in the Circular and the prospectus for a private placing that was occurring at the same time. They evidently did sign off the relevant documents, without any qualification as to the adequacy of due diligence undertaken. It is impossible to say that no director of reasonable competence could have shared that view.

803. It is right to note that as late as 28 October 2008 UBS was saying to Mr Roughton-Smith that they were concerned at the level of their participation in the due diligence process as they headed towards the meeting at which they would have to sign of the Circular. But this is not relevant to the issue for decision. The board was not aware of e-mail traffic between specialists when undertaking the relevant work; the board received the final product, a report or an endorsement made or given after concerns such as that expressed by UBS had been overcome. There is no doubt that UBS did endorse the Circular.

804. The expert evidence of Mr Williams in particular (but also less authoritatively of Mr Deetz), confirms from a depth of experience that what was undertaken was in line with the due diligence customarily undertaken, and in some respects exceeded it; though of course what is ultimately required is a matter of judgment in each case. I have noted the evidence of Mr Parr that in fact the circumstances of the present case afforded the opportunity to obtain greater access, and he so reported to the board. The actual judgment made by the Defendant directors about whether to qualify their recommendation therefore seems in line with what might be expected of reasonably competent directors.

The £7bn additional capital requirement

805. This was a section of the Circular which the UKLA had specifically required be included. It cannot be denied by the Claimants that the Circular's summary of the Treasury statement and of the advice of the FSA is literally correct. The complaint of the Claimants is twofold. First, that the suggestion that there was an *immutable* requirement for Lloyds to raise £7bn in the event that the Acquisition did not proceed was misleading and did not fairly characterise the choice facing the Lloyds shareholders. Second, that the suggestion that there was some material uncertainty about the ability to raise that sum in the public market was misleading. In each case it is said that the object of the disclosure was to make it appear that the rejection of the board's recommendation was excessively risky.

806. The first complaint rests upon an analysis of events in which the Defendant Directors (or at least Mr Daniels as a director and Mr Tookey as senior management) are said to know that the £7bn requirement (i) was irrational and unfair and not supported by the Lloyds' balance sheet or exposures; and (ii) was not final and was up for a negotiation that would very likely lead to a reduction.

807. The second complaint rests upon the proposition that the Lloyds board could have told the Lloyds shareholders that it was certain that £7bn (or any lesser sum) could successfully be raised in the public markets on acceptable terms (and that to the extent it could not, then that the Treasury would participate on predictable and acceptable terms no worse than those currently on offer).

808. In my judgment neither complaint is justified. In the light of the FSA's letter of 28 October 2008 I do not think that the Circular could have been expressed any differently. In the light of the FSA giving "the cold shoulder" to a suggestion that the reference to £7bn might be replaced by a reference to the need to raise "at least £5.5bn" I do not think that the Circular could properly have said that the £7bn was up for negotiation to a lesser sum in the event that the Acquisition was not approved. I reject the proposition

that the £7bn capital additional capital requirement was not final and was wrongly used as the comparator when assessing the benefits of the Acquisition.

809. In the light (i) of the advice which the board had received over the Recapitalisation Weekend from Merrill Lynch; and (ii) of the terms of the FSA's letter of 28 October 2008 I do not think that the Circular could properly have said that in the event of the Acquisition not being approved and of Lloyds remaining a "standalone" bank then any additional capital requirement could be raised on the public markets on terms as attractive as those on offer from the Treasury (or that any shortfall would be underwritten by the Treasury on attractive terms).

810. Such advice would have been adventurous. As to using the public markets, UK banks had in the recent past tapped the market for £25.7bn, and they were again doing so at the time of the Circular (for a further £38bn). This was reflected in the advice which Mr Greenburgh and Mr Wilmot-Sitwell had given to the Lloyds board as to the prospects for a capital-raise. It is unsurprising that in this context Mr Ellerton (the Claimants' expert) acknowledged in cross-examination the difficulty that would have faced a "standalone" Lloyds seeking additional capital in the market. I consider that Sir Victor made an entirely fair point in the Chairman's letter in saying the discount in the market necessarily get a pre-emptive rights issue away would have been of the order of 35%-45%. That was in fact the experience of those who tapped the market. HBOS had had to offer a 45% discount on its rights issue and could not get it away. Material referred to at trial showed that Bradford & Bingley had offered a 55% discount, Standard Chartered a 48.7% discount and HSBC a 47.5% discount.

811. As to Treasury support, Mr Tookey rightly acknowledged in evidence that it would probably have been available: the Tripartite having gone to great lengths to facilitate the saving of HBOS, it was unlikely to precipitate the failure of Lloyds by withholding capital that could not be obtained in the market but which it had required to be raised. The uncertainty relates to the terms on which it would be available and the degree to which Lloyds would become "nationalised" (which is why the Circular warned that Government capital might not be available on a pre-emptive basis).

812. The Claimants assert that it is obvious that capital would have been available to a "standalone" Lloyds on the same terms as had been offered on the Recapitalisation Weekend. But that is plainly not the tenor of the FSA's letter to Lloyds of 28 October 2008, nor of the letters which the Chancellor sent to the Chair of the Treasury Select Committee and to Alex Salmond at the end of October and the beginning of November 2008: and the Claimants have not proved that assertion.

813. This complaint is not made out.

The £10bn net negative capital adjustment

814. The Circular contained (in compliance with Listing Rule 13.3.3R) an analysis of the pro forma capital of the Enlarged Group based in part on the capital position of HBOS as at 30 June 2008 (its last published figures). Lloyds thought it right to amend that statement (which was an amalgamation of raw figures from two "standalone" entities) to reflect the consequences of the process of their becoming one entity i.e. acquisition accounting. The book value of the HBOS assets and liabilities shown in the pro forma statement of HBOS's assets and liabilities as at 30 June 2008 would have to be shown

at their fair value in the opening books of the Enlarged Group. So, in order to avoid the market assuming from the pro forma statement that the Enlarged Group would be better capitalised than it would be if the hypothesis were worked through, Lloyds included in the Circular information about likely adjustments ("the net negative capital adjustments") based on material available at 30 September 2008 (but warning that the actual adjustments would only be known at completion). The process of acquisition accounting would have an impact on regulatory capital: so that was why the preliminary adjustment was tied into the pro forma Core Tier 1 ratio.

815. The statements on pp21-22 of the Circular, that Lloyds had made a preliminary assessment that net negative capital adjustments of no more than £10bn after tax would need to be made to HBOS's financial position for Core Tier 1 capital purposes as a result of the Acquisition, were literally correct. They were explained in detail at p.243 of the Circular. The Circular at p.238 explained that the exercise had been undertaken for illustrative purposes and did not represent the Enlarged Group's actual financial position. Mr Ellerton (the Claimants' expert) acknowledged that as such they were not misleading.

816. However, the Claimants say that this voluntary disclosure created a false impression of the extent of the anticipated actual write-downs of HBOS and that the Circular ought to have disclosed Mr Roughton-Smith's impairment estimates (which had not been disclosed in any public document), and that such disclosure would have signalled to the market that the Lloyds' assessment of the HBOS balance sheet was too optimistic ("the impairment disclosure point").

817. The Claimants also say that it was not possible successfully to cross-check the £10bn net negative capital adjustment and the Roughton-Smith impairment figures about which the board knew ("the impairment cross-check point").

818. I agree with the Claimants that the "net negative capital adjustment of £10bn" comes across as a grounded assessment (albeit preliminary), not as a purely hypothetical figure generated for illustrative purposes: a grounded assessment is what it was. Of course, when applied to pro forma figures even a grounded preliminary assessment can only produce an illustration and not a prediction of the "point in time" valuation that will be made at completion: and that is exactly what the Circular warned.

819. But I do not accept the rest of the argument of the Claimants on the impairment disclosure point. First, the capital adjustment exercise ("What will the opening balance sheet look like as at January 2009?") is different from an impairments analysis ("What will be the impact be of anticipated defaults during the course of 2009?"). So bare disclosure of anticipated impairments would not of itself have facilitated a re-assessment of the outcome of the preliminary capital adjustment exercise: a lot more context would have been required - to explain the somewhat tortured relationship between the net negative capital adjustment figure and the impairments figures, to inform the reader of the probability of the occurrence of the impairments disclosed and to explain the macro-economic assumptions underlying the impairment figures i.e. that the Lloyds figures had been prepared on much more pessimistic assumptions than the consensus view on the forthcoming recession.

820. Second, in my view the Directors were under no obligation to include in the Circular Mr Roughton-Smith's views on the impairments that might occur in a "1 in 15" scenario

(£16-9bn-£22.3bn) or in a "1 in 25" scenario (£20.65bn-£28.8bn). These were Lloyds internal figures (albeit produced by a high quality and experienced team) based on partial access to HBOS's books and had not been subject to any process of verification: as Mr Tookey put it, this work "was not done to prospectus standard". By way of contrast HBOS obviously had full access to its own books and they were subject to audit review by KPMG. If information was to be published I do not regard it as unreasonable for that information to consist of the published HBOS Interim Management Statement, signed off by the HBOS management, approved by KPMG and supported by letters of representation to the Lloyds board by the HBOS board and by KPMG, and to reflect work on capital adjustments contributed to by the HBOS specialist team (but modified by Lloyds' specialist team).

821. Third, so far as was reported to the board the impairment figures did not contradict or undermine the net negative capital adjustment figure included in the Circular. The Lloyds Group Risk team made no such suggestion.

822. Fourth, my attention was not drawn to any instance of any bank takeover in which the acquirer's internal estimate of the target's impairments had been published: nor yet any instance of any bank releasing *its own* impairment figures to the market in annual or periodic statements. Mr Ellerton himself could think of only one unspecified instance in 1991 when it may have happened. Plainly, there was no market practice to publish internally generated impairment figures. Because the Lloyds takeover was being undertaken in extraordinary conditions I do not regard this absence of market practice to be determinative: but it is a factor of very considerable weight.

823. Fifth, UBS confirmed to the Lloyds board that they were not aware of any matters not disclosed in the Circular which ought under the Listing Rules to have been disclosed. UBS created its own financial model and knew of Mr Roughton-Smith's last impairment figures; and the Circular itself set out the net negative capital adjustment. A reasonable director could properly take comfort from that; no sponsor bank suggested further disclosure on the issue.

824. Sixth, the Lloyds shareholders were warned that (even if they were to take the £10bn figure for the net negative capital adjustment as a grounded estimate) changes in the credit quality of borrowers arising from their own behaviour or from systemic risks in the UK or global financial system could reduce the value of the Enlarged Group's assets "and the Enlarged Group's write-downs and allowances for impairment losses". Risk Factor 1.4 went on to draw attention both to the lower rating of the HBOS loan portfolio and its greater exposure to leveraged finance and subordinated loans and to its concentration in the commercial real estate sector so that the corporate lending portfolio (like the mortgage portfolio) was "likely to generate substantial increases in impairment losses which could materially affect the operations, financial condition and prospects of the Enlarged Group". Lloyds shareholders were not being lulled into false sense of security by the reference to the preliminary assessment of the capital adjustment: they were warned of its limitations.

825. In short, I do not regard the "failure" to publish impairment figures as a negligent misstatement or a deficiency in the provision of sufficient information. It cannot be said that the only course open to a reasonably competent director would be to publish the Roughton-Smith figures. It cannot be said that the "sufficient information" duty could only be discharged by the inclusion of those figures in the Circular.

826. I turn to the "impairment cross-check" point. I will deal with the argument before making what I think is the key point.

827. The argument was located deep in the depths of acquisition accounting. I have explained the need for the amalgamated balance sheets to reflect the process of merger, both by the adjustment of the AFS reserve and the adjustment to fair values. The necessary work was undertaken by senior members of the HBOS team (who alone had access to all of HBOS' books) and was provided to Mr Tookey and the Lloyds Group Accounting Team and to UBS for modelling and to PwC for challenge and review. It included the calculation of fair value adjustments to HBOS assets by reference to credit spreads. The point of detail was whether the adjustment to fair values had as an indirect input HBOS's own view of likely write-downs and impairments for H2 2008 and 2009 as recorded in its books.

828. At some point one would want to do a "ballpark" comparison with the other method of estimation the value of HBOS assets on acquisition i.e. the impairment exercise undertaken by means of a sampling by Lloyds Group Risk of portfolios to assess HBOS impairments in H2 2008 and 2009. It could only be a "ballpark" comparison because the credit spreads assessed by the market would not (in other than a perfect world) match the individual impairments assessed in a particular scenario. The point of detail at issue was: if you are to compare the outcome of the "credit spread" and "portfolio analysis" exercises in an attempt to arrive at a "ballpark" figure for likely adjustments, do you have to deduct HBOS's own disclosed impairments from the Lloyds impairment assessment?

829. The Defendants' expert Mr Deetz thought that you should. He thought that if you did not then you would be comparing apples (Lloyds' view of HBOS's impairments without off-setting HBOS's own existing allowance) to oranges (the portion of the net negative capital adjustments related to the fair valuing of the HBOS loan portfolio). Mr MacGregor could not see the point of such an exercise but thought it wrong. Mr Hill QC cross-examined Mr Deetz on the basis that the Deetz approach did not comply with the requirements of IFRS 3: and in closing submitted that Mr Deetz must have muddled up two separate exercises (forecasting the capital of the Enlarged Group: and applying a capital adjustment to pro forma figures), though his report had clearly distinguished between the two.

830. Whilst I am not wholly persuaded that Mr Deetz's simple deduction is right, I think there is something in his approach. It is true that impairments for H2 2008 and for 2009 would not form part of a balance sheet prepared as at 30 June 2008: but such of them as were then known ought to have been reflected in the credit spreads as at 30 September 2008 that were applied to the balance sheet items. So some form of adjustment was required if there was to be a comparison with an impairments analysis. But I am not at all sure that the crude tool he uses to make that adjustment is appropriate. We are here in the depths of the impact of acquisition accounting.

831. For me the key point is that (as with the impairment disclosure argument) the Claimants are asserting that the Defendant directors made an implied negligent misstatement that as a matter of reality and on the basis of material then available a net negative capital adjustment of no more than £10bn after tax could reasonably be predicted as needing to be made to HBOS's financial position for Core Tier 1 capital purposes as a result of the Acquisition: and that no director of reasonable competence could have made such

a prediction. But that case is not made out by showing that highly qualified experts deep-drilling into acquisition accounting might hold the view that a particular adjustment should or should not have been made.

832. The grounded assessment of a £10bn net negative capital adjustment after tax was a statement of a current expectation about a future event, based on identified material (which excluded post 30 June 2008 trading) and, incidentally, made in a document with a whole section on the value of "forward-looking" statements. Its function was to warn readers of the Circular that the capital position would not be as strong as the unadjusted pro forma statement might suggest. Its function was not to suggest what the capital position after actual adjustments actually would be. The Circular warned that the statement should *not* be taken as a prediction of the Enlarged Group's actual financial position. I do not consider that a reasonable reader of the Circular would have taken it as saying the opposite.

833. The Defendant Directors honestly believed their preliminary assessment to be reasonable: the contrary is not suggested. They plainly believed that they had reasonable grounds for making the assessment, for it was included in a document prepared for them by specialists whom they had retained for the very purpose of ensuring that the Circular was in accordance with English law, the City Code and the Listing Rules (and who had undertaken a thorough statement verification process). They did in fact have reasonable grounds for the belief they expressed. The estimated adjustment had been undertaken by senior HBOS personnel in close liaison with senior members of Lloyds' Group Corporate Treasury and challenged by PwC. Reasonably competent directors could properly rely on them to have done a competent job unless some obvious error was apparent in the figures they produced. The assessment had been cross-checked by PwC for the purposes of their Working Capital Report, including a review of assumptions. The board had been told on 29 October 2008 by Mr Tookey that even the top end of Mr Roughton-Smith's new figures could be accommodated within the working capital figures on which the board had been proceeding (and so the figures that would be reflected in the Circular). If and to the extent that Mr Tookey based that view on an adjustment of the impairment figures to take account of known HBOS impairments then there was a respectable basis for that view (as set out in the evidence of Mr Deetz), even if that was not the only view. As regards the board members, I hold that a reasonably competent director is not expected to deep-drill into acquisition accounting in order to challenge whether a confirmatory "ball-park" comparison has been properly made and whether a preliminary estimate of the net negative capital adjustment could properly be included in the Circular. As Mr Ellerton himself acknowledged in the section of his Second Report dealing with disclosure of impairments:-

> "What emerges very clearly from the Tim Tookey witness statement is that the accounting with respect to fair valuing HBOS's balance sheet was a complex process involving inputs from HBOS and Lloyds and, in the detail relating to accounting standards, was outside the understanding of most market participants at that time (including myself), and even of bank analysts with an accounting qualification."

I agree.

834. In short, this complaint is not made out.

The adequacy of working capital

835. It was the Claimants' case in opening that the Circular ought either to have contained a clear or a qualified working capital statement: of course, it did neither because of the waiver granted by UKLA. It was, I think, common ground that Lloyds (in common with every other bank that depended on SLS) could not give an unqualified working capital statement because of the political risk that in the next 12 months the Bank might withdraw or not renew SLS. The focus of the complaint then became the reasons given for the omission of a qualified working capital statement. The application for the waiver founded itself on the proposition that the Enlarged Group (like every other bank) was not immune from the effects of an extended closure of the wholesale markets and so was to some degree dependent upon the availability of support from the BoE: and that such disclosure risked an undue loss of faith in Lloyds and HBOS because, although every other bank was in an identical situation, no other bank was involved in a merger which might require such disclosure.

836. The Circular itself explained the omission of a working capital statement in this way:-

> "Due to the severity of this dislocation which has catalysed unprecedented levels of government intervention around the world and extraordinary uncertainty facing the banking industry in the medium term, and the availability of the UK government facilities described above being conditional upon, inter-alia, the passing of various resolutions including those relating to the Acquisition, the United Kingdom Listing Authority has agreed that a statement regarding the adequacy of working capital for at least the next 12 months should not be required in this document."

The emphasis here was that the availability of Government funding through the arrangement made at the Recapitalisation Weekend was dependent upon the Acquisition proceeding. Risk Factor 1.5 then drew attention to inherent liquidity risk which could affect the ability of the Enlarged Group to meet financial obligations as they fell due. The Claimants say that this did not provide sufficient information to the Lloyds shareholders and concealed that the Enlarged Group might need central bank support.

837. In my judgment the disclosure relating to the working capital statement did not amount to a misstatement or demonstrate an insufficiency of information. There are two aspects. The first relates to whether the board could properly take the view that sufficient working capital would be available such that an express warning about the non-availability of working capital needed to be made. The second relates to whether the board should have provided some context around the waiver and alerted the Lloyds shareholders as to the inability to give a clean (or indeed a qualified) working capital statement.

838. As to the first, the wholesale funding requirement of the Enlarged Group was projected to be £400bn of which £230bn would need to be refinanced within 15 months of the Acquisition completing. The issue for the board was (i) whether the wholesale markets

plus SLS plus guaranteed debt issuance could be relied upon to provide that funding: and (ii) if the wholesale markets returned to their paralysed state and all headroom under the SLS and other schemes had been used then whether the Tripartite would provide additional funding (either as short-term ELA or by relaxing the collateral requirements on other sources). In the light of economic forecasts as to the depth of the coming recession, the clear statement from the Bank as to the availability of at least £185bn under the SLS/LTR and guaranteed issuance streams and the "nod and wink" given by Mr Bailey of the Bank in respect of any shortfall arising in the wholesale market (for no more could realistically be expected) the board could properly take the view that the explanation for the absence of a working capital statement coupled with the elaboration of a risk in Risk Factor 1.5 correctly communicated to shareholders the basis on which they were being invited to make their decision. There *was* a risk attached to the funding plan: but there was every reason to think that if it eventuated the Tripartite would underwrite the Enlarged Group's liquidity.

839. As to the second, there was clear disclosure of the reliance of the Enlarged Group on central bank funds, and attention clearly drawn in Risk Factors 1.4 and 1.5 to the uncertainties around this. In that context it was unnecessary, in explaining the waiver granted by UKLA, to say that it had been granted because a "clean" working capital statement could not have been given. Indeed, that would have defeated the objective of the waiver. The Circular correctly explained to the Lloyds shareholders that the working capital of the Enlarged Group depended on the injection of Government capital agreed over the Recapitalisation Weekend, which was dependent upon their approving the Acquisition.

840. I must deal with one "tag-along" allegation. This was that the form of the Circular represented to Lloyds shareholders that the £5.5bn capital to be raised by Lloyds under the Recapitalisation Weekend arrangements related to the balance sheet and business requirements of Lloyds (rather than, it is said, being allocated to Lloyds but in fact destined for use by HBOS). This allegation depends heavily upon an analysis of what actually happened in the recession which actually occurred. In the event little of this additional capital was needed by Lloyds: the great majority was used to absorb losses from the business introduced into the Enlarged Group from HBOS. But, of course, the fact that that was the outcome does not mean that it was the aim.

841. Over the Recapitalisation Weekend the FSA made plain that its object was to ensure that the amount of capital to be raised by each institution would sustain confidence in that institution in a severe recession: and by agreement between the FSA and the Treasury Lloyds was to raise £5.5bn to absorb losses assumed to be generated by the Lloyds' business in that scenario. Exactly what was that scenario was not known to the Lloyds board and cannot now be reverse engineered. From the material that is available it cannot, in my judgment, be established that every director of reasonable competence would have known that Lloyds really needed *no* additional capital at all in an assumed severe recession and that this £5.5bn was destined for use by HBOS. On the contrary, the evidence demonstrates that even before the collapse of Lehman Brothers consideration was being given by Lloyds senior management to raising additional capital: and after the collapse of Lehman Brothers (and the opportunistic £800m rights issue) there remained a need. On Lloyds' own figures that need might have been £4bn. If the Circular had said that the £5.5bn to be taken under the Recapitalisation Weekend

programme was being taken to cover anticipated losses deriving from HBOS it would not have been accurate.

842. I hold that complaints in this category are not made out.

Funding and the ELA

843. The Circular disclosed that Lloyds relied, and the Enlarged Group would substantially rely for the foreseeable future, on the continued availability of the BoE liquidity facilities as well as HMT's guarantee scheme for short- and medium-term debt issuance. This disclosure (accompanied by the warning in Risk Factor 1.5 both of the inherent possibility of serious liquidity constraints and of the higher funding risk facing the Enlarged Group than a standalone Lloyds faced and the further warning in Risk Factor 1.12 of loss of confidence causing depositor withdrawals) was accurate and sufficient as regards the future of the Enlarged Group. It gave a clear warning that looking forward the Enlarged Group could not rely on the market to meet its funding needs: but that of itself did not put the Enlarged Group in any different position from any of its peers, all of whom relied on the availability of SLS (and some of whom would have failed without SLS). But the Claimants' complaint focuses not on the future but upon history and the present relevance of past events.

844. It is beyond dispute that HBOS was from 1 October 2008 in receipt of the facility which became known as "ELA": and the Defendant directors admit that the Lloyds board knew this to be so (see paragraph 99(b)(2)(iii) of the Re-Re-Amended Defence). This admission was not withdrawn. It will be apparent from my account of the facts that the Lloyds board did not seek specific advice as to their disclosure obligations regarding the existence of ELA, but simply relied on their banking and legal advisers to prepare the Circular in a form compliant with regulatory obligations and the general law. But Linklaters were not informed of the use of ELA by HBOS (probably because the Lloyds board believed that it had to be kept confidential) and therefore gave it no consideration.

845. In the result the Circular, when dealing with the HBOS liquidity risk, simply contained an account of the then-current liquidity management systems at HBOS. That account drew attention to the existence of a liquidity portfolio consisting of mainstream eligible collateral, and a substantial pool of high-quality secondary liquidity assets which, it was said, permitted HBOS to manage through periods of stress taking into account the likely behaviour of depositors and the wholesale markets. In essence the Claimants complain that this was not a candid and fair account because it did not disclose that the only way HBOS had been able to manage through the then-current period of stress was to turn, not to the market, but to the BoE; and to do so outside the mainstream facilities on offer (namely, SLS and the ELTR facility). Accessing ELA enabled HBOS to meet liabilities which it could not immediately meet from its own resources, or from the market, or from the mainstream market-wide central bank liquidity facilities. The Claimants say that the simple disclosure of the use of ELA would have told Lloyds shareholders that HBOS was "funding insolvent" and that would have had a materially adverse impact on the value of HBOS.

846. In response to that argument the Defendants say, first, that what was important to the shareholders was the future i.e. HBOS as a contributor to the Enlarged Group. I agree. But that does not necessarily mean that either its past or its current condition was irrelevant. A fair, candid and reasonable view could properly emphasise the strengths

which HBOS contributed but might still require reference to any material weaknesses it brought.

847. Second, the Defendants say that the acronym "ELA" (and its rather alarmist full form of "Emergency Liquidity Assistance") were not in current usage in 2008. The expert evidence of Mr Benkert for the Claimants and of Prof Persaud for the Defendants is all but agreed on this point: they agree that the frequency of its use then was not what it was after 2012. Mr Benkert has found a couple of instances of use in 2008, but Prof. Persaud does not accept that they are usages consistent with what we now call "ELA". The point of the Defendants' observation is not about simple labelling: it is about the ready recognition of a distinctive category of stigmatised assistance. Thus, the Defendants submit, Mr Daniels, Mr Tate, Mr Tookey and Mr Short all appeared to regard ELA as a variant of the SLS scheme (Mr Short in evidence called it "SLS lite") under which the collateral that could be offered in return for Treasury bills did not fit the SLS profile but in due course could in most cases be securitized into a compliant form (as 70% of it was); in the meantime ELA offering a temporary "bridge" facility that was immaterially different. On this analysis HBOS was simply accessing a functionally connected additional line of SLS funding.

848. This difference of view led to an intensely theological debate about the true nature of ELA. Mr Benkert (the Claimants' expert) and Prof Persaud (called by the Defendants) were agreed on the similarities between SLS and ELA. (i) Both were liquidity facilities provided by BoE operating by means of swaps (under which the BoE provided gilts in return for collateral). (ii) The collateral accepted under the ELA was unsecuritised loans of a type similar to those accepted in securitised form for SLS. (iii) The fact and extent of any usage by individual banks was in neither case disclosed by the BoE: disclosure was on an anonymised, aggregated basis with a suitable time lag (scheduled in the case of SLS and individually determined in the case of ELA) and whilst subsequent repo transactions might give a clue who were large scale users of the facilities, no analysis could tell the market whether it was SLS or ELA that had generated the T-bills. (iv) As Mr Benkert and Mr Ellerton both acknowledged, whilst is was true that ELA was a "last resort" facility it was equally true that many banks could not have survived without SLS and that *in that sense* SLS was also the provision of a "last resort" facility. (v) The "haircuts" applied by BoE to the value of the collateral was broadly similar: according to Prof Persaud it was 40% for SLS and 43% for ELA, figures with which Mr Benkert agreed, though he thought ELA simply mimicked SLS because of lack of experience of valuation in an ELA context.

849. Whilst Prof. Persaud emphasised these similarities Mr Benkert thought that there were marked differences. (i) The key difference (which Mr Hill QC hammered home time and again) was that SLS was a mainstream facility that was permanently available on demand to a range of users, whereas ELA was an idiosyncratic and bilateral arrangement arising out a request for assistance by a systemically important institution. In my own mind I characterised the point he was seeking to make as the difference between HBOS being an applicant for SLS and being a supplicant for ELA. He argued that the making of the request for bespoke assistance (rather than the making of an application for access to an open facility) differentiated the applicant from its peers, and that differentiation ran the risk of attracting "stigma". Hence the great secrecy surrounding the ELA provided by the BoE to HBOS and to RBS. Although the Tripartite had widely publicised its intention to do "whatever was necessary" the BoE

was in no mood to test whether its offers of help had been de-stigmatised: so it kept everything about ELA covert. (ii) The objective of SLS was to unblock the flow of liquidity assistance to the banking sector generally (by camouflaging and de-stigmatising its use): but ELA was institution specific and available only to systemically important institutions. (iii) The collateral provided was, in the case of SLS, securitised loan packages; and in the case of ELA was otherwise ineligible raw loans held through a trust structure. This was an indicator of the urgency with which the assistance was needed (for it could not await the securitisation process). (iv) The interest rate charged upon ELA was in general higher than that charged under SLS (200bps as against an average of 140bps at the time ELA was first granted, though the latter average rose to 178bps) but was not necessarily so (because the rate payable under SLS increased with the proportion of funding that SLS constituted for the applicant bank). It is difficult to know whether this difference resulted simply from a desire on the part of BoE to encourage securitisation and to disincentivise the use of raw loans: or whether a higher ELA rate represented some pricing of increased risk. But in either event the difference was hardly material to the market at large: and I shall leave this difference out of account. (v) SLS was accessible under a standardised process utilising pro-forma documentation whereas ELA only became available upon individualised application and after the Governor of the Bank had sought and received authorisation from the Chancellor. Once granted ELA was managed by a different department within the Bank from that which managed SLS. (vi) The assistance provided under SLS was the provision of 9-month Treasury bills that could be repo-ed with an option to roll-over for up to a maximum of 3 years: whereas ELA provided 14-day money (though again with a roll-over option). So, ELA could not be used to refinance maturing wholesale funding but was subject to frequent review.

850. The point of this debate was to establish whether ELA was *really* the provision of an idiosyncratic basis of emergency funding to an institution that had nowhere else to go for funds that were immediately required: or whether it was *really* a form of SLS designed to "bridge" the institution whilst it securitised its collateral ready for submission to SLS. My conclusion is that if one has to examine the issue at the technical level at which the debate was conducted then the former is the more accurate characterisation. Mr Benkert said:-

> "… the most crucial difference between the BoE's ELA facility and all other BoE liquidity-providing facilities is that this bilateral ELA was viewed as a rescue operation for an institution at imminent risk of funding insolvency and failure, whereas the other multilateral facilities were seen as preventative of and an insurance against such funding-related failure."

I would omit the words "and failure": but otherwise accept the force of the distinction. SLS might in any given case in fact be used as an LOLR facility, or it might not: ELA always was an LOLR facility.

851. I put in the qualification "if one has to examine the issue at the technical level" because identifying what ELA "*really*" is does not get one that far. What matters is what ELA would or might have appeared to the market to be at the end of October 2008: and what it "really" was would simply have influenced (not determined) that perception.

852. Although with perfect integrity the Lloyds witnesses now say that at all times to their present recollection they thought of ELA as a form of SLS, I think that on a careful analysis it would have been seen by an objective observer, a reasonably competent director, in October 2008 as being a single source of short-tenor reviewable funding for HBOS likely to be renewed through to completion, not as a series of "bridging" loans covering proposed parcels of collateral in the course of being securitised. It was in my view properly seen as an addition to (and not a functional aspect of) SLS.

853. Third, the Defendants say that the true question which the Lloyds shareholders needed to address was whether HBOS could be funded until completion: and how that was achieved was not "material". I agree that this was one of the vital questions. It had arisen at the end of September 2008 when Sir Victor was confronted with the possibility that HBOS might not open its doors; but the problem had then gone away. All Lloyds shareholders would have known that HBOS was vulnerable, for it was that very vulnerability that afforded the opportunity for the Acquisition. Furthermore, Sir Victor had observed to shareholders in the Chairman's Letter that HBOS had been significantly affected by recent challenging market conditions which had negatively affected its funding model. The Circular set out how those vulnerabilities would be addressed once HBOS became part of the Enlarged Group: but the question is whether it was material for the shareholders to know how the vulnerabilities were addressed in the interim. Mr Daniels, Mr Tate, Mr Tookey and Mr Short were all of the view that interim funding was an immaterial consideration. I think the UKLA were probably also of the view that it was immaterial: for I think it likely that the HBOS supervisory team at the FSA must have been aware that HBOS was accessing funds outside the SLS yet the UKLA did not insist upon the Circular reflecting that fact. (There is no documentary evidence to that effect: but it is supported by some of the evidence of Mr Sants, and by the improbability of HBOS concealing from its supervisor how it was meeting its funding needs). However, the "sufficient information" principle requires the Court to subject the Circular to scrutiny, not simply to accept the judgment of those preparing the Circular as to the materiality of information about interim funding. The honestly held views of the participants at the time cannot be determinative.

854. Fourth, the Defendants submit that the key issue is whether there was some distinct feature of ELA knowledge of which would have provided material information to the Lloyds shareholders that they needed to know in order to make an informed decision about the merits of acquiring HBOS: and they argue that there was not. On their case how HBOS was funded to completion was immaterial. The question for the Lloyds shareholders was: given that HBOS was there, should its business be merged with that of Lloyds? The Claimants, of course, argue that knowledge of ELA would have told Lloyds shareholders that HBOS was a "failed bank" and was "valueless" and so should not be merged with Lloyds because it would weaken Lloyds and excessively dilute shareholder value.

855. I have found the "materiality" question one of considerable difficulty. Having considered the competing arguments this is my conclusion. I accept that the focus of the shareholders' consideration was HBOS as part of the Enlarged Group: and the Circular was right strongly to emphasise this. The argument which starts and finishes with this point is very powerful. But the giving of focus and direction to the shareholders in the Circular does not mean that only material supportive of the recommended outcome needs to be included. The business of the EGM would be to

approve (or to withhold approval from) the recommendation of the board as to the incorporation of HBOS into an Enlarged Group. That involved an assessment of its strengths - what it would contribute to the Enlarged Group that a "standalone" recapitalised Lloyds would lack. But an informed assessment of HBOS would also note its weaknesses, because the extent to which the remedying of those weaknesses would sap the strength of Lloyds within the Enlarged Group might well be a matter of concern to shareholders. A fair, candid and reasonable account of the purpose of the meeting should therefore note (though need not emphasise) those weaknesses. It is a question of balance whether that is done through the enumeration of risk factors, or whether it is done in the course of laying out the proposal itself.

856. One of the weaknesses of HBOS as matters stood was that it did not have enough collateral available to satisfy its demands for immediate funds using generally available sources (which it may, indeed, have already exhausted). Its then-current position (and one that would continue until the implementation of the Recapitalisation Weekend proposals) was that its needs were being met by the availability to HBOS, as a systemically important institution, of a particular "lender of last resort" facility that was not generally on offer to HBOS's peers, was not used by Lloyds and which would cease to be used on completion. The exact extent of use and the precise features of this facility would not be of concern to a Lloyds shareholder: to provide such detail in a proper context would overwhelm the reader and confuse the issue. But the *existence* of the facility potentially was of concern: not (in my view) because it was an indicator that HBOS was a "failed bank" and was "valueless" (though some shareholders did already view it as such), but because 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. Part of the additional capital raised following the Recapitalisation Weekend would not provide additional strength in the anticipated downturn but would be absorbed in repairing shortfalls that had already occurred. For a fair and candid account of what was before the meeting the existence of the facility that we at trial have referred to as "ELA" ought in my judgment to have been noted.

857. I should make clear that I do not regard the Lloyds board as having deliberately concealed the HBOS ELA from the Lloyds shareholders. I simply consider that their view of "materiality" was wrong.

858. I have challenged this assessment by reference to the view given by Mr Parr of Linklaters in evidence, because he was an experienced professional there at the time and attuned to all the subtleties of the situation. He said that if he had been asked whether ELA needed to be disclosed he believes that he would have advised that it did not: but he accepted in cross-examination that if he had known the full details of ELA then the disclosure in the Circular might have looked different in that it might have included some description around ELA. This assessment of the position (of course, not given as an expert but retrospectively as an active participant) confirms my own view.

859. I would add two footnotes. The first footnote is that, to be clear, my primary holding is that in my view there was a breach of the "sufficient information" duty. It does not follow that in failing to discharge that duty the Defendant directors were necessarily guilty of a negligent misstatement by omission. How to assess the materiality of ELA and whether to refer to existence of the ELA facility was a judgment call. But the problem the Defendant directors face is that the evidence does not disclose any process through which that judgment call was made. The Circular said on p.246:-

> "To the best of the knowledge and belief of the [Lloyds] directors (who have taken all reasonable care to ensure that such is the case) the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information. "

However, the directors had not taken all reasonable care to ensure that the Circular dealt adequately with ELA (about which they admittedly knew): they did not inform Linklaters about it, they did not seek advice and they did not clearly consider the issue. So my secondary holding is that there was a misstatement about the care exercised in relation to how the Circular dealt with ELA.

860. The second footnote is that Defendant directors did not argue that the degree of secrecy that the Tripartite attached to the extension of ELA (and its estimation of the systemic risk) modified in any way the disclosure duties of the board. This argument remains for another day. It is essential that a central bank be able in appropriate cases to act covertly to maintain the integrity of the financial system. There may well be an argument that directors of a particular company (be that company a quoted company in receipt of ELA, or the predator of such a company) are not obliged, in the discharge of their duties to their particular shareholders, to risk the integrity of the entire financial system within which they operate (including the value of their shareholders' economic interests), and that covert operations of the central bank present circumstances in which it is "impracticable" to present all material to shareholders. Duties are sometimes in conflict, and the conflict may lead to a qualification of the duty.

Material contracts

861. The focus of the argument here was "the Lloyds Repo", the full £10bn facility that Lloyds granted HBOS. The issue is whether it should have been disclosed in the Circular. I have said above that the first tranche could be regarded as advanced in the ordinary course of business. The second tranche was at the time treated (by Lloyds and by the regulators) as "ordinary course" business and Lloyds was not at the time required to seek shareholder approval for it as a Class 1 transaction. I shall not revisit that treatment in that context. But that does not answer the question posed here by the Claimants: should the Lloyds Repo have been disclosed in the Circular?

862. It is acknowledged by the Defendant Directors that the fact that UKLA treated tranche 2 of the Lloyds Repo as "ordinary course business" for Class 1 purposes does not determine the question whether the board ought to have disclosed it in the Circular.

863. The second tranche of the Lloyds Repo had a number of extraordinary features:-

    i) It was not dependent purely upon ordinary interbank lending considerations. The origins of the Lloyds Repo lay in a proposal that Lloyds should provide a deal-specific facility available until completion of the Acquisition, and to be made available in order to assist in preserving HBOS as a target. This feature was an undercurrent in the entire process. The Defendants acknowledge in their pleaded case that the Acquisition was a factor in the lending decision: and it was clearly a factor of some weight given that the counterparty was in such a financial state that it was

vulnerable to a takeover. A desire to preserve the acquisition target was an obvious consideration.

ii) The actual facility itself was considered only at the highest levels within Lloyds and (at the insistence of the Chief Risk Officer) required explicit sign-off by the FSA senior personnel.

iii) It is common ground that the very nature of the facility was unusual and that *in normal times* it would not be regarded as a bankable proposition because it lay outside Lloyds' normal risk appetite.

iv) The security taken (trusts of raw loans) was at the time highly abnormal. It was unsuitable for an ordinary "repo" transaction. It did not confer upon Lloyds ownership of immediately realisable assets, but ownership of a non-marketable beneficial interest in a portfolio of hard-to-value loans that were vulnerable in an insolvency. It lacked that ability to achieve a clean and immediate "close-out" on default which renders the standard "repo" agreement such an attractive commercial tool. It was not acceptable to BoE for the purposes of SLS. In summary, there were very unusual risks inherent in the transaction and whilst some steps were taken to mitigate the risks, the unusual risks themselves remained.

v) The ability of HBOS to draw on the facility was linked by Lloyds to the degree of support for HBOS being provided by the BoE.

vi) Its size as an overall facility was significantly larger than any previous repo (the largest of which had been £5bn).

vii) The Lloyds Repo was made available at a time when wholesale markets were effectively closed and banks were generally seeking to reduce their own funding requirements (rather than increase them to undertake interbank lending to more vulnerable institutions); and it entailed Lloyds breaching its own internal liquidity ratio.

864. These were extraordinary features. The Claimants also laid stress on the fact that Mr Tate in particular did not want the existence of the Lloyds Repo to be disclosed. He articulated this concern in late September 2008 when he characterised the transaction as "potentially dynamite stuff" and required "radio silence" to be maintained. The Claimant's point is that such an attitude would not have been adopted in relation to "ordinary course" lending. They further relied upon the instant reaction of Linklaters when first informed of the intention to make the Lloyds Repo viz. that on account of its size and the circumstances of its grant it would need to be disclosed.

865. The argument of the Defendant directors points to a number of indicators. First, at the time of the grant of the facility the UKLA were of opinion that it was a facility extended in "ordinary course". I have held that the UKLA were not deceived into giving that view. Second, the UKLA approved the Circular which made no mention of the Lloyds

Repo (about which it undoubtedly knew). Third, Linklaters, Citigroup and Merrill Lynch all signed off the Circular which did not mention the Lloyds Repo (although they knew of it). In particular Linklaters, which had (as the Claimants have noted) flagged up the need to consider disclosure of the Lloyds Repo in the Circular as a separate issue, must have reached the view (departing from its initial instant view) that disclosure was not required; for the draft Circular made no mention of it and Linklaters did not, when putting the draft Circular before the board, advise the Lloyds board to address the issue. Fourth, HBOS and its advisers did not mention the Lloyds Repo in any of the material which they produced for their shareholders. Although none of these views relieved the Lloyds board of the obligation to consider the matter the Defendant directors say that the alignment of their view with these other views is significant.

866. Those were contemporaneous views. The Defendant directors also say that later expert views chime with them. Mr Ellerton (the Claimants' expert) accepted that an arm's length transaction that would probably have been undertaken with a different counterparty was a material factor in identifying "ordinary course" business. Although Mr Williams (the Defendants' expert) took the same view in his report, I did not, after his cross-examination on the point, feel able to rely on that expression of view since he lacked expertise in the interbank lending market. But I did find of assistance his evidence that, as an investment banker, he could find no instance of any inter-bank loan being disclosed in a circular or prospectus.

867. Further, the Defendant directors say that (whatever weight was given to the desire to preserve HBOS as an acquisition target) (i) the Lloyds Repo was ultimately granted on acceptable arms-length commercial terms, priced in line with similar transactions and with carefully selected sound collateral that met Lloyds' risk criteria; and (ii) it was in the best interest of the Lloyds shareholders that HBOS should be able to fund itself successfully until completion.

868. These submissions are plainly directed to the question whether the Defendant directors were guilty of negligent misstatement by omission. They are not compelling in the context of the "sufficient information" duty. There the question is whether the Court itself considers that, objectively viewed, the document in question gives a fair, candid and reasonable account of the circumstances which will enable an informed decision to be made.

869. In my judgment the existence of the £10bn facility (viewed as a whole) ought to have been disclosed as material which information shareholders could take into account in deciding whether or not to follow the board's unanimous recommendation. I do not say that it should have been disclosed as a "material contract" with all the associated disclosure of terms that is then required. But like ELA, the existence of the arrangement ought to have been disclosed.

870. Whatever the technical view of "ordinary course" business taken at the time of the conclusion of the Lloyds Repo, the question of disclosure in the Circular as a "material contract" or otherwise required separate consideration. The question to be addressed in that context was: was the Lloyds Repo (viewed as an overall facility) a contract about which an investor might reasonably need to be aware in order to make a properly informed assessment of the way in which to exercise his or her voting rights?

871. The fact that the Lloyds Repo could be wrestled into a shape that minimised (though did not eliminate) the risks and produced commercially satisfactory terms does not in my view provide an answer to that question. The fact that the same facility might have been extended to another counterparty does not provide an answer to that question: it shows only that in extraordinary times Lloyds might be prepared to enter two exceptional transactions. The fact that interbank lending was not normally disclosed does not mean that the Lloyds Repo (granted in far from normal circumstances and having a far from normal shape) did not need disclosure.

872. On the other hand, the sheer absolute size of the transaction (significantly beyond anything done before), its size relative to the capital base of Lloyds, its grant at a time of tight markets, the connection between the grant of the facility and the Acquisition itself, the connection between the Lloyds Repo and the provision by the BoE of such additional facilities as would preserve HBOS until completion of the Acquisition, in short, all of the extraordinary features listed above, were strong pointers towards this being a contract about the *existence* of which Lloyds shareholders should know.

873. From the outset the transaction was known to be a high profile one which, if irresponsibly leaked, would be "dynamite". Whether the Lloyds Repo should now be responsibly disclosed had to be examined. The evidence does not show that these matters were actively considered at the time the Circular was finalised: nobody recalls any specific discussion. Rather the evidence shows that the technical view taken at the time of the grant of the Lloyds Repo (that it was "ordinary course" business not regarded as needing shareholder approval) was taken (by Mr Daniels, Mr Tate, Mr Tookey and Linklaters) as presumptively providing an answer to the disclosure question in relation to the Circular, and the only issue addressed (and it was addressed by Linklaters) was whether anything had changed. That was not the right question.

874. I think that a fair, candid and reasonable account of the proposed transaction would have disclosed that HBOS was to a degree dependent on bilateral funding and that (i) if the Acquisition completed then up to £10bn of resources otherwise available to Lloyds to meet its own challenges had already been absorbed by HBOS; and (ii) if the Acquisition did not complete Lloyds had a £10bn exposure to HBOS, a bank that it was common knowledge had an uncertain future. A reasonable disclosure would not have been in alarmist terms: it would not have been in the interests of Lloyds to excite speculation or to trigger panic or to jeopardise a beneficial transaction. But in a 286-page account of the circumstances of the transaction there was room for some disclosure that, in order to ensure that HBOS had (in tight wholesale markets) stable funding until completion Lloyds had provided a facility of up to £10bn, a significant part of which remained undrawn.

875. Once I have found that the issue was not considered I must again hold that there was a misstatement on p.246 of the Circular. The Defendant directors had not taken all reasonable care to ensure that the Circular did not omit anything that was likely to affect the information they did provide. They did not consider whether the Lloyds Repo needed to be disclosed but assumed (without testing or enquiry) that Linklaters had considered the question in the course of drafting the Circular.

Restructuring

876. Following the Recapitalisation Weekend the European Commission had announced its obscure proposals for the restructuring of "illiquid but otherwise fundamentally sound banks" that had received State aid. The Enlarged Group probably fell into that category. Exactly what was required by way of restructuring a merged group was unclear: but Mr Daniels was right to note that at one extreme it might require a break-up or significant downsizing that would negate the merger benefits i.e. fail to obtain for Lloyds the market dominance that the Acquisition was designed to secure and to undermine cost synergies that grounded the EPS accretion.

877. However, the signals being sent by the Tripartite were to the effect that the merger itself, with the proposal to exert Lloyds' conservative controls over the HBOS lending book coupled with the planned redemption of the Government preference shares, would probably suffice. It was encapsulated in the Treasury's letter of 31 October 2008 to Mr Daniels referring to conversations that had taken place that week:-

> "The Commission has already approved the overall recapitalisation scheme and has indicated that it will work expeditiously to scrutinise individual restructuring plans…The key requirement for a successful application will be a plan that demonstrates a clear path to an exit from State aid. Central to that will be adequate capital and liquidity and future profitability. You indicated to us that your plan would meet these requirements and we have undertaken to work constructively with you to secure Commission approval."

This re-framed the risk identified by Mr Daniels. In my judgment reasonably competent directors could properly rely on those indications as to the nature of the restructuring risk and as to its potential impact upon the benefits of the Acquisition, could frame the Circular accordingly and could with fairness and candour identify (in Risk Factor 1.14) that the presentation of a restructuring plan could have a materially adverse effect on the operations of the Enlarged Group.

878. This complaint is not made out.

Federal Reserve funding

879. The Claimants' pleaded case (and their opening skeleton argument) made complaint that it was material for the Lloyds' shareholders to know the extent to which HBOS was reliant upon Fed funding accessed through the Discount Window Facility (recognised as a "lender of last resort" facility) or the Term Auction Facility (a "de-stigmatised" form of LOLR facility). That is one issue I have felt able to leave out of the narrative or analysis.

880. It is common ground that the Federal Reserve positively encouraged US banks and the US branches of overseas banks to make use of the TAF and the DWF in order to minimise the risk of another bank failure: and that 17 out of the top 25 users of these facilities were overseas banks. These banks had built up dollar assets on their books funded, not by dollar deposits, but by short-term wholesale funds from US money market mutual funds, creating the classic maturity mismatch. To overcome it the

Federal Reserve had to provide liquidity to foreign banks. The use of TAF in particular was enormous with at least $3.8trn being taken by 4,200 borrowers.

881. HBOS accessed a peak drawing of $17.9bn from the TAF (on 10 September 2008) and of $12bn from the DWF (on 23 October 2008). This represented 2% of HBOS' total liabilities and 5% of its wholesale funding requirement. It is common ground that many UK banks borrowed from the Fed using these facilities over the same period. It is the evidence of Prof Persaud (which I accept) that some such banks borrowed significantly more than HBOS and were more reliant on this funding source. Whereas the average for HBOS was $10.9bn that for Barclays was $12.2bn; whereas the peak for HBOS was $17.9bn that for Barclays was $33.3bn. It is Mr Benkert's evidence that in the period September to December 2008 HBOS's usage of the TAF (as a proportion of the total usage by UK banks) fell.

882. It is also Mr Benkert's evidence that using the TAF was at that time in the ordinary course of a bank's business i.e. something which did not exhibit unusual characteristics by the standards observed by the markets at that time but does have similar features to other transactions executed between similar parties. He acknowledged that the same could be said of the DWF, although (to give a nuanced answer) it was "less ordinary course" than using the TAF. Mr Benkert plainly did struggle with the conclusion that using DWF was "ordinary course" (although that was the conclusion to which the logic of his position took him): and he continued to struggle with it even though he agreed that the market would not have been surprised to learn that an entity like HBOS with dollar assets on its books had accessed the DWF. It was the opinion of Mr Ellerton (the Claimants' expert equity analyst) that the use by HBOS of the TAF and the DWF schemes could reasonably be regarded as the use of "ordinary course" facilities. Taking that evidence together with that of Mr Benkert (and there is no evidence to the contrary) it is plain that resort to Federal Reserve funding for dollar requirements was nothing remarkable. It was a way of dealing with the need to raise funds for dollar cover (as many banks had to do) before the BoE itself began to offer dollar facilities. It did not differentiate HBOS from other banks. It did not demonstrate that HBOS was a "failed" bank: only that the US public market could not provide dollar cover for dollar liabilities. It was not something to which attention needed to be drawn in the Circular.

883. Even if Federal Reserve DWF funding needed to be and had been disclosed, I do not consider that it would have had any independent operative effect. The key effects (if any) would have been generated by the disclosures relating to ELA and the Lloyds Repo. Disclosures relating to DWF would at best have provided a mild confirmatory effect.

884. This complaint is not made out.

Breaches of the sufficient information duty

885. The Claimants have, however, established to my satisfaction that there were two breaches of the "sufficient information duty". It is therefore necessary to consider how the duty would properly have been performed and to consider what are the consequences of a failure to perform the duty in that way. Mr Tookey was cross-examined as to what context he said would have been provided for any disclosure as to what the context might have been: but he declined to be drawn into speculation . Mr

Hill QC submitted that it was impossible to identify any fair and honest context which would not exacerbate rather than reduce a negative market reaction. I do not agree.

886. I consider first, the disclosure of ELA. I am clear that, intensely concerned as the Tripartite was to avoid anything that would undermine market confidence and cause significant harm to consumers and to the UK economy, no member of the Tripartite would have sought to prevent the Lloyds directors from discharging what they conceived to be their duty to shareholders. The view of the Tripartite in October 2008 (confirmed to Parliament in November 2009 when the advance of ELA was revealed) was that it was for the Lloyds directors to decide what to disclose.

887. The information about ELA would have been provided in carefully framed terms. Given the intense concern of the Tripartite to avoid "unforced errors" I consider it probable that the UKLA would not have approved any wording in a Circular which ran the risk of destabilising the market in any degree. The Circular would not have said baldly that the BoE had provided and was providing £X emergency liquidity assistance to HBOS. It might properly have said HBOS relied on SLS, government guaranteed issuance *and other bilateral fully collateralised Bank facilities*. The disclosure would have said that the Lloyds board affirmed the Acquisition because it was satisfied that HBOS was funded until completion and that following completion the Enlarged Group would not need to utilise the bilateral facilities currently available to HBOS. That would have given a candid and fair (but not inflammatory) indication that HBOS was to some degree dependent upon bespoke bilateral arrangements rather than its needs being met by participation in mainstream arrangements.

888. I consider next the disclosure of the Lloyds Repo. Here, fair, candid and reasonable disclosure would have been achieved by (i) stating that in order to ensure that HBOS had (in tight wholesale markets) stable funding until completion Lloyds had provided a facility of up to £10bn, a significant part of which remained undrawn; and (ii) stating that Lloyds regarded the terms as commercially acceptable, noting the limit on the facility, and the need to sanction and approve the collateral offered at each draw-down. It would not have been necessary in order to comply with the "sufficient information" duty to give details of the Lloyds Repo and the UKLA would not have insisted upon it. Disclosure of the terms of interbank lending was (as Mr Benkert and Mr Trippitt agreed) unprecedented.

889. There may well have been further context provided: Mr Williams in his expert report at paragraph 277 and following canvassed further possibilities. But all one can say with confidence is that the disclosure, whilst sufficient to notify the shareholders of the existence of the two facilities, would have been carefully calibrated in consultation with the Tripartite and with HBOS (i) so as to minimise the risk of exaggerated speculation and (ii) so as to avoid a disproportionate emphasis on an issue which did not go to the heart of the Director's recommendation (being an arrangement that would not continue beyond completion).

The consequences of not disclosing ELA or the Lloyds Repo

890. The normal consequence of a breach of the "sufficient information" duty is that the Court will enquire there any reasonable ground for supposing that such imperfections as may be found in the Circular have had the result that the majority who have approved the transaction have done so under some misapprehension of the position with a view

to setting aside the result of the meeting and giving directions for the convening of a fresh meeting. That is not the relief sought by the Claimants. They want damages or equitable compensation: and to recover such they will have to show that the failure to discharge the "sufficient information" duty and the misstatement about the degree of care exercised in preparing the Circular in relation to matters known about but omitted have been causative of loss.

891. In addressing this part of the case I shall adopt as a working assumption that the same rules as to causation and remoteness of damage apply to both equitable compensation and common-law damages. I do so because that is the basis on which the case has been run on each side.

Causation

892. The essence of the Claimants' case on causation is that if the Lloyds board had recognised that they were bound to make disclosure of the existence of ELA or of the Lloyds Repo then the Acquisition would not have completed because one or more of the following events would probably have occurred, namely:-

a) The board would have declined to proceed ("Termination"); and/or

b) The transaction would have collapsed ("Collapse"); and/or

c) The majority of shareholders would have voted against the transaction ("Rejection").

Termination

893. The causal chain that I have labelled "Termination" can be disposed of shortly. The case has been conducted on the footing that the board knew of the use of ELA and of the Lloyds Repo. The board nonetheless unanimously recommended the Acquisition to shareholders and voted their own shares in accordance with their recommendation to others. Those directors who were asked about the matter (Mr Tookey, Mr Daniels and Mr Tate) confirmed that, if they had been told that disclosure of what they knew of ELA and the Lloyds Repo was required, then they would not on that account have terminated the transaction. Mr Tookey would have given disclosure. Mr Daniels would have thought about the terms of the demands of the regulators. Mr Tate did not know what he would have done. On the evidence the Claimants have not established that the board would have declined to proceed with the transaction.

894. The likelihood is that the board would have put the disclosure before the shareholders together with their recommendation that the Acquisition be approved. The question of whether the Acquisition was beneficial to shareholders could not logically or properly depend on what the shareholders had to be told of the circumstances of the transaction. The board could not abandon the Acquisition simply to avoid having to comply with their equitable disclosure obligations. They could, of course, have recommended the shareholders not to approve the Acquisition if of the opinion that they could no longer recommend it as beneficial. But (i) that was not the actual view of the board, and the shareholders were entitled to be told of the genuinely held views of the board: and (ii) the board would have been obliged to explain in the Circular why it was departing from

its announced intention (which it could only achieve, in this scenario, by saying that it did not wish to disclose ELA or the Lloyds Repo).

895. A case was argued (though the material facts were not pleaded and the Defendants did not come prepared to meet it) that the Tripartite would have prevented the Lloyds board from disclosing the grant of ELA. As I shall shortly remark, there is no doubt that the Tripartite did want to keep the activities of the Bank (as a central bank) covert. It is also right to observe (as did the *Plenderleith Report* at para.270) that safe disclosure of ELA requires both (i) an assurance that the recipient has found a more permanent and credible basis for future viability without ELA and (ii) confidence that the system as a whole has stabilised sufficiently for it to absorb that information without precipitating a loss of confidence: and whilst the Circular could deal with the first requirement the second requirement posed a thorny problem as at 3 November 2008 (particularly in view of the related concerns surrounding RBS).

896. But I do not regard it as probable that the secrecy could have been successfully enforced had the Lloyds board decided upon disclosure. (i) The Tripartite could not prevent the Lloyds' board discharging what it conceived to be its duty, and whilst undoubtedly it would have influenced the shape of the disclosure into a sufficient but non-inflammatory form, I do not regard it as probable that the Tripartite could successfully have suppressed all mention of ELA (as the Chancellor's statement on 25 November 2009, to the effect that the matter was one for the Lloyds board, acknowledges). (ii) The marginal cost to the Government of pursuing partial nationalisation (by taking £12bn of shares in a "standalone" HBOS, or perhaps more) was relatively small; but the threat to the stability of the financial system by abandoning the merger (instead of issuing the Circular) and substituting partial nationalisation was very considerable. An absolutely key stability measure would be being abandoned. As Mr Mervyn King explained to the Treasury Select Committee in oral evidence on 3 November 2008:-

> "There is no doubt that when we made that recommendation [sc. the merger was a desirable outcome] we were very conscious of the difficulty facing HBOS, the merger was the right way forward, and now that it is there on the table you cannot undo it. It is a merger there, it is going to be a commercial transaction, and we will see what happens. "

897. Coupled with the result of leaving the Government with large stakes in two relatively weak competing clearing banks, I do not think it probable that the Tripartite would have chosen that outcome over a controlled disclosure of ELA in the Circular, given the choice.

898. In my judgment the first causal chain is not established.

Collapse

899. The Claimants' pleaded case is that if ELA and the Lloyds Repo had been disclosed to the Lloyds' shareholders then:-

a) The price of HBOS shares would have collapsed;

b) It would have been "obvious" that the share exchange would result in a grossly disproportionate dilution of the Lloyds' shareholders' interest;

c) The financial press would have written extensively on the "folly" of the Acquisition;

d) The EGM would have been cancelled;

e) Lloyds would have withdrawn from the arrangements proposed over the Recapitalisation Weekend.

After some general observations about this case I will look at each of these elements in turn.

900. I begin by observing that the Tripartite undoubtedly saw a promptly announced and soundly structured takeover of HBOS by Lloyds as the answer to the concerns surrounding HBOS in September 2008 and during the following weeks. That is the basis upon which it supported a waiver of competition concerns and justified the grant of supportive ELA. It would have done whatever it could to support that takeover, though it was not going to give Lloyds a free ride and was going to extract a price for the competition waiver by ensuring that Lloyds bore a share of the risk. The Tripartite strongly preferred a capital contribution to an Enlarged Group over a complete or partial nationalisation of HBOS.

901. I further note that it is undoubtedly the case that the Tripartite was extremely anxious to avoid disclosure of ELA and went to great lengths to keep it secret: the grant of ELA was kept within the Bank's Transaction Committee and not released to the Court of the BoE or to the Chair of the Treasury Select Committee. The former is perhaps in part explained by the presence on the Court of competitors of HBOS and of Lloyds: but the latter is a straightforward instance of a desire to preserve secrecy for its own sake. It is clear that the Tripartite did so because of the extreme fragility of the markets in which they feared a negative market reaction (from depositors and the debt and equity markets); and because they believed that the risk of disorderly failure of HBOS or of observable distress (and the effect of contagion) was of such magnitude that they did not wish voluntarily to incur it.

902. However, great as this anxiety was, it had to be balanced by a recognition, evident in confidential papers of the Bank, that the announcement of the Acquisition had already had beneficial effects (it is common ground that it had stabilised the HBOS share price and stemmed the deposit outflow), had taken HBOS out of the firing line, had provided it with a credible long-term strategy and would pose its own risks to financial stability if it failed. Thus, once announced, failure of the merger (or indeed any rumour that the Tripartite no longer supported the merger) would harm financial stability and risk contagion in the same way.

903. The fact that a risk is foreseen does not mean that it will eventuate. The worst fears may not be realised. The risks apprehended by those involved at the time (who were, of course, highly informed) are naturally an input into any assessment of what might have happened if real events had taken a different course: but that is all. Having identified the distinction between contemporary assessment of the risk and a retrospective analysis of a counterfactual scenario I address the individual issues.

904. First, is it probable that upon disclosure of ELA and the Lloyds Repo there would have been a collapse of the HBOS share price? It is common ground that the reaction of a share price to the release of information depends upon the significance of the new information assessed in the light of what is already known or suspected. It is also common ground that the disclosure of bilateral central bank assistance says something about a bank's ability to fund itself.

905. In my view *what* it says can be obscure. ELA (as its very name suggests) addresses a shortage of liquidity. Mr Sants emphasised the point when he said in Edinburgh on 15 October 2008 that the immediate issue for the banks was not their capital and that no-one had run out of capital; the problem was with liquidity. But ELA may convey a wider message. The point is made in "The Review of the Bank of England's Framework for Providing Liquidity to the Banking System" prepared by Bill Winters in October 2012. The following citation deals with why (when issues of underlying solvency and short-term illiquidity are considered) banks are special:-

> "The banking model involves running maturity mismatches, for example between the bank's short-term funding… and long term lending…. This exposes banks to liquidity risk as their borrowings may need to be paid back before they are repaid on their loans. If this risk crystallises, what started out as a liquidity problem can quickly become a solvency or viability problem. Specifically, if creditors of the bank see it as accessing a central bank liquidity facility, they may fear that the bank is insolvent or otherwise non-viable and stop lending the bank additional funds. The blurring of this distinction between liquidity and solvency makes distinguishing liquidity problems and solvency problems very difficult. This may be even more difficult to judge in times of stress. And part of the reason for stigma in central bank facilities is likely to be that the market does not believe central banks are always able and willing to make this distinction. Indeed, the solvency problem may initially manifest itself as a liquidity problem. So the discovery that a firm has used central bank liquidity can be taken as a signal that they are in trouble and may become or already be insolvent.… The link between liquidity and solvency may be self-fulfilling in some circumstances."

906. I regard that as a fair summary of the *general* risk to which a bank would *normally* be exposed if it became known that it had accessed central bank funds. The Claimants say that it is an accurate summary of what would actually have happened in the present case had it become known that HBOS benefitted from ELA: the link between liquidity and solvency would have been self-fulfilling and the market would have reacted accordingly.

907. The first reason they advance is because it was what was feared by informed people: not simply a fear about HBOS as an institution but a fear of the creation of a dynamic that would have been detrimental to the stability of the system. Collapse would probably have happened because it was expected to happen. ELA was a stigmatised bilateral facility and the normal consequences of accessing a stigmatised facility were to be expected.

908. The second reason they advance is that collapse is what had in fact happened in previous cases where ELA had been disclosed. The expert evidence identifies four cases.

a) In August 2007 it became known that Barclays had made significant use of the BoE overnight facility to the tune of £1.55bn: the cause was entirely technical but it triggered false rumours.

b) On 13 September 2007 there was the leak of the Bank's intention to provide ELA to Northern Rock. It led to an immediate "run". Although the Bank continued to provide funding the "run" proved terminal and Northern Rock was nationalised about 5 months later.

c) In March 2008 Bear Stearns was assailed by liquidity rumours which were trenchantly denied by its CEO; two days later J P Morgan provided an emergency loan (itself funded by the US Federal Reserve). Bear Stearns stock halved in value.

d) In March 2008 HBOS was assailed by liquidity rumours. This led to an 18% decline in its share price and some deposit outflows. Although the true position was rapidly established the incident caused a change in the market perception of HBOS's relative strength.

The Claimants submit that there is no case in which ELA has been disclosed or rumoured that has not been followed by a "run": and no contemporaneous evidence that anybody thought that disclosure would be neutral or positive in effect.

909. The third reason they advance is that collapse would probably have happened because savers would have withdrawn their deposits (not necessarily because *they* had reassessed HBOS but because of a fear that that is what everyone else was doing) and wholesale funders would not have extended credit. The basis for this is:-

a) The febrile atmosphere following the Lehman Brothers failure;

b) The extreme share price volatility that HBOS had suffered in September 2008;

c) The fact that HBOS had suffered significant deposit outflows in September and early October 2008 (not constituting a "run") when doubts emerged about its financial stability;

d) The desire (at the time of its grant) to keep the Lloyds Repo undisclosed for fear that it constituted "information that created an exaggerated diminishing of liquidity" (as Mr Tate put it in cross-examination).

At the heart of all these concerns is a fear of triggering a misplaced over-reaction on the part of depositors.

910. The fourth reason they advance is the expert evidence of Mr Ellerton and of Mr Benkert.

911. The evidence in chief of Mr Ellerton was that in his opinion disclosure of ELA would have clearly signalled to the market that HBOS was not an independently viable bank,

and that it was clearly "funding insolvent", which would have resulted in a material adverse impact upon the perceived value of HBOS, which he described as a "death spiral". But when pressed in cross-examination he made clear that he was not suggesting that the immediate reaction to the disclosure of ELA would have been an immediate collapse in the HBOS share price; indeed, that he was not suggesting that the most likely outcome was a collapse in the share price. His "nuanced" answer was:-

> "So we're going from: would it have been a collapse? Probably not. That's not the most probable outcome. Would it have had a significantly negative…? Depends on how you view "significantly negative"….Would it have had minus 5%? Minus 10%? I would have thought at least 10% but I could be wrong. It could be anything between plus 15% and minus 15%. It is impossible to put any confidence … on any forecast within that fan chart."

That "nuanced" answer was very much in line with his original view (expressed on much more limited material and after much shorter consideration) to the Defendants' solicitors that had the market known of ELA it would have had little impact because it would have been regarded as simply another funding source for banks having difficulty with funding.

912. Fairness to Mr Ellerton requires that I also note a further "nuance" to his evidence. He was asked to express a view on the likely share price reaction to disclosure of the Lloyds Repo. He did not think such disclosure would have had a positive effect: it might demonstrate that Lloyds was committed to the transaction, but in a sense that was already known from the offer itself. He agreed that the most likely outcome of its disclosure would not be an *adverse* share price reaction, but added:-

> "Possibly not the most likely outcome; it would depend upon the circumstances of the disclosure. If it was disclosed at the same time that HBOS was receiving ELA, it is part of the ELA package, I think that would have been a likely outcome."

When tested on what "outcome" he was saying was "likely" he agreed that he was not saying that it was probable that the HBOS share price would have "collapsed", or that there would have been an impact on the Lloyds share price or on the Lloyds vote.

913. It was Mr Benkert's view that the debt market would have reacted negatively to news that HBOS was being supported by ELA. He stated in his first report:-

> "There is a theoretical argument that suggests that if HBOS's use of ELA was disclosed then creditors would have sought comfort from the fact that the repayment of the debt was back-stopped by the central bank. In reality, however, in a market that is full of fear and angst, in my experience and, as was seen at this time, people's reaction is to get to the front of the queue to be repaid if at all possible and withdraw funding as soon as possible. This creates the pro-cyclical vicious cycle that exists in bank liquidity management where there is a perceived or an actual run on a bank. "

914. It was the same in relation to disclosure of the Lloyds Repo:-

> "Given the highly unusual nature of this transaction, especially the unusual collateral structure and (in my view) the overly generous terms for HBOS, I believe the market would have reacted extremely negatively towards both HBOS and Lloyds had the details become known for example through disclosure in the Circular a recognised news service…… If it was also known… that he before the Bank of England had provided an alarmingly similar funding package to the same borrower it would give rise to some significant concerns that there is a co-ordinated rescue underway… Investors and creditors would in my view have been significantly concerned about such coordinated action especially in the light of the announced acquisition such that they would not have wanted to be part of it. "

This evidence (which assumes a particular level of disclosure) of course relates to the anticipated reaction of the debt market, and the plea the Claimants seek to prove is that the price of HBOS *shares* would have collapsed. So it is necessary to consider (i) the likely relationship between the debt and the equity markets; (ii) the extent to which the Government, in order to ease the Acquisition to a conclusion, would have met any funding shortfall (as it continued to do for Northern Rock over the five months preceding the decision to nationalise); (iii) the message this support would have sent to debt market investors or to the equity market; and (iv) how the debt market would have treated the Enlarged Group. Item (i) was the subject of some direct evidence from the Claimants. Item (ii) was addressed in background material and in evidence from the Defendants. Items (iii) and (iv) were not specifically addressed.

915. As to item (i), the Claimants accept that the equity market would not have reacted in exactly the same way as the debt market. Mr Benkert accepted that whilst the money market would take a negative view, equity analysts might take a different view: he suggested that with technical or complicated schemes there might be telephone exchanges, in which he assumed that the debt market view would prevail over the equity market view (though why that might be was not explored, and neither ELA nor a £10bn interbank facility seems technical or complicated). The Claimants argue that disclosure of ELA and the Lloyds Repo would have shown that HBOS was in a weaker position than other banks, that shareholders would understand that HBOS could not survive as a standalone bank and that they stood to be wiped out absent the Acquisition and that the price to be paid under the Acquisition appeared "excessive".

916. As to item (ii) the background material discloses that the Government continued to fund Northern Rock for some five months after the leak of its ELA support whilst it sought a solution other than wholesale nationalisation of the institution: and the evidence of Mr Trippitt (the Defendants' expert) was that if there had been a withdrawal of deposits following disclosure in the HBOS Circular then the likely Government response would have been the grant of further funding. This evidence struck me as entirely coherent. Why would the Government trigger the very event it had been so anxious to avoid? Why, having promised to stabilise the system by the provision of sufficient liquidity, would it destabilise it by withholding funds requisite to see HBOS through to acquisition?

917. Each of the principal reasons advanced by the Claimants depends upon the view that history repeats itself (or will be believed to repeat itself): and that is a very powerful argument. I do not in the end accept it because I think disclosure in the Circular would have presented a number of material differences, and there is evidence pointing the other way.

918. The first difference is that these events are occurring (i) in a financial system that had learned lessons from Northern Rock by strengthening depositor protection so that 97% of depositors were fully protected; and (ii) after the Lehman Brothers crisis, and the clear signal sent by the Bank on 8 and 10 October 2008 that it would do whatever was necessary to end what was an historically unprecedented shutting down of global markets. I am in no doubt that these measures did (as intended) establish a "new normal" in which the Bank had ceased to act simply through open market operations, the provision of "standing facilities" and as a "lender of last resort" and had become a mainstream provider of liquidity under arrangements (the SLS) that were not transparent to the market (because the amount taken by any individual bank and the circumstances in which it sought to use SLS were not disclosed). These measures did indeed substantially reduce the "ghost run" on HBOS that had happened in September and early October 2008: in other words, the new arrangements influenced not only the technically minded market participants but also the ordinary retail and corporate depositor.

919. The second difference is that the disclosure would have been controlled not leaked. Much of the apprehension about disclosure (and what drove the desire for secrecy) was a fear of uncontrollable and unpredictable market reaction, such as had followed the BBC leak of the plans for Northern Rock. So there was an understandable desire on the part of Lloyds and of the BoE to avoid "unforced errors". But if disclosure is required then attention can be (and would have been) focused on the manner and terms of disclosure so as to minimise the risk of damaging speculation. This was recognized to have been a possibility in the case of Northern Rock, where the Treasury Select Committee Report of January 2008 expressed the view that there was a reasonable prospect that an official announcement of the BoE support operation would have re-assured depositors, whereas the "leak" caused panic. Of course, one cannot be sure: not every controlled release successfully avoids a markedly negative reaction. But each of the other matters to which I refer is mutually reinforcing.

920. The third difference is that the disclosure was contextualised. The grant of ELA and the use of the Lloyds Repo were not leaked or made known to the market as unanchored facts inviting speculation. A reader of the Circular would know why the ELA (and the Lloyds Repo) had been granted (to provide stable funding until completion of the Acquisition) and would know that it would not be needed by the Enlarged Group. This would reduce (though I do not consider it would eliminate entirely) the consequences of using stigmatised facilities. Stigma is related to uncertainty. I found helpful Prof Persaud's explanation at para 95 of his First Report:-

> "The economic distinction between risk and uncertainty is very relevant to stigma… Risk as articulated by economist Frank Knight is something that you can put a price on. Uncertainty is something you cannot. Stigma is not that markets believe the risk of an asset has risen to some level and that there is some compensating level of interest rate that could offset this new risk

> and draw funders back, but that there is an increase in uncertainty of future outcomes and investors do not know how to price it, and so they prefer not to have any of it at all. ”

In another section he opined:-

> “What matters is whether you have certainty about how the authorities will respond to your need for liquidity… Stigma is made worse if you doubt whether the central bank is going to provide liquidity for an illiquid institution or the government will provide capital for an insolvent institution…”

Here the Circular explained what the outcome would be for HBOS depositors and for providers of credit to HBOS, removing uncertainty. There was no real doubt about the Government’s intention both to provide liquidity for illiquid institutions and to subscribe for capital (though the terms of provision were not certain), nor about the Government’s support for the Acquisition. If the Lloyds shareholders approved the Acquisition in accordance with the recommendation of the Lloyds board (an element of risk that could be and was constantly priced by the market, reflected in the fact that HBOS shares traded at a discount to the Lloyds offer price) their relationship would become one with the Enlarged Group. The Enlarged Group itself was one that had been scrutinized by the regulators and had been recapitalized by the Tripartite at what might well be (and in the event was) a premium to the market price. There was no need to assume the worst because the long-term future for HBOS had already been mapped out. That is crucial.

921. The fourth difference is that there is available another datum point. There was the leak of the “secret” Lloyds Repo on 9 November 2008, picked up by the Sunday Times, and then by the BBC, the Financial Times, the Daily Telegraph and the Independent and by various analysts and the main subscription services. It is right to note (i) that this “leak” did not precisely replicate the sort of disclosure that would have been contained in the Circular, in particular the very fact of disclosure in the Circular would have indicated that the transaction was one that was thought to need special mention as in some respect out of the ordinary; (ii) that a press story (however well it is said to be founded) is not the same as a statement from Lloyds; and (iii) it was not associated with any disclosure of ELA.

922. This datum point is therefore not completely aligned with the counterfactual disclosure. But Prof. Schifferes and Dr Unni are agreed that the “Sunday Times” story regarding the Lloyds Repo did not lead to significant change in the share price of HBOS (or of Lloyds). Prof. Schifferes thought that this was entirely due to the fact that the story was not confirmed by Lloyds and was not taken seriously. But it was widely reported and taken seriously; it was picked up by analysts. It was not overshadowed by the simultaneous stories relating to the two Scottish interventions (and possible foreign interest): these were not the dominant market drivers, as the Claimants suggested (contrary to the view of their expert). Indeed, the co-incidence of the stories focused attention on the very question: what did HBOS need to survive as an independent bank? In my judgment the muted market reaction does run entirely counter to the thesis that in febrile times the market would seize upon any sign of weakness and punish the institution concerned; and it does tend to favour the argument that measures supportive of a planned restructuring were at least to be viewed as neutral.

923. The fifth difference is that, unlike the reference cases, by 3 November 2008 there was already a great deal known by the market about HBOS and its liquidity problems. There was an undoubted loss of confidence in HBOS, its Chief Executive had publicly expressed the view that its troubles were not temporary, and there was a widely held view in the market that HBOS did not in reality have an independent future. 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. HBOS would (after the Recapitalisation Weekend) have to raise £12bn as a stand-alone bank and it could look only to the Government to provide it i.e. at best partial nationalisation.

924. It is right to observe that of course not everybody took the view that there was no truly independent future for HBOS: such people held to the view, current amongst a significant body in mid-September 2008, that this was a temporary liquidity problem that would be overcome as soon as the markets were restored - as the Scottish interventions in late October/early November 2008 show. The Claimants make the point if the disclosures would cause a material number of these market participants (who did not currently believe that HBOS had no future as a stand-alone) to re-evaluate then it would cause a material market movement. I acknowledge the theoretical point: but there is no evidence available to make the point of any utility.

925. As to the direct expert evidence, I have already recorded that of Mr Ellerton. He was not of the view that disclosure of ELA and the Lloyds Repo would have caused a collapse in the HBOS share price. This was also the view of Mr Trippitt. He said that the market would not view these disclosures in isolation but (i) as part of the narrative contained in the whole Circular – the gaining of market share with the benefit of the competition waiver, the anticipated synergies, the expected accretion to earnings; (ii) in the context of a £660bn HBOS balance sheet; (iii) in the light of what was already known about the HBOS vulnerabilities; and (iv) against the background of the "new normal" where the central bank funding played a prominent role. By way of qualification he wrote:-

> " I would accept however that the fact that the funding facilities had to be extended reflected the severity of liquidity conditions at that time, particularly for a bank with HBOS's funding structure . "

Overall, he considered the impact of the disclosures would have been "neutral", because the deterioration in liquidity conditions generally had significantly altered analysts' and investors' perceptions of what was "normal". By "neutral" he did not mean "static" but rather fluctuating within a narrow band of -10% to +10%. His key point was this:-

> "In the eyes of the shareholder, the fact that HBOS was fully funded regardless of the source or the name or what three sets of initials we would like to give it, if it's fully funded it can be valued by the shareholder as such. And that goes right back to the heart of my hypothetical disclosure that if on 3 November the Lloyds shareholders learned that ELA was being utilised, it would be neutral, but actually it would be, as I've said before, an absolute emphatic signal from the Bank of England that it was

> prepared to stand behind HBOS to get the acquisition completed."

926. This was also the view of Dr Unni. He thought that, given that the liquidity problems of HBOS were widely discussed, disclosure relating to the use of ELA and the Lloyds Repo "would have conveyed a solution to an existing problem rather than reveal a hidden problem." Although Dr Unni drew on the opinion of one analyst that evidence of support for HBOS from the BoE should lead to a recovery in the HBOS share price, I do not follow Dr Unni so far as to agree that there would have been a positive effect on the HBOS share price: in fairness, he only speculated that it "may have increased the share price".

927. There is some objective evidence that supports this view that disclosure of ELA and the Lloyds Repo would not have a negative effect. In the case of Northern Rock it was plain that it faced an idiosyncratic problem. But even though the grant of ELA was plainly "emergency liquidity assistance" there were those who regarded it as a positive indicator and bought shares: see the account at SRM Global Master Fund [2010] BCC 558 at [3]. Amongst those buyers was the fund which Mr Ellerton himself advised. It was also the evidence of the Governor of the Bank of England that the announcement of ELA for Northern Rock had the immediate effect of reassuring wholesale funders to Northern Rock: though I think that reassurance may have waned as it became increasingly apparent that there was no long term private sector solution to the Northern Rock problem (whereas the Acquisition offer price always afforded a "floor" in the case of HBOS).

928. Further, in the USA, immediately after the collapse of Lehman Brothers both Goldman Sachs and Morgan Stanley obtained permission to convert from being investment banks into being commercial banks, a move widely read as being designed to allow them to access the DWF (otherwise not available to them): this had a positive effect on their respective share prices. In the interests of balance, I should note that access to DWF was not the only benefit of conversion, and I do not seek to press the example so far as to suggest that accessing emergency funding naturally has a positive effect on the share price. All I draw from this example is that knowledge that an institution is accessing emergency funding does not necessarily cause a collapse of the share price.

929. Having reviewed the competing arguments my conclusions are these:-

    a) If the Circular had contained disclosures of the type I have outlined above concerning ELA and the Lloyds Repo then this would have been clear incremental information (reinforced by the *simultaneous* disclosure of both ELA and the Lloyds Repo).

    b) The immediate response of the debt market would have been negative. It is not established that the Tripartite would have refused to replace any shortage of deposits or credit occasioned by that negative reaction, and the probability is that sufficient ELA would have been made available. It is almost certain that Tripartite would not have permitted HBOS to fail as an institution because of the debt market's negative response but would have ensured that it remained funded.

c) For an ELA operation to be successful the Bank must provide enough liquidity to bridge the gap between the initial liquidity shortage and the stable future state. To limit liquidity provision once ELA is underway would risk precipitating the systemic impact which it was the object of ELA to avoid. So from the beginning of October the Bank must have recognised that it would need to provide sufficient liquidity to provide a breathing space until HBOS acquired a permanent and credible basis for future viability.

d) Whilst it remained an operating bank reliant (to varying degrees) until completion upon bilateral funding, HBOS shares would have continued to be traded; but the discount to the offer price would have widened because of the increased risk that the Acquisition might not be approved by the Lloyds shareholders.

e) The widening of the discount would have been slight because the increased risk that the transaction would not be approved would be largely confounded by signals that both the Government and Lloyds wished to fund HBOS until completion.

f) If the discount to the offer price widened and if (as the Claimants argue) the HBOS shareholders themselves thought that the price they would receive on completion of the Acquisition was "excessive" then this would disincline rational HBOS shareholders to sell and incline them to keep their shares and support the Acquisition.

g) The inherent probabilities confirm the evidence of Mr Ellerton and of Mr Trippitt that the HBOS share price would not have collapsed. There would probably have been a mildly negative reaction: a decline of 10%-15%.

930. A decline of 10%-15% is well short of a "collapse". The key allegation under this head is therefore not established. If ELA and the Lloyds Repo had been disclosed the HBOS share price would not have "collapsed". But I will briefly address the other pleaded points.

931. Before doing so I would simply comment that my conclusion that disclosure would not have led to a "collapse" is not inconsistent with my view of the "materiality" of these two issues. What must be provided in a circular is information sufficient to enable an informed decision to be made (rather than simply information sufficient to justify the recommended course). But the fact that the Circular contains material which may not be supportive of the recommendation does not mean that shareholders will seize upon it and say "Well that shows the recommendation must be wrong". The *informed* decision might well be (and I think in this case would have been):-

> "The disclosure of ELA and the Lloyds Repo tells us that HBOS is further down the road to ultimate non-viability than we previously thought. But we agree with your recommendation that it is still worth our acquiring it because of the benefits it will bring us, not least the removal of a competitor."

932. The second pleaded allegation raises this question: is it probable (having regard to the extent of any "collapse") that it would have been obvious that there was a gross dilution of the Lloyds' shareholders' interests? On the evidence I would answer that question in the negative. Any transaction based on a share exchange depends upon the relative share prices. There is no evidence of how the Lloyds' share price would have reacted to the assumed disclosures in the Circular and a 10%-15% decline in the HBOS price. But in any event the transaction was based on the underlying strategic value of HBOS to Lloyds: this was the point made by RiskMetrics in its commentary supporting the deal, where it said that the deal was not value-based by about strategic acquisition. The plea is really an echo of the allegation that HBOS was "valueless": but that is not an argument that the evidence supports.

933. The third pleaded allegation raises this question: would the financial press have written about the "folly" of the Lloyds deal in the light of the disclosures? This brings focus to bear on the evidence of Prof. Schifferes. He set out to assess the probable response of the financial press to disclosure of ELA, Federal Reserve funding and the Lloyds Repo. He did so by postulating that there was a high probability that these disclosures would have been widely and negatively reported and would have led to a shift in opinion against the merger: and then examined the evidence to see if that hypothesis was *disproved*. If his hypothesis was not disproved, then he regarded the hypothesis as proved. This struck me (and still strikes me) as a very odd methodology with an inbuilt confirmation bias.

934. I can omit consideration of those parts of his report which established that journalism was a profession, that during the financial crisis financial journalists covered the crisis, that news can and routinely does have a large effect on assets prices, that during the financial crisis there was a marked increase in media attention to banking risk, and that the BBC leak about Northern Rock led to big increase in the media coverage of that bank. I can start with the interviews with journalists.

935. Prof. Schifferes discovered that 16 of the 17 selected journalists interviewed (they were not a random sample) thought that "disclosure" of ELA and the Lloyds Repo would have been a major story which they would have covered. The finding comes with a "health warning" that:-

> "…journalists could suffer from social desirability bias, where journalists retrospectively judge their actions in a more favourable light."

The health warning is plainly right: and I think deprives the journalists' response of almost all significance. To journalists who know the distressing outcome of the HBOS takeover the question:-

> "If you had been aware at the time of the merger that Lloyds, the Bank of England and the Federal Reserve had been providing £30bn in secret support for HBOS, would you have reported that?"

invites only one response. It is not of any worth.

936. It is also important to understand what "disclosure" Prof Schifferes was asking the journalists to assume. He was not asking them to assume that the "disclosure" was part of the Circular or in a formal statement explaining what facilities were being provided. He was inviting their reaction to the emergence of the information *in any way*. Thus, their responses do not address the precise circumstances with which I am concerned. An answer to the question:

> "How (if at all) would you have commented upon a disclosure in the Circular that HBOS was accessing a bespoke bilateral facility at BoE pending completion of the Acquisition and had access to a £10bn facility at Lloyds for that same purpose?"

might have been illuminating.

937. Although Prof Schifferes propounded the hypothesis that the financial press would have reacted negatively to the assumed disclosures and would have shifted sentiment against the merger, the interviews that his assistant conducted did not test that hypothesis.

938. On the other hand, the Professor's oral evidence did disclose that in the case of Northern Rock the initial Peston "scoop" was withdrawn and "toned down" by the BBC. This does indicate a consciousness on the part of financial journalists of the need not to over-excite markets by sensationalist reporting. I am sure that any reporting of the disclosures in the Circular would not have been alarmist (even if negative). I see no reason to think that press coverage would have departed in tone or content from the range of views actually expressed by analysts and journalists (i) when commenting on the deposit outflows actually disclosed in the HBOS IMS included in the Circular or (ii) when the Lloyds Repo was uncovered. I think the probable tone and content is represented by the Reuters report of the "Sunday Times" story:-

> "The newspaper said the "covert agreement" showed how closely the two were working together ahead of [Lloyds'] agreed acquisition of Britain's biggest home lender and said the scale of support was surprising."

This was a balanced commentary, and a more reliable indicator of press treatment of disclosures than Prof. Schifferes' unproven hypothesis.

939. I do not accept that the Claimants have proved their plea on this aspect of the case.

940. The fourth question posed was: would the EGM have been cancelled? This was not a case that was put to any of the Defendant directors. Given that the board believed that the Acquisition was for the benefit of the Lloyds shareholders and recommended it to them, and given that I have found the effect of the assumed disclosures to have been "neutral" (in the sense of being negative to the extent of -10%) I see no basis to suppose that the EGM would have been "cancelled", or (as I think the proper approach would require) that the board would have altered its recommendation. The share price was one thing: the underlying value of the HBOS business to Lloyds was another.

941. The fifth and final question raised on this part of the case was: would Lloyds have withdrawn from the Recapitalisation Weekend proposals (leaving the pre-recapitalisation shareholdings unaltered)? The short answer to that question is "No".

During the Recapitalisation Weekend the realistic choice facing Lloyds was to proceed with the Acquisition and raise £5.5bn: or to reject the Acquisition and recapitalise with £7bn. Not complying with the Tripartite's view that "bullet-proofing" against a severe recession over a five-year horizon required additional capital was not a realistic option. The Tripartite would have made it as difficult as possible for Lloyds to abandon the Acquisition and to decline to participate in the recapitalisation programme: and the market (parts of which were looking to Lloyds to raise additional capital in any event) would have commented adversely on the adoption of such a course.

942. In the result the second causal chain is not made out either. Since neither "Termination" nor "Collapse" is proven I turn to consider "Rejection".

Rejection

943. The pleaded case here is that no shareholder (or at least not the requisite majority of shareholders) if "fully and properly informed" would have voted in favour of the Acquisition or of participation in the arrangements made during the Recapitalisation Weekend. The plea that not one shareholder would have voted in line with the unanimous recommendation of the board is unnecessarily ambitious. I shall focus on the "requisite majority".

944. The number of shares voted at the EGM was 3,116,962,477. There is no evidence to suggest that a greater or lesser number would have attended if the Circular had disclosed that HBOS benefitted from ELA or the Lloyds Repo; although the Claimants do have an argument about the attendance to be presumed. Of those attending 96% supported the view of the directors (and of RiskMetrics): they held 2,991,725,191 shares. 125,237,286 shares (4%) voted against the recommendation. The Claimants seek to prove that if the general body of shareholders had been "fully and properly informed" the dissentient 4% would have been joined by 1,433,234,954 votes of other shareholders (46% + 1). What is the evidence for this?

945. Of the 5800 Claimants only 9 say they would have voted differently if the ELA and Lloyds Repo had been disclosed. They held (approximately) 0.37% of the shares. Of those Messrs Bennett, Fenwick, Johnson and Scott were retail investors who gave unchallenged evidence that they would have cast their votes differently. But their shareholdings were minute: perhaps 0.005% of the total shares in Lloyds. The remainder of the witnesses gave evidence on behalf of institutional investors. Real doubt was cast on the accuracy of their evidence that they would have voted against approval by (i) the disclosure of standing instructions to vote in favour of management recommendations; (ii) the disclosure of automatic proxy voting procedures operated by RiskMetrics; (iii) the disclosure of material showing that they already held the view that HBOS was going bust and knew it had borrowed £10bn from Lloyds (notwithstanding the form of the Circular) but voted in favour nonetheless; (iv) the revelation that they had made no serious attempt to reconstruct the circumstances in which the actual decision would have fallen to be made. But I will assume that their evidence is to be accepted.

946. Let it be assumed that the Claimants who have given evidence (and did not in any event vote against the recommendation) would have changed sides and swelled the rank of the dissentients. They total (at a generous estimate) 0.55% of the voting shares. Where is the other 45.5% of the voting shares to come from to create (together with the 4%

actual dissentients) the majority against the Acquisition? The evidence of the Claimants does not say. Mr Hill QC simply invited me to infer that the requisite swing would have occurred.

947. But there is no basis for such an inference. There is, for example no properly structured survey evidence of those who voted in favour of the Acquisition (or of those who did not vote) which might establish some sort of factual basis for the drawing of inferences. There is no evidence adduced from individual really big stakeholders with extensive voting rights to say they would have voted differently. One has the evidence of 13 shareholders. There is no reason to think that the small number of self-selected retail or institutional Claimants is in any way representative. There is one witness who is not a Claimant (Mr Hammond-Chambers of Hansa Trust, who was part of the dissentient minority at the EGM). What reliance can one put upon that one witness to represent the likely views of a statistically significant part of other non-claimant institutions? I think none, given that he voted "No" even on the information he had. In short, there is no material on which to found the inferences that if disclosure had been made the outcome of the vote would have been different.

948. Such evidence as there is does not point in the direction of the suggested inference. First, the factual evidence of the Claimants itself shows that in general shareholders cast their votes in accordance with the recommendation of the board: on this counterfactual the board is recommending the transaction. This is a manifestation of what Mr Torchio called "the Wall Street walk", which he memorably encapsulated as "shareholders either vote with their hands or they vote with their feet" i.e. they will either vote in favour or they will have sold out already. Second, the factual evidence of the Claimants shows that some shareholders recognize that they simply cannot say how they would have voted in the counterfactual world. Third, the expert evidence adduced by the Claimants (Mr MacGregor and Mr Torchio) established that in general shareholders do not wish to undermine the company's management ("if the management's in favour, its highly likely that it's going to be voted in favour") and will vote in accordance with a recommendation. Fourth, analysts recognised (and advised their clients) of the risk of contagion if shareholders voted against management ("shareholders will recognise that if they block the deal they might start a storm from which Lloyds TSB itself will not be able to shelter"). Fifth, the most prominent shareholder advisers (RiskMetrics and PIRC) were both advising shareholders to vote in favour: the Claimants did not seek to prove that the advice of either body would have been different if ELA and the Lloyds Repo had been disclosed in the Circular (notwithstanding the qualified terms in which the RiskMetrics advice was tendered). All these are contra-indications.

949. What indirect evidence might support an inference? First, the Claimants acknowledge that it was widely known that HBOS was in difficulties, at the weaker end of the spectrum, and widely viewed as not having an independent future (though they resist the suggestion that this was a consensus view). I have found that the disclosure of "ELA" and the Lloyds Repo would have been significant incremental information which would tell investors more about how far on its journey HBOS was and would have been mildly negative. Would this reaction have swayed a vote? I do not think that if the counterfactual includes the proposition that disclosure would have a mildly negative effect one can infer the overthrow of a majority of 96%. What would weigh with the Lloyds shareholders was the strategic objectives of the Acquisition not the

temporary funding arrangements pending completion. These temporary arrangements did not of themselves clearly signal that the strategic objectives would only be achieved at a cost increased by an unexpectedly deep and long recession.

950. Second, the Claimants say that that only about half the shareholder population actually voted: they submit that the Court should presume that the absent and abstaining other half did not support the proposal as it was revealed, and that if ELA and the Lloyds Repo had been revealed and reinforced the market response assumed in the counterfactual then it may be presumed that a sufficient number would have become active, all of whom would have voted against the proposal. I part company at the first stage. The fact that some people did not vote does not mean they were opposed to the proposition. They may simply have not got around to voting (whatever their view). They may have been content simply to follow the majority (whatever that view was). They might have understood that the management view is generally backed and have gambled that that would again be the case with the vote at the EGM.

951. Third, the Claimants argue (i) that the Court should infer from the 4 retail shareholders who have given evidence and from those retail shareholders who voted against the proposal that all retail shareholders would have been against the proposal if the disclosures had been made; (ii) that the Court should infer from the investment objectives of institutional shareholders that they would have taken a prudent long-term course (and *sub silentio*) that disclosure of the ELA and the Lloyds Repo arrangements pending completion of the Acquisition would have been in conflict with those objectives; and (iii) that on the evidence adduced by the Claimants it can be shown that some who voted in favour of the Acquisition did so hesitantly, so that if incremental information had been issued showing even a slightly worse position than had been previously revealed then retail and institutional investors would have voted against.

952. The tiny sample of retail and institutional investors selected to give evidence in support of the claim simply will not bear the burden of this argument. There is no basis for leaping from the evidence of 15 individuals to the conclusion that 1.4 billion votes would have been cast differently. Many shareholders would have been guided by the (correct) advice of Sir Victor that they should focus on comparing (i) Lloyds as part of the Enlarged Group and (ii) Lloyds, not as it used to be, but as it stood to be after the Recapitalisation Weekend. Many shareholders are likely to have weighed the negative signals sent by temporary central bank support against the strategic advantages and earnings accretion the Board anticipated would accrue. Some may well have gone through the same balancing exercise as the analysts at Rensburg did in early October. Their early and insightful summary suggests that a merger might mean that a well-capitalised bank is dragged down by the HBOS commercial lending, but the discount on book value gave scope for write-downs and (Rensburg suspected but a Lloyds shareholder would know) there is some sort of facility from the BoE to oil the wheels. It suggests that in some ways the deal is very positive: Lloyds gets a huge number of retail customers in a deal that would normally be blocked on competition grounds, and retail customers are more important in a world where wholesale lending has stalled. It observes that the Enlarged Group needed to get through the immediate hitches but on a 2-3-year view Lloyds should emerge strong. In other words, shareholders would focus on Lloyds, not on HBOS.

953. The Defendants raised (as an obstacle to the Claimants' argument about the creation of a majority against the recommendation) the fact that there was significant overlap

between the Lloyds and HBOS registers – an argument based on cross-holdings. The top 100 shareholders in Lloyds included 28 shareholders who collectively held 49.13% of HBOS. The top 20 shareholders in Lloyds held 29% of the shares in HBOS. They, it was suggested, would have voted on a "portfolio" basis, so that if the Claimants were right that the Acquisition was bad for Lloyds but good for HBOS then cross-holders may be presumed to vote their Lloyds shares in favour.

954. The Defendants argued that the right to vote was in essence a right of property which might be exercised by reference to the interests of the owner of the right (subject to some immaterial restraints imposed where in particular situations there is a duty to act *bona fide* in the interest of the company): they cited *Gower: Principles of Modern Company Law* (10th ed) at para 19-4, Pender v Lushington (1887) 6 ChD 70 at 75-76 and Carruth v ICI [1937] AC 707. This provoked the Claimants to respond that to exercise votes attaching to shares partly by reference to your private economic interest in other shares was unlawful, improper and impermissible since it stood to impoverish Lloyds shareholders who did not have such cross-holdings and contravened a general principle that all votes must always be exercised in a way that is *bona fide* in the interest of the company as a whole.

955. I do not intend to spend long on this debate. Assuming (as the Claimants contend) that a shareholder can only *ever* exercise a vote attaching to his share in a way that is *bona fide* in the interest of the company as a whole, whether that test is passed is something that would have to be objectively assessed. The touchstone for that would be whether an honest shareholder might reasonably hold the view that the matter under consideration was beneficial to the company. In the counterfactual scenario under consideration the board has unanimously recommended the Acquisition as beneficial to Lloyds and its shareholders and has done so without negligence. Moreover, each director who holds shares is voting the entirety of his or her shares in accordance with that recommendation. The Claimants would be unable to show that *no* honest and reasonable shareholder could have supported the Acquisition. If a cross-holder voted in favour of the Acquisition it would therefore not necessarily be because he put his private economic interests above the interests of the company as a whole. Thus, even if the Claimants' view of the law is right it does not help them. A cross-holder whose economic interests align with the course unanimously recommended by the board does not oppress a dissentient minority.

956. Nor do I see it necessary to enter into a debate about whether this is a case in which each Claimant has to prove on the balance of probabilities that but for the failure to make the ELA and Lloyds Repo disclosures he or she would have been joined by the requisite number to defeat the board's recommendation: or that he or she has to prove that a chance of doing so has been lost (and compensation adjusted accordingly).

957. The primary position of the Claimants was that they would establish on the balance of probabilities (i) that each Claimant would have voted differently if properly informed and (ii) (by inviting the Court to infer from a demonstrably representative sample of views) that sufficient retail investors and institutional investors would have voted against the proposition in a counterfactual scenario in which the board continued to recommend the transaction. But in the alternative they pleaded that because of breaches of duty by the directors each of the 5800 Claimants has lost the chance that other shareholders would have voted against the Acquisition.

958. The event which caused the loss alleged to have been suffered by each Claimant was the approval of the Acquisition. It was common ground that whether that individual Claimant had suffered loss depended not only upon how he, she or it would have altered their vote in the light of incremental knowledge, but also on how other shareholders would have reacted to that same information. The "loss causing event" would not have happened if enough shareholders had reacted in the same way as the individual claimant. The primary position of both parties was that because the question was how the individual claimant and the other identically placed shareholders would have reacted to the same external input (of incremental information) the outcome was to be determined on the balance of probabilities. "If the material had been released the meeting would have been called off". "If the material had been released the price would have halved". "If the material had been released the motion would have been defeated". The question in each such case is not how the other persons would have reacted to some input from the claimants, such as "Would they have made a bargain?" It is: "how would the body of which I am part have reacted to an outside stimulus?."

959. The Claimants favoured this approach because they said that the Claimants and the general body of shareholders were "a unity" sharing an identity of approach: in so doing they were drawing on language that had been used in Veitch v Avery [2008] PNLR 7, Dayman v Lawrence Graham [2008] EWHC 2036 and The Connaught Income Fund [2016] 2286 (Ch). They did so because they wanted to argue that it may be inferred from the evidence of the very small number of Claimants who say would have voted differently that the evidence of the very large number of shareholders whose votes had to swing to alter the outcome of the meeting would have been to the same effect.

960. To cover off the rejection of this suggested inference the Claimants argue, in line with Allied Maples [1995] 1 WLR 1602 (recently considered in Perry v Raleys [2019] UKSC 5 and Moda International Brands v Gateley [2019] EWHC 1326 (QB)) that whilst each Claimant must prove on the balance of probabilities how they would have reacted to the incremental information, they have only to show a real or substantial chance that the requisite number of other shareholders would have joined them to defeat the proposal. I think such an analysis sits uneasily in the context of company general meetings with their settled remedies for the protection of minority rights and for the correction of inequitable decisions. I think it is the law that a dissentient shareholder is bound by the result of a company meeting unless he can demonstrate that the business before the meeting was not fairly put (so that its outcome must be set aside) or there was oppression of the minority. I do not think it is the law that a dissentient shareholder is bound by the result of the meeting but can nonetheless seek compensation for breach of equitable duty (ultimately from the company) on the footing that he has lost the chance that the meeting might have reached a different view.

961. But let me grant that the analysis is sound. Assume that a defeated shareholder may allege that the directors are in breach of some duty to him and that but for their breach of duty either his proposal had a chance of acceptance by the general meeting or their proposal had a chance of rejection, for the loss of which he must be compensated. In the instant case that chance must be deep into the "speculative" end of the spectrum.

962. This is an action by a collection of individual shareholders. On this analysis each shareholder has to show that there was a real or substantial chance that had the existence of ELA been disclosed and had the existence of the Lloyds Repo been confirmed more than 1.4 billion other votes would have been cast with his own and with the existing

dissentients. Mr Hill QC submits that if the step required of an actor is clearly for his benefit then the Court will have little difficulty in concluding that it would be taken. But the step required here is to vote against the unanimous recommendation of the board made on reasonable grounds (which incorporate their assessment of the future course of events); and the supposed justification for taking that step are the suggested implications to be drawn from temporary funding arrangements. These implications (in essence that the transaction occasioned serious risks to Lloyds itself) were already spelt out in the "Risk Factors": risks arising from general and sector specific threats to the market, a further deterioration in economic conditions, further material negative adjustments to fair values, risks to borrower credit quality which might affect loan recoverability (particularly on the lower-rated HBOS corporate portfolio which was exposed to substantial increases in impairment losses), liquidity risks (especially if the Government were to withdraw liquidity support), the threat to regulatory capital posed by greater than anticipated assets impairments, reductions in Lloyds' credit ratings, all these risks and more were drawn to the attention of Lloyds shareholders. Yet 96% of the voting population supported the decision of management. That is what the expert evidence shows overwhelmingly happens: and it is what the factual evidence shows. The only factual evidence (an analysis of the disclosed voting pattern of NFU Mutual Insurance Society) showed that it voted against a management recommendation in only 0.02% of cases. The evidence of a handful of witnesses as to what they would have done is thus insufficient to establish that there was a real and substantial chance that 1.4 billion others would have joined them.

963. In my judgment it is not established that on the balance of probabilities that if the ELA and Lloyds Repo disclosures had been made then the Acquisition would not have been approved: nor is it established that there was a real and substantial chance of that outcome occurring. Accordingly the third causal chain is not established.

The result

964. I am not persuaded that the two failures to provide sufficient information were in fact causative of any loss. The information ought to have been disclosed in the manner I have indicated in order to present a fair, candid and rounded view of the question before the Lloyds shareholders. But if the shareholders had been presented with that information they would not have reached a conclusion other than that which they did in fact reach. Despite the imperfections in the Circular the majority who approved the Acquisition did not do so under some misapprehension of the position. They knew the course recommended unanimously by the board. They knew the risks identified by the board. They knew that the board assessed the chance of advantage as outweighing the risk inherent in the transaction. If it had been disclosed that in making that assessment and recommending the transaction, the board also knew of the grant of ELA to HBOS and the use by HBOS of the Lloyds Repo until completion of the Acquisition that would not have caused a sufficient part of the 96% majority to alter their vote (nor was there any real prospect of that occurring).

965. In the result both the recommendation and the disclosure cases fail and the claim must be dismissed.

Damages

966. This means that no question of the assessment of loss arises. But I should record that on the evidence before me I would not have awarded damages.

967. The loss that the Claimants seek to recover is either:-

a) The loss per Lloyds share occasioned by the dilution caused by (i) the acquisition of HBOS at an overvaluation and (ii) participation in the arrangements made over the Recapitalisation Weekend ("the Overpayment Measure"); or

b) The loss per Lloyds share measured as the difference between the actual value of a share in the Enlarged Group and the assessed value of a share in a standalone Lloyds (adjusted to exclude any general decline in bank shares and any element of reflective loss) (the "Diminution Measure").

968. Although capable of statement in those two sub-paragraphs Mr MacGregor's evidence supported 14 calculations resulting in a range from 74p per share to 207p per share.

Remoteness

969. The Defendants submit that each measure seeks to recover in respect of loss that is too remote, and that no Claimant can establish that the board owed a duty in respect of the kind of loss claimed. As a first step they submit that the disclosures relating to ELA and the Lloyds Repo are the provision of incremental information feeding into an overall assessment of the merits of accepting or rejecting the board's recommendation: and that since the disclosures relate to the provision of information the Defendant directors can only be responsible for the consequences of the information being incomplete. As a second step they submit that the incompleteness of the information about HBOS had no impact on the share price of Lloyds.

970. I would have accepted the Claimants' responsive argument to the first step. They argued and I accept that it is not possible to draw a bright line between the provision of advice and the provision of information. Here the board was bound to provide a recommendation together with all information necessary to enable a decision to be taken: they shaped the information that was provided to the shareholders and guided the decision-making process. If (as on this counterfactual hypothesis is the case) the absence of information about HBOS' use of ELA and the existence of the Lloyds Repo was critical to the decision whether or not to approve the transaction then I would have held that remoteness was not a bar to recovery of loss flowing from the approval of the transaction.

971. As to the second step (if relevant) I note that there is no evidence that the disclosures could have had any adverse impact on the *Lloyds* share price (which is what the quantum claims focus upon). The only suggestion is that if loss is to be assessed at the date of completion Lloyds' share price was in fact at that date *inflated* (see the Claimants' Closing at para.1972ff). I address this below.

Overpayment

972. The argument here is that the non-disclosure of ELA and of the Lloyds Repo artificially inflated the price of an HBOS share so that when the share-for-share exchange occurred under the fixed ratio the Lloyds shareholders gave away more than they gained. The economic value of their shares in the Enlarged Group is different from what it should have been. I would not have awarded any damages on this basis.

973. First, the Claimants advance this case on the basis that HBOS was valueless to Lloyds. But they adduce no actual "valuation" of HBOS (as is conceded) and I have not accepted the argument that, as a matter of principle, simply because HBOS faced liquidity difficulties it is to be treated as insolvent and subject to wholesale nationalisation that would have wiped out all shareholder value. Second, and I say this with some hesitation, if the directors did cause an overpayment for HBOS then that is a matter for the company to pursue (either directly or through a derivative action). Any individual shareholder seeking to recover that loss by means of some other cause of action would be met by an argument grounded in the principle of "reflective loss".

974. I would have accepted the argument of Mr Hill QC that the burden lies on the Defendants to demonstrate that the "reflective loss" principle applies. The burden would not appear difficult to discharge. If Lloyds had acquired the HBOS shares for a cash consideration there is no doubt that Lloyds would have had a cause of action against any directors who negligently overpaid: and it would be for current directors or for the shareholders in general meeting (either effectively directing the existing board or by electing a new board) to cause the company to pursue that claim. If neither the directors nor a voting majority of shareholders wanted to pursue the claim, then a group of shareholders could seek to pursue a derivative action. In each case the recoveries would form part of the assets of the company. Does the fact that the consideration was not a cash payment but a new Lloyds share make any difference? Does it mean that individual shareholders can take for themselves what would otherwise have been available to the company and its creditors?

975. Mr Hill QC submitted that the Australian decision in <u>Pilmer v Duke Group Limited</u> [2001] BCLC 733 demonstrated that it did: and he referred to the analysis of Dr Fidelis Oditah in "Takeovers, shareholders and the meaning of loss" (1996) 112 PQR at 425. Shortly put, the argument is that the predator company acquires the target's assets at no cost to the predator company because the predator company itself has never been entitled to the bundle of rights represented by one of its shares.

976. The Defendants countered with the argument (based on <u>Osborne v Inspector of Taxes</u> [1942] 1 All ER 634) that when a company issues shares credited as fully paid in return for control of assets it is giving up the right to call for the payment of the par value in cash, and the par value of the new shares is the consideration provided by the predator for the assets taken over.

977. As a matter of principle I would have favoured the argument of the Defendants and held that to the extent that any diminution in value through dilution of the old Lloyds shares is attributable to an overpayment for HBOS assets it is not recoverable by the Claimants as individual shareholders: I would, however, have recognised that that approach cannot provide a completely satisfactory answer (i) because an enhancement of the assets of the Enlarged Group operates for the benefit of all shareholders (including the overpaid

ex-HBOS shareholders) and (ii) if the measure of overpayment exceeds the par value of the newly issued shares then that excess can only have come from the existing Lloyds shareholders (as the careful formulation of the Claimants' damages claim, which seeks to strip out reflective loss, postulates). But I would have been bound to hold that 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).

978. I should note that both Mr Hill QC and Ms Davies QC addressed reflective loss arguments only in the context of the "diminution" case and on the footing that the Defendant directors were liable for a negligent recommendation: hence the hesitation with which I express this view. But it seems to me as a matter of principle to apply also to the "overpayment" claim.

979. Finally, I would not have awarded compensation based on dilution arising from the Recapitalisation Weekend. During that weekend the Lloyds board faced a choice each limb of which required Lloyds to undertake an inevitably dilutive capital raise. They could not avoid that choice. There was no prospect of avoiding any capital raise at all.

Diminution

980. The Claimants' case was quite complicated. In essence it seeks to measure the difference between the value of a share in the Enlarged Group and the assessed value of a share in a "standalone" Lloyds as at the Acquisition date. It does so on the footing that the Claimants succeed in their "negligent recommendation" case). Mr MacGregor first sought to identify "Pre-Acquisition Loss". For this he takes as his starting point the actual Lloyds share price on 17 September 2008 and as his end point the actual Lloyds share price on 15 January 2009 (the day before completion). He then compares that with the hypothetical share price of a "standalone Lloyds" on 15 January 2009, recalibrated from 17 September 2008 by reference to an index of banking stocks. This, of course, assumes that the Announcement had never been made.

981. This exercise does not enable one to calculate the loss claimable by a Lloyds shareholder if the EGM had rejected the board's recommendation. On the assumption that one divides the loss calculation in the manner suggested, I think one has to look (in relation to the "Rejection" case) to compare the actual price of a Lloyds share at the date of the EGM in the events which actually happened with the hypothetical price of a Lloyds share on that date on the assumption that the EGM had not approved the merger (because of the disclosures) and Lloyds remained "standalone". But it is not possible to undertake that exercise on the evidence.

982. Mr MacGregor then sought to identify "Post-Acquisition Loss": this is the "loss" caused by the *overvaluation* of the shares in the Enlarged Group following the Acquisition because the market "was not yet….aware of the full extent of HBOS position". The "loss" is caused when this inflation of the Enlarged Group's share price is dissipated by the release to the market of the true position. I have difficulty in seeing that reversion to "true" value is a loss recoverable by an existing holder (as opposed to it being claimed by a purchaser at an inflated price).

983. Mr MacGregor takes as his starting point the Lloyds share price as at 15 January 2009 which he opines will have been driven primarily by the market's view of the imminent

Enlarged Group (and not by Lloyds as a standalone): I accept that opinion. He says that a "standalone" Lloyds would have been valued differently: I accept that that is possible.

984. Mr MacGregor then suggested three approaches to calculating post acquisition loss. The first is an attempt to calculate as at 15 January 2009 the value of a "standalone" Lloyds share diluted by the issuance involved in the transaction and adjusted for the value added to the Enlarged Group by merging HBOS. The method was not pressed. It is dependent upon there being a valuation of HBOS (which there is not). I would not have awarded damages on this basis.

985. The second is to take as a starting point the price of a "standalone" Lloyds share on 17 September 2008 and as an end point the price of a share in the Enlarged Group as at 26 February 2010 (by which time all information must have been in the market). The starting price of a Lloyds share is then adjusted by reference to a banking index and recalibrated to 26 February 2010. The end price of a share in the Enlarged Group is then adjusted to take account of issuance. The two adjusted prices are compared. The difference between the two is said to constitute the loss. It is said that under this method loss is not being calculated as at 26 February 2010, but rather that events down to that date are being used to illuminate "the true value" (as opposed to the market value) of a share in a "standalone" Lloyds at the completion date.

986. Although this method does not depend on a valuation of HBOS it does commence analysis as at 17 September 2008 (for which on my findings there is no warrant). I would not have awarded damages on that basis.

987. If the Court was to adopt this approach it would have to take as a starting point the price of a share in a "standalone Lloyds" as at 3 November 2008 to be its actual share price at that date (reflecting the proper state of market knowledge at that date). That was more than 50% lower than Mr MacGregor's starting point. From that base it would be necessary to recalibrate the Lloyds share price by reference to a banking index (whose constituent members all have all relevant information in the market reflected in their price), but taking into account the adverse effect of the rejection of the board's recommendation and the systemic shock caused by the failure of the Tripartite's stabilisation strategy; one might then reach a hypothetical "standalone" share price for Lloyds at the Acquisition date. Only if there were clear evidence that in the period 15 January 2008-26 February 2010 some disclosure was made that caused a shift in the share price at the disclosure date would any further adjustment need to be made. The Acquisition date is the date upon which the actual dilution of the Lloyds shares took place and the date from which the Enlarged Group was created. It would then be necessary to establish the date upon which (in this counterfactual world) Lloyds would have raised £7bn: and to establish the terms on which the Tripartite would have offered to take that capital. That recalibrated price could then be compared with the actual price of a Lloyds share on that date. Only then would it be possible to assess "loss". But none of that is possible on the evidence adduced.

988. The third approach was to take the actual share price of a share in the Enlarged Group on 26 February 2010 (by which date it is assumed full disclosure has been given) and then try to work backwards to the Acquisition date, recalibrating that share price by reference to a bank index to see what the price of a "standalone" Lloyds share might have been. This approach suffers from the twin methodological flaws of indexing over a sustained period (where shortcomings in the index become magnified) and in

assuming that any departure from the indexed performance must be attributable to some disclosure; and as a matter of principle I am unconvinced that it is proper to take some distant post-event date and then try to work back towards the assessment date. Critically it includes the actual disclosure on 24 November 2009 of the use by HBOS of ELA, which the market simply took in its stride. So I would not have awarded damages on this basis.

989. Of necessity the previous paragraphs address damages in general terms, because the individual claimants have not adduced evidence of what Lloyds shares they held at the date of breach, and whether they retained down to the date for the assessment of damages. No Claimant actually proved loss.

990. I should record (in case it is of any utility) my views on other disputes.

991. I find Mr MacGregor's UK Banks Index (which is weighted by capitalisation) to be preferable to that constructed by Dr Unni (i) because it includes RBS; (ii) because it employs the methodology adopted by leading index compilers; (iii) when cross-checked against a sample period it has a high correlation with known events. I would not use it to compute mathematically to the nearest 0.01p the loss per share, because there are sensitivities for which allowance might properly be made. But I would have taken it as a good guide.

992. Amongst the sensitivity adjustments I would have made would have been an allowance for the effect of a rejection of the Lloyds boards' recommendation of the Acquisition. In my judgment that rejection would have had a very significant effect (i) on the market generally (and in particular on bank sector shares) since it would have removed a central plank of the Tripartite's strategy for the restoration of financial stability; and (ii) a particular idiosyncratic effect on Lloyds (whose management would have lost credibility). Accordingly, Mr MacGregor's UK Banks Index would have to be adjusted for this disruptive event; and there would need to be a specific further reduction in Lloyds's hypothetical "standalone price".

993. As to general contagion I agree with Dr Unni's opinion that a rejection would have triggered a reaction in the sector. It seems to me obvious (given (i) the Tripartite's oft-stated concern to avoid disorder in the affairs of a systemically important institution like HBOS and (ii) the nervousness of the market when the possibility of the Acquisition not completing emerged) that the necessity to abandon the Tripartite's plan and to fall back on a partial nationalisation of HBOS would have effects beyond Lloyds and HBOS themselves. In this connection I have already referred to analyst's comment: I would add the succinct observation of Robert Peston soon after the Announcement:-

> "If [Lloyds'] takeover of HBOS were to collapse, HBOS itself
> would collapse and we'd all be staring into the abyss"

It would have been the unplanned rejection by the Lloyds shareholders of the Government's package (clearance of the merger and a capital contribution) that would have been disruptive, more than the emergency partial nationalisation compelled by the adverse vote (partial nationalisation having always been in the background as less desirable option). I am unsurprised that amongst the various "events analyses" undertaken no real comparable can be found.

994. On my findings these points do not arise for decision.