



23 January 2013

PRESS SUMMARY

Lloyds TSB Foundation for Scotland (Respondent) v Lloyds Banking Group Plc (Appellant)
[2013] UKSC 3
On appeal from [2011] CSIH 87; [2011] CSOH 105

JUSTICES: Lord Hope (Deputy President), Lord Mance, Lord Clarke, Lord Reed and Lord Carnwath

BACKGROUND TO THE APPEALS

In 1986, upon the flotation of the TSB Group plc, four Deeds were agreed and executed by which the appellant covenanted to provide four charitable foundations with payments totalling 1% of the TSB Group's pre-tax profits. The respondent was one of those charitable foundations. The original Deed was executed in 1986, amended in 1993 and replaced in 1997. Under Clause 2 of the 1997 Deed, the appellant covenanted to pay the respondent the greater of either (a) an amount equal to 0.1946 per cent of the Pre-Tax Profits for the relevant Accounting Reference Period or (b) the sum of £38,920. The term "Pre-Tax Profits" was defined in Clause 1 of the Deed as "in relation to any Accounting Reference Period... respectively the 'group profit before taxation' and the 'group loss before taxation' (as the case may be) shown in the Audited Accounts...".

At the time the Deed was entered into and at all times thereafter up until 2005, only realised profits were included in the consolidated income statement (the modern equivalent of a profit and loss account). This changed in 2005 as a result of the passage of the Regulation (EC) 1606/2002 which required that any "gain on acquisition" arising from a bargain purchase be recognised on the profit and loss account as of the acquisition date in line with International Financial Reporting Standards requirements.

During the financial crisis in 2008, Lloyds TSB Group acquired HBOS. As a result of the acquisition, the appellant's group Audited Accounts for 2009 included a figure for "gain on acquisition" of over £11 billion. This figure reflected the difference between the book value of HBOS's assets and the consideration given by Lloyds Bank of about half that amount.

The inclusion of the "gain on acquisition" had the effect of converting a loss of over £10 billion into a profit before taxation of over £1 billion in the appellant's Audited Accounts. The respondent asserts that this latter figure constitutes the group profit before taxation shown in the Audited Accounts, with the effect that they are due to receive a payment of £3,543,333 from the respondent pursuant to Clause 2 of the Deed. The appellant rejects this assertion and contends that it was unthinkable prior to 2005 that an unrealised "gain on acquisition" would be included in the consolidated income statement; indeed its inclusion would have been contrary to both the law and accounting practice. Accordingly, the appellant contends that the figure for "gain on acquisition" should be disregarded for the purposes of calculating the payments due to the respondent, with the effect that they should receive the fixed sum of £38,920.

The Outer House of the Court of Session found for the appellant and the Lord Ordinary granted decree of absolvitor dismissing the claim. The Inner House of the Court of Session allowed the respondent's appeal. The appellant appeals to the Supreme Court on the grounds that on its proper

construction the figure for “gain on acquisition” should be disregarded when calculating the payments due under the Deed.

JUDGMENT

The Supreme Court unanimously allows the appeal and restores the Lord Ordinary’s decree of absolvitor dismissing the claim.

REASONS FOR THE JUDGMENT

- The Deeds should be understood in the legal and accounting context at the dates when they were executed. In this respect, when the original Deed was made in 1986, amended in 1993 and replaced in 1997, two fundamental legal and accounting principles applied: (a) that a profit and loss account was concerned with ordinary activities before taxation and (b) that only profits realised at the balance sheet date could lawfully be included in the profit and loss account [7].
- The Deed should be given a contextual and purposive interpretation [21]. Here the landscape, matrix and aim of the 1997 Deed were concerned with and aimed at realised profits or losses before taxation [22]. The change introduced in 2005 by Regulation (EC) 1606/2002 which required that negative goodwill be recorded in the profit and loss account as a “gain on acquisition” was wholly outside the parties’ original contemplation and is something they would not have accepted had they foreseen it [22].
- Given that the 1997 Deed did not require an unrealised “gain on acquisition” to be taken into account in identifying the “group profit before taxation”, it is circular to try and draw any inference from the fact that the parties did not renegotiate or amend the Deed [14, 17].
- Nor does the phrase “group profit before taxation... shown in the Audited Accounts” have the effect of tying the appellant to any similarly phrased line which may be found in a future year’s Audited Accounts, no matter how different the basis on which that figure is arrived at from that which existed or was in mind when any of the Deeds were executed [20].
- As the Deed has not been frustrated, it is necessary to determine how its language best operates in the fundamentally changed and entirely unforeseen circumstances in light of the parties’ original intentions and purposes; this is best achieved by ignoring the unrealised “gain on acquisition” in the 2009 accounts [23].
- Ignoring the figure for “gain on acquisition” would not pose difficulties in later accounting periods [26-28]. Indeed, it is inconceivable that the parties could have intended the respondent to derive from an unrealised gain a benefit it could not derive from a realised profit yet this could occur were HBOS to be sold at a profit over and above its ‘fair value’ as such a realised gain would be excluded from the calculation under the Deed [29].
- The doctrine of equitable adjustment forms part of Scots law and resort may be made to it in cases where the contract has become impossible of performance or something essential to its performance has been totally or partially destroyed [46]. However, the Court cannot equitably adjust a contract on the basis that its performance, while not frustrated, is no longer that which was originally contemplated [44, 47].

References in square brackets are to paragraphs in the judgment

NOTE

This summary is provided to assist in understanding the Court’s decision. It does not form part of the reasons for the decision. The full judgment of the Court is the only authoritative document. Judgments are public documents and are available at:

www.supremecourt.gov.uk/decided-cases/index.html