Still a capital outcome: CoCos can be redeemed

The Supreme Court has, by a majority, upheld the Court of Appeal's decision that, on the interpretation of the relevant terms, a bank is entitled to redeem convertible contingent securities because they had ceased to help the bank to pass the PRA's stress tests. The Supreme Court perhaps took a more restrictive view as to what could be taken into account in determining what the words in question meant, but still reached the same conclusion.

"Over the past 20 years or so, the House of Lords and the Supreme Court have given considerable (some may think too much) general guidance as to proper approach to interpreting contracts and indeed other commercial documents, such as the Trust Deed in this case." So said Lord Neuberger in *BNY Mellon Corporate Trustee Services Ltd v LBG Capital No 1 plc* [2016] UKSC 29, before going on to express no surprise that the Court of Appeal should have differed from the first instance judge or that there was a dissenting minority in the Supreme Court. The meaning of the relevant words was, he thought, "a difficult question to resolve", which is often the case in changing circumstances.

The issue

The case concerned contingent convertible securities (referred to as enhanced capital notes, or ECNs) issued by a bank in 2009 in order to help meet its capital requirements. The ECNs constituted lower tier 2 capital on issue but converted to core tier 1 (in this case, shares) if the bank's core tier 1 ratio fell to 5%. Banks were at that time required to have a core tier 1 ratio of at least 4%. As a result, the ECNs helped the bank pass the regulator's stress tests because if the bank's core tier 1 ratio fell below 5% in the test, the ECNs were treated for the purposes of the test as having converted and thus as boosting the bank's core tier 1 ratio.

Bank capital requirements have not stood still since 2009. Basel II has been succeeded by Basel III and the EU's CRD I by CRD II, III and now IV. Core tier 1 has been replaced by the more restrictive common equity tier 1 (CET 1) and lower tier 2 by additional tier 1. Further, banks are required to hold a CET 1 ratio of at least 4.5%.

The terms of the ECNs recognised that change in capital requirements was coming. They provided that the bank could redeem the ECNs:

> "if as a result of any changes to the Regulatory Capital Requirements or any change in the interpretation or application thereof by the FCA, the ECNs shall cease to be taken into account in whole or in part... for the purposes of any "stress test" applied by the FSA in respect of the Consolidated Core Tier 1 Ratio"

All the judges in the Supreme Court agreed with the two lower courts that the reference to Consolidated Core Tier 1 in this clause should be read as a reference to the top tier of capital at the relevant time. They accepted that this interpretation involved a departure from the literal meaning of the words, but considered that it was clear that something had gone wrong with the drafting and that it was clear what the correction should be.

This left as the principal question whether, in the words of Briggs LJ in the Court of Appeal, it was sufficient that the ECNs "continue to be taken into account for some purposes in the stress-test now applied by the [PRA], which in my view they do, or must they play a part in enabling [the bank] to pass that test, which they clearly no longer do..." The ECNs no longer played a part in helping the bank to pass the stress tests because the bank would have failed the stress test long before the ECNs converted to common equity. Indeed, a core tier 1 ratio of 5% was said to be equivalent

Key issues

- Cocos can be redeemed despite a mistake in the drafting
- Ultimately, a pragmatic approach should be taken to the words used

to a CET ratio of 1%, so the bank would have to fail the stress test by a wide margin before the ECNs were converted into shares.

The decision

The majority of the Supreme Court considered that where publicly traded debt securities are concerned, "very considerable circumspection is appropriate before the contents [any other] documents are taken into account" in construing the relevant terms. Nevertheless, the majority referred to the capital environment at the time of issue, commenting that while not all purchasers of the ECNs would be sophisticated, it would be appropriate to assume that they had advice from reasonably sophisticated and informed advisers before purchasing such "moderately complex financial products".

Against that background, the main contention between the majority and the minority in the Supreme Court was whether being "taken into account" in a stress test was a practical requirement or whether it only referred to the eligibility of the ECNs to be taken into account.

The majority took the practical line because they considered that the background showed that the ECNs were issued for the purpose of helping to pass the stress-tests; the changes in the regulatory requirements meant that the ECNs could no longer do this. Further, if that were not the case, the ECNs would never be redeemable under this provision since the ECNs converted into shares, which would always be relevant in any stress test.

The minority considered that redemption of the ECNs could not depend upon how the bank fared in any actual stress test or on the regulator's rules and practices in conducting such tests. The ECNs were long term notes, which could not have been intended to be redeemed early except in some extreme event undermining their intended function, which had not happened. The utility to the bank of the ECNs had been much reduced because of the stricter capital requirements, but the ECNs still featured in stress tests.

Conclusion

The minority observed that, although the case was of considerable financial importance to the parties, it raised no questions of wider legal significance. The issue was what the particular words meant, against the limited background that could properly be taken into account in construing them. The judges who heard the case, from first instance to Supreme Court, split 6-3 on that meaning, the majority taking the wider, perhaps more pragmatic, approach. Interpreting a contract is not always easy, even for the most senior judges.

Contacts

Paul Deakins
Partner

T: +44 20 7006 2099
E: paul.deakins
@cliffordchance.com

Stewart Dunlop
Partner

T: +44 20 7006 2787
E: stewart.dunlop
@cliffordchance.com

Simon Sinclair
Partner

T: +44 20 7006 2977
E: simon.sinclair
@cliffordchance.com