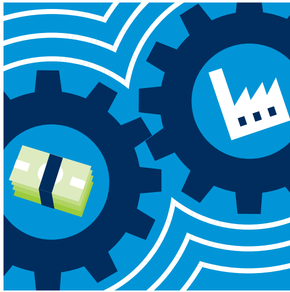

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Northern Rock

From nationalisation to potential litigation?

Alarna Carlsson-Sweeny of **PLC** talks to **Robert Falkner** of **Morgan Lewis, Andrew Head** of **Forsters** and **Jennifer McDermott** of **Withers** about the potential grounds for shareholder litigation arising from the nationalisation of Northern Rock.

Alistair Darling's announcement on 17 February 2008 that Northern Rock would be taken into "temporary public ownership" marked the first nationalisation of a sizable British bank for more than 25 years. The decision to nationalise and subsequently rebuild the beleaguered lender poses a number of potential legal difficulties for the government, not least from disgruntled shareholders who have threatened legal action if they do not receive what they perceive to be compensation for the loss of their shares (*see below, Shareholder compensation*).

However, according to Robert Falkner, a partner at Morgan Lewis: "Despite some enthusiastic pronouncements about taking the government to court, investors are in a difficult position. It would be an uphill battle for them to succeed in any legal action."

As well as dealing with the shareholders, the government is also treading carefully to avoid a perceived distortion of competition in the mortgage and lending market, and to keep on the right side of EU state aid rules (*see box, State aid*).

The road to nationalisation

In September 2007, news of an emergency Bank of England loan to Northern Rock triggered the first run on a British bank in more than a century. Once the bank had been stabilised, the government came under intense pressure to secure repayment of the £25 billion loan of taxpayers' money, as well as to offload the guarantees the Treasury gave the bank's creditors, which amount to an estimated £30 billion. The government's preferred solution was to find a private-sector buyer. However, ultimately there were only two bids on the table: one from the Virgin Consortium and the other from Northern Rock's management. The government rejected both bids because, as Mr Darling said, "the numbers didn't stack up", particularly given the high level of continued government support sought by both proposals. Nationalisation was therefore the government's only viable option.

The process of nationalisation

Prime Minister Gordon Brown proclaimed that, despite the nationalisation, it would be "business as usual" at Northern Rock, signalling the government's plan to rebuild the bank as a going concern rather than gradually sell it off. The intention is to secure repayment of the Bank of England loan in full with interest, through gradual repayment and the proceeds from the sale of the revived lender to a private-sector buyer, when market conditions make this possible. The bank will be managed at arm's length on the government's behalf by Ron Sandler, former chief operating officer of NatWest Group and chief executive of Lloyd's of London.

The Banking (Special Provisions) Act 2008 (2008 Act), which received Royal Assent on 21 February 2008, gives the Treasury powers to transfer the ownership of UK-incorporated banks and building societies to maintain the stability of the UK financial system, or to protect the public interest in situations where the Treasury has provided financial assistance to the deposit-taker to maintain financial stability.

On 22 February 2008, the Treasury announced that it had acquired all the shares in Northern Rock, including its preference shares, and that all share options and other entitlements to shares issued by the company had been extinguished by a Transfer Order made under the 2008 Act.

Shareholder compensation

The 2008 Act provides that an Order can be made to assess the amount of compensation, if any, that is payable to holders of shares that were transferred to the Treasury. According to Andrew Head, a partner at Forsters: "The most controversial part of the [2008] Act as far as the shareholders are concerned is the terms of reference provided for the valuation of the shares."

The Order must assume for valuation purposes that all financial assistance from the Bank of England or the Treasury has been withdrawn, and that no financial assistance would be provided in the future (apart from ordinary market assistance) (*section 5(4), 2008 Act*). It can also make further assumptions in relation to whether the deposit-taker is un-

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State aid

The EC Treaty prohibits EU member state authorities from granting state aid which distorts competition and trade in the EU. Articles 87 to 89 of the Treaty provide the European Commission (the Commission) with wide-ranging powers to investigate illegally paid subsidies and to order member state governments to recover subsidies which distort the market in favour of state-aided enterprises.

The aim of regulating state aid is to ensure that companies can compete throughout the EU on a level playing field. According to Falkner: "The threshold for what will affect trade is very low, any kind of unfair advantage will be seen as affecting trade." For further background on state aid, see *Practice Note, Competition regime: State aids* (*www.practicallaw.com/3-107-3715*).

However, the Treaty leaves room for a number of policy objectives for which state aid can be considered compatible with the common market (*Article 87(3)*), and a series of legislative acts provide for a number of exemptions.

Rescue aid

The UK authorities first contacted the Commission about the assistance provided to Northern Rock on 28 September 2007. Since then representatives from the authorities and the Commission have met and exchanged information on several occasions. In a document dated 5 December 2007, the Commission outlined its assessment and concluded that the assistance provided by the Bank of England from 17 to 20 September and on 9 October was indeed state aid as defined under Article 87(1). However, it also concluded that the aid qualified as "rescue aid" pursuant to the 2004 Rescue and Restructuring guidelines, and was therefore compatible with the common market under Article 87(3).

Under the guidelines, if certain conditions are fulfilled, rescue aid in the form of loans and guarantees is permitted for a period of six months. The aid must be subject to normal market interest rates and must be justified on the basis of "serious social difficulties". Any subsidy beyond the six-month period is illegal unless it is part of a Commission-approved restructuring or liquidation plan, or unless the loans have been repaid.

Restructuring aid

As Northern Rock was nationalised within the six-month timeframe, the authorities must now convince the Commission to convert the rescue aid to restructuring aid. The UK authorities submitted a business plan for Northern Rock on 18 March 2008.

The nationalisation measures will be assessed on their own merits according to the rules on restructuring aid. Under the guidelines, the Commission must be convinced that the restructuring plan submitted will restore the long-term viability of Northern Rock within a reasonable timeframe.

Additionally, the restructuring plan must contain measures to minimise any adverse effects on competition. If the Commission is not satisfied that competition will not be distorted, it could impose specific conditions and obligations on Northern Rock, such as divesting assets, or reducing its capacity or market presence. Aid is limited to the minimum needed to implement the restructuring measures, and the beneficiary must also make a significant contribution.

able to continue as a going concern, is in administration and is being wound up (*section 9(2), 2008 Act*).

The draft Northern Rock plc Compensation Order (Order) was laid before Parliament on 22 February 2008 and was passed through the House of Lords on 11 March 2008. Under the Order, an independent valuer will determine the value of the shares immediately before the transfer (*paragraph 3(2)*), based on the valuation assumption that Northern Rock is unable to continue as a going concern and is in administration (*paragraph 6*).

As expected, shareholders reacted angrily. Northern Rock shares were trading at £0.90 before they were suspended on 18 February 2008 after the nationalisation announcement. "Given that the valuation is to be done according to what the share value would have been worth without the Bank of England's loans and guarantees, and assuming the bank is not a going concern and is in administration, it is likely that any recovery by the shareholders will be minimal at best," says Head. Some investors have suggested that the bank had net assets of about £4 or £5 per share (*Financial Times, 20 March 2008*).

Jon Wood of the SRM Global hedge fund, which was Northern Rock's biggest shareholder with an 11.5% share, said: "We will pursue all avenues to protect that value for shareholders" (*Financial Times, 17 February 2008*). SRM has hired White & Case to explore its legal options. RAB Capital, which was the second-largest shareholder with 8.1%, has engaged Ian Binnie from Nabarro.

Additionally, some 7,000 investors have joined the Northern Rock Shareholders Action Group (NRSAG), which has hired David Greene from Edwin Coe as its legal adviser. Greene previously represented the Railtrack small shareholders against Stephen Byers, the former Secretary of State for Transport, and the Department for Transport, when Railtrack was put into administration. However, this may be of little comfort to Northern Rock shareholders, as the Railtrack shareholders' claims were comprehensively dismissed in the High Court (*see box, Misfeasance in public office*).

On 19 March 2008, the UK Shareholders Association (UKSA) on behalf of NRSAG, and SRM Global sent letters before action to the Treasury. The letters seek withdrawal of the 2008 Act within 21 days, or the shareholders will seek a judicial review (in separate actions). The core of UKSA's complaint is that the government has "rigged the basis of the valuation of the shares so that shareholders are likely to receive little or nothing" (*UKSA Press Note, 19 March 2008*).

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There are several possible avenues shareholders could pursue, including:

- Challenge the valuation of the shares.
- Bring an action for illegal expropriation of property under the European Convention on Human Rights (the Convention).
- Bring a misfeasance claim against the Chancellor.

Challenging the valuation

The independent valuer is yet to be appointed under the Order. The Treasury will make the appointment in consultation with the Institute of Chartered Accountants in England and Wales, after receiving "expressions of interest". Lord Davies of Oldham in his speech to the House of Lords said: "We will of course be looking for someone who is independent of all interested parties, with extensive company valuation skills and the ability to handle the range of relevant stakeholders" (*11 March 2008*).

According to Jennifer McDermott, a partner at Withers: "The valuer is likely to be from one of the big accountancy firms without, of course, any connection to Northern Rock. The government will want someone completely independent with a solid reputation."

The legislation provides for the right to request a reassessment from the independent valuer, and if the investor is still not satisfied with the valuation, to have the matter referred to the Financial Services and Markets Tribunal (the tribunal).

However, the tribunal is limited in what it can achieve: "There is no provision for a full appeal on the merits, the tribunal can only undertake a legal review and if appropriate refer a case back to the independent valuer," says Falkner. This could be done based on factors such as an error of process, insufficient consultation, or if the valuer acted unreasonably or outside the statutory parameters. "If the valuer followed the valuations assumptions set out in the Act there will be very little that the Tribunal can do to change the amount of compensation," adds Falkner.

The shareholders' main gripe is with the assumptions themselves. According to Head: "As the shareholders seem to view it, the government has effectively nobbled the independent valuer by inserting narrow terms of reference into the [2008] Act, namely that Northern Rock is unable to continue as a going concern and is in administration. They would argue that the government is aiming for a nil or very low valuation".

Challenging provisions within primary legislation is difficult. McDermott says: "Primary legislation can be challenged

Misfeasance in public office

Misfeasance in public office is a common law tort, which can be very difficult to prove. The tort of misfeasance in public office was unsuccessfully argued in two high profile class action cases:

Weir v Department of Transport **(Railtrack litigation)**. In 2005 proceedings were brought by almost 50,000 shareholders of Railtrack, after it was forced into administration in October 2001 when the government cut off funding. The former transport secretary, Stephen Byers, was accused of "targeted malice" (*see below*) against Railtrack shareholders as he sought to renationalise the company without compensation, and of then lying to cover up his actions.

Three Rivers District Council and ors v Bank of England **(BCCI case)**. 6,000 depositors of BCCI who lost money when the bank became insolvent as a result of internal fraud brought proceedings against the Bank of England. They alleged "untargeted malice" (*see below*) in public office and breaches of Directive 77/780/EC on banking co-ordination in wrongfully granting BCCI a licence, failing to supervise it properly and failing to revoke its authorisation.

In a preliminary ruling in the *BCCI* case in 2000, the Court of Appeal clarified the elements of the tort. In essence, the ruling confirmed there are two kinds of misfeasance by public officials: "targeted malice" and what is sometimes known as "untargeted malice". Both types of misfeasance require the defendant to have committed a deliberate and dishonest abuse of power. However, to establish liability for resulting economic injury a further mental element must be proved.

Targeted malice occurs when a public officer intentionally abuses his powers with the predominant motive of inflicting damage on the claimant. This was the basis of the claim by Railtrack shareholders, who alleged that Mr Byers intended to injure them "by impairing the value of their interests in that company without paying compensation and without the approval of Parliament". It does not matter if the public official has exceeded his powers or acted within his powers for an improper motive.

Untargeted malice, which was alleged in the *BCCI* case, is committed by a public officer who acts knowing that he has no power to carry out the act in question, and that the act will probably cause injury to the claimant. Reckless indifference to the injury may also be sufficient. The predominant motive for the defendant's act need not have been the infliction of injury.

According to Head, there appears to be no issue in the Northern Rock case in relation to an officer exceeding his powers, so any misfeasance claim would have to be brought on the basis of targeted malice. On the face of it, this type of claim stood more chance of success in the *Railtrack* case, where the judge found that Mr Byers told an "untruth" to parliament and that his explanation in court of this episode "seemed to me little above gibberish". Despite this, the judge dismissed the misfeasance claim stating that: "I have no sufficient reason to find an intent to impair the financial interests of the shareholders…as being the sole, the predominant or as any intent lying behind Mr Byers actions."

"Therefore, as matters currently stand," says Head, "any similar claim brought by the Northern Rock shareholders would be doomed to fail."

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on the grounds that it is contrary to the Convention, but the courts only have the power to make what is called a 'declaration of incompatibility' to encourage the government to change the law. However, if a challenge to the Order were successful, this delegated legislation could be quashed."

Expropriation of property

If shareholders are not satisfied with the amount of compensation offered they could make a claim for expropriation of property under the Convention. Article 1 of Protocol 1 states: "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law." So the government is allowed to acquire property if it is both in the public interest and if reasonable compensation is offered.

In determining the reasonableness of the compensation, the valuation assumptions in the 2008 Act would no doubt be raised. According to press reports, Mr Greene believes that the shares should be valued over a three-year period which reflects the length of time the vast majority of small shareholders have held their stakes in the bank (*Times Online, 18 February 2008*).

Greene's client, NRSAG, claims that: "it is grossly unethical [for the government] to set the terms of reference….when clearly the company is not in administration and is a going concern. It would not be a going concern if the government had demanded repayment of its loans but it has not done so and is unlikely to do so. Otherwise it continues to do business in a normal manner and has a surplus of assets over liabilities" (*Update No. 25, 20 February 2008*).

According to Head: "The obvious riposte to this is that the government's primary duty is to safeguard the public purse and that if it allowed the shares to be valued in the way suggested by Mr Greene and NRSAG, it would effectively be using taxpayer's money to subsidise compensation to shareholders. The Northern Rock shareholders should also have been well aware of the risk that their shares would decline in value and were free to sell their shares at any time up to the date that Northern Rock was nationalised. In these circumstances, the government's compensation proposals appear to be both reasonable and defensible".

In an expropriation claim the court would look at whether the compensation bears a reasonable relationship to the value of the property being expropriated. Falkner says: "It is very difficult to challenge the view that what's reasonable compensation is the market valuation of the amount that the shares were worth at the time the government acquired them. Why should the government pay more to compensate for value that would not have existed without its assistance?"

McDermott notes that there is some early European Court of Human Rights case law governing compensation in cases of nationalisation, such as *Lithgow and others v The United Kingdom [1986] 8 EHRR 329* which challenged the compensation offered to ship builders when their interests were nationalised under the Aircraft and Shipbuilding Industries Act 1977. However, despite the terms of compensation being, as the government admitted, grossly unfair to some of the nationalised companies, the claim in Strasbourg failed. The UK had been entitled to act as it did in the wider public interest.

In terms of the public interest element, the government would justify its actions based on the need to protect the integrity of the UK financial system and protect the taxpayers' funds tied up in Northern Rock. According to Falkner: "Although there might be questions about the route the government took to nationalisation and the way things were handled, ultimately, the decision to nationalise is a defensible one."

Even if the shareholders were able to prove their expropriation claim, any damages they receive would be limited. "The claim would be brought by judicial review proceedings in the UK and, if it were successful, the Administrative Court would award damages based on Strasbourg principles," says McDermott. "This provides for damages to ensure 'just satisfaction' only, which historically have not been high".

Misfeasance in public office

To bring a successful misfeasance claim, shareholders would have to prove that in the decision to nationalise, the Chancellor acted in bad faith, with a deliberate intention to harm shareholders' interests. "There is a very high threshold for proving the element of bad faith," says McDermott. "It is not enough to show mere negligence or that things could have been done better." Consequently, misfeasance claims rarely succeed. It was unsuccessfully argued in two high profile class action cases, the *Railtrack* litigation, and the *BCCI* litigation (*see box, Misfeasance in public office*).

"In the case of Northern Rock, finding evidence against the Chancellor to show he was acting with bad faith against the shareholders would almost certainly be difficult," adds McDermott. "A misfeasance action against the Chancellor would be a bold claim to make."

Head agrees: "It defies common sense to believe that Mr Darling or other public officers in the Treasury hatched a deliberate plan to defeat the interests of Northern Rock shareholders. There would not have been any benefit to the government in doing so".

Going forward

Given the uncertainty of their position, investors might be wary of making any claims, particularly because an unsuccessful action could lead to a hefty award of costs against them. Investors might simply be hoping to stir up enough publicity to pressure the government into increasing its compensation payment. However, Falkner says that the government is limited in its options: "In order not to cross the boundary of illegal state aid, the government must deal with Northern Rock as if it is a commercial entity. This runs counter to the position of investors who are looking for a higher amount of compensation than the market would otherwise provide."

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