LOSS RELIEF - Loans by bank to leasing subsidiary - Whether for the purposes of the bank's business or in its capacity of shareholder

THE SPECIAL COMMISSIONERS

AB BANK Appellant

- and -

HM INSPECTOR OF TAXES Respondent

Special Commissioners: PAUL W de VOIL

T H K EVERETT

Sitting in London on 1, 2, 3 and 4 February 2000



ANONYMIZED DECISION

1. AB Bank appeals against the disallowance of losses in the region of £30m -there is no dispute as to the figures. The point at issue is whether loans which it made to its leasing subsidiary J Finance Ltd were made for the purposes of its own banking business or were made for the purpose of supporting its subsidiary.

2. The following statement of agreed facts was put in:

AB Bank

1. AB Bank is the London branch of AB. Until 1998 that was a co-operative bank owned by its depositors and had its Head Office in a European country. It was incorporated under its own act of the national Parliament and its object was to act as the central liquidity manager for the national co-operative system, and to promote that system. It changed its constitution in 1998 to a form roughly equivalent to a PLC in the UK by an amending act of the national Parliament.

2. By 1989 the Bank had capital and reserves of about £1,171m and branches in London, New York and Hong Kong. It also had major subsidiaries outside its own country

in Switzerland and Luxembourg. Each of the branches were established to facilitate international business and to act as profit centres in their own right, by lending into the domestic markets in their host country. Within its own country the bank was among the top ten financial institutions with interests in fund management, insurance, mortgage lending and security dealing.

The London Branch

3. The London branch of AB Bank was opened in 1981 dealing at that time in Treasury (i.e. money market and foreign exchange) and lending activity.

4. Mr C and Mr D were joint general managers of the London branch until 1 October 1989.

5. Dr E was the general manager of the London branch of AB Bank in London (hereafter referred to as ABL) from 1 October 1989 until 31 July 1991 and was succeeded by Mr F.

London and GH Ltd

6. Additionally, in London, investment banking activity was also undertaken i.e. dealing in share and debt issues and making operating investments in companies seen as good prospects. This was undertaken by a consortium bank - London and GH Ltd ("LGH"). LGH was established in 1974 and from 1982 to 1985 AB Bank owned between 35% and 36% of the company with the remainder of the shares owned by some eleven other national co-operative institutions. In 1986 another shareholder who owned 18% sold their interest to AB Bank thus giving AB Bank control of LGH. In the subsequent three years negotiations were completed to arrange for AB Bank to acquire the whole of the share capital of LGH, which changed its name on 16 October 1989 to AB Investment Bank.

7. Dr E was managing direct of LGH from 1987 to October 1989 and was succeeded by Mr S who remained in that post until June 1990.

J Finance Limited

8. AB Bank’s interest in hire purchase and leasing developed from 1982 through a foreign leasing company called KL. KL had a UK subsidiary called KL (UK) Ltd. On 17 May 1984 ABL acquired a 49% stake in KL (UK) the other 51% being owned by LGH. KL (UK) Ltd altered its name to J Finance Limited ("JFL") on 26 March 1984.

9. Subsequently ABL’s % shareholdings in JFL were reduced in a 1:3 rights issue date 11 August 1986 which resulted in ABL’s shareholding being reduced to 25% and

LGH's being increased to 75%. This proportion was maintained in all future rights issued on 23 August 1991 when LGH transferred its 75% holding JFL to ABL. Therefore between 1987 and 1991 ABL directly owned 25% of JFL. During that same period it also had a stake in JFL through its shareholding in LGH outlined above,. From December 1986 JFL was an indirect subsidiary of AB Bank (AB Bank holding a 25% direct stake and a 75% indirect stake).

10. JFL had a number of subsidiaries and was involved in the full range of lease finance e.g. computers, office equipment, motor vehicles, commercial vehicles.

11. Mr M was the managing director of JFL from 1986 until 9 April 1991.

12. Dr E was a director of JFL between 20 May 1988 and 6 August 1991 (and chairman from 26 June 1990).

The Operation of the JFL facility

Increase in facility from £10m to £17m

13. An application dated 21 December 1988 was made by JFL to ABL to increase the credit facility from £10m to £17m.

14. In March 1989 the AB Bank's Head Office approved the increase in credit facility.

15. On 29 March 1989 ABL offered to increase the facility to £17m. This offer was accepted by JFL on 31 March 1989.

Increase in facility from £17m to £30m

16. An application dated 30 May 1989 was made by JFL to ABL to increase the credit facility from £17m to £30m.

17. In July 1989 the AB Bank's Head Office approved the increase in the credit facility.

18. On 26 July 1989 ABL offered to increase the facility to £30m. This offer was accepted by JFL on 1 August 1989.

Increase in facility from £30m to £45m

19. An application dated 17 October 1989 was made by JFL to ABL to increase the credit facility from £30m to £45m.

20. In December 1989 the AB Bank's Head Office approved the increase in the credit facility.

21. On 19 December 1989 ABL offered to increase the

facility to £45m. This offer was accepted by JFL on 21 December 1989.

Increase in facility from £45m to £60m

22. An application dated 2 July 1990 was made by JFL to ABL to increase the credit facility from £45m to £60m.

23. At a meeting at AB Bank's Head Office on 7 August 1990 approval was only given for the facility to be increased by a further £5m i.e. from £45m to £50m.

24. An application dated 4 September 1990 was made by JFL to ABL to add a guarantee facility to the existing facility. This was approved by AB Bank's Head Office on 26 September 1990.

Increase in facility from £50m

25. The AB Bank's Head Office approved a facility of £56m on 18 September 1990 and agreed to allow temporary overruns whilst the Bank decided the future of JFL.

26. By December 19990 the credit facility had risen to £57m. However by 6 December 1990 AB Bank had decided to stop ongoing funding to JFL.

27. An application dated 6 December 1990 was made by JFL replacing the then existing £57m revolving credit facility with a term loan in that sum, to

enable the portfolio to be run down in an orderly way. This facility was approved by AB Bank's Head Office on 29 January 1991.

Loans to other companies

28. As will be evident from the attached chronology ABL approved loans to certain other leasing companies during 1989/1990 namely:

(1) 10 August 1989 - N Leasing plc £3m

(2) 26 July 1990 - O Leasing plc £5m

(3) 19 September 1990 P Leasing plc £5m

Loss made on loan to JFL

29. Loss made by AB Bank on the loan to JFL is in the sum of £30,491,102. This loss arose on the term loan made in January 1991 which replaced the then existing facility of £57m.

30. The parties are agreed that the Commissioners be invited to determine this matter in principle and that the amount of any allowable deduction should be subsequently determined, if not agreed, in the light of that decision in principle.

3. The statement of agreed facts was accompanied by an agreed chronology, which reads as follow:-

1974 A consortium bank LGH. established in which AB Bank had an

investment of 36%.

1981 AB Bank opened a London branch ("ABL").

17 May 1984 ABL acquires 49% (122,500 shares) in a leasing company called JFL (formerly KL (UK) Limited; the other 51% (127,500) being held by LGH.

Mr C and Mr D appointed directors of JFL to reflect ABL

interests.

6 June 1984 ABL inject £245,000 into JFL as part of a 2:1 rights issue.

16 November 1984 ABL and LGH issue joint facility to JFL. Revolving cash

facility of £2.5m and a guarantee facility up to £12.5m.

21 June 1985 Revision to facility letter of 16 November 1984.

5 February 1986 A B Bank's Head Office asks Mr C for up to date financial

information on JFL to allow an efficient audit to take place.

21 May 1986 Mr D supports the proposal that ABL increase its capital stake

in JFL providing that Mr M spends 95% of his time with JFL.

Sees no need to obtain outside funding - profit on lending to be

made by the shareholders.

26 May 1986 Head Office paper:

(1) suggesting growth of JFL's "relevant market" to £25-

£30

billion

(2) noting that present gearing ration is 15:1 and that in the UK

6:1 is more normal

(3) suggesting that capital be increased to £3m but that

additional capital is not to be used to acquired third party

funding.

(4) suggesting that ABL's direct share in JFL business be

reduced from 49% to 25%.

10 June 1986 Head Office approve recommendation of 26 May 1986

11 August 1986 JFL carry out rights issue altering the ownership as follows:

ABL 25%, LGH 75%.

22 August 1986 M reports that with the concurrence of its shareholders JFL

is looking initially to AB Bank as its source of funding which

would no longer be pro rata to each shareholder.

12 December 1986 ABL grant JFL revolving credit facility of £3m.

4 March 1987 ABL and LGH agree to amend their 16 November 1984

facility to JFL so as to reflect their altered shareholding in JFL.

9 April 1987 JFL send to ABL set of annual accounts for the 9 months to

31 December 1986

2 June 1987 M requests an increase in the ABL facility to £5m. Notes that

ABL have the 1986 accounts, an information memorandum of

March 1997 and in March 1997 two ABL representatives on

the board of JFL received "the first quarterly report".

16 June 1987 Formal credit application prepared by credit department of ABL

to increase facility of JFL from £3m to £5m.

26 June 1987 ABL executive board approve increase in JFL credit facility

from £3m to £5m.

2 July 1987 Memorandum from M complaining of delay in approving facility increase.

21 July 1987 ABL issue facility letter increasing JFL revolving credit facility

from ABL.

9 September 1987 M paper to the JFL board warning of increased costs of rapid

expansion.

10 September 1987 M reports loss of £50,000 due to insolvency of customer. Main

lesson is not to provide finance to intermediaries only to end

users.

17 September 1987 M reports that Q Financial Services Limited wished to terminate

their agreement with JFL. Reports that this is not a negative

development in the medium term. JFL Management was

considering terminating the contract at the end of 1988 in any

event.

30 October 1987 M reports to the JFL board with a Group balance Sheet and a

profit and loss account as at 30 September 1987. He notes that the operating surplus continues at 7% ahead of budget.

20 November 1987 JFL board meeting at which a 28 page budget and plan 1988 was approved. Resolved to increase authorised capital from

£3m to £5m and paid up capital be increased from £1.5m to £2m.

23 November 1987 JFL make application to ABL for increase in facility from £5m

to £10m (as approved at the JFL board meeting and attach

Group Budget and Plan for 1988.

24 November 1987 M memo to AB Bank's Head Office recording that he under-

stood that the JFL Budget and Plan 1988 had been forwarded

to them and providing a synopsis.

1 December 1987 M reports to ABL an opportunity to purchase 1,200 new

accounts with receivables of £2.4m. Requests shareholder

decisions on capital increase and on increase in facility.

Formal credit application prepared by credit department of

ABL to increase facility of JFL from £5m to £10m.

7 December 1987 Internal AB Bank memorandum requesting "internal

supervisory submission" on JFL.

11 December 1987 Internal AB Bank memorandum to Head Office recommends

increase in JFL's capital by £500,000 and notes that in the UK

a gearing ratio of 6:1 is expected for a company of JFL's size.

17 December 1987 LGH memorandum to AB Bank's Head Office outlining JFL's

strategy, commenting on appointment of four more staff, stating

that M’s budget is justifiable and that his budgets have "always

been cautious". Also stating that "the last years achievements

show M is capable of leading an organisation".

December 1987 AB Bank’s Head Office approves increase in JFL facility.

22 December 1987 ABL offer to increase JFL revolving credit facility from £5m to

£10m.

30 December 1987 JFL carry out a rights issue. ABL inject £125,000 of capital

into the Company (Respective shareholdings remain unaltered).

4 January 1988 JFL accept increased credit facility.

16 February 1988 JFL board meeting at which statutory accounts for year to

31 December 1987 are approved - show pre-tax profit of

£166,465.

4 May 1988 AB Bank remind ABL of its review dated 30 June 1988 and asks for a credit review in relation to JFL.

16 May 1988 M seeks an amendment to existing facility to allow drawings for

up to 2 years having regard to the nature of the underlying lease contracts.

20 May 1988 Board meeting of JFL at which DR E appointed director of JFL.

Board meeting noted and discussed M’s "5 year plan". The

board agreed with the new aim of £50m of new business per

annum using large number of brokers. Supported 2 year

utilisation request.

23 May 1988 Credit application and Credit Review prepared by ABL in

relation to JFL application to amend facility to extend utilisation

to 2 years.

July 1988 ABL executive board approve extension of JFL facility

(utilisation period to 2 years).

19 September 1988 Amendment to JFL £10m facility by extending utilisation period

to 2 years.

9 December 1988 Internal AB Bank memorandum approving of capital increase of

£500,000 by ABL and LGH - noting that JFL had "exceeded its

scheduled targets in 1988 in almost all areas" ... and noting "a

further upward business trend is anticipated for the financial

year 1988 ...". Noting that in the UK a gearing ration of 6:1 is

expected and that therefore JFL was planning to increase its

paid up capital.

13 December 1988 JFL board meeting at which the "5 year plan" was discussed and

the "Budget & Plan 1989" approved. New business to increase

by 70% per annum. Group's borrowing requirements stated to

be around £45m by 1991. Resolved to seek an increase in share

capital so as to remain within agreed gearing limits and to apply

to ABL for an increase in the facility to £17m. Agreed that

JFL

should submit accounts directly to AB Bank's Head Office one

month in arrears.

JFL application to increase ABL facility from £10m to £17m.

20 December 1988 ABL Bank Head Office approves introduction of further

£500,000 capital to JFL.

21 December 1988 Credit application prepared by credit department of ABL to

increase facility of JFL from £10m to £17m to which was

attached a "5 year plan" requiring funding of £45m by 1991.

23 December 1988 LGH writes to JFL in relation to the need for LGH consolidated

accounts.

29 December 1988 JFL carry out a rights issue. ABL inject £125,000 capital into

the company. Respective shareholdings unaltered.

4 January 1989 AB Bank internal memorandum recording a meeting at Head

Office on the 11 November 1986 at which the participation of

the Bank in the share capital of JFL was agreed upon.

12 January 1989 M writes letter to LGH regarding his consolidation request.

16 January 1989 Reply from LGH referring to the consolidation of accounts as

an "administrative accounting exercise within the LGH Group".

10 March 1989 M informs ABL that JFL had applied to National Westminster Plc to double its overdraft to £200,000 and seeks the response

of AB Bank to the provision of a "letter of awareness" in

relation thereto.

14 March 1989 AB Bank asks ABL for a detailed analysis in relation to JFL.

March 1989 AB Bank’s Head Office approves increase in JFL facility to

£17m.

29 March 1989 ABL offer to increase JFL revolving credit facility from £10m to

£17m.

31 March 1989 JFL accept increased facility.

10 May 1989 JFL request ABL to arrange the provision of a letter of

comfort.

19 May 1989 Request from JFL to increase £17m facility to £25m having

regard to quicker than budgeted growth the existing limit would

be exhausted by the summer.

22 May 1989 Internal memo from ABL to AB Bank in relation to provision of

letter of comfort.

26 May 1989 Formal credit application prepared by credit department of ABL

to increase facility of JFL from £17m to £30m. Annual review

credit analysis also prepared.

2 June 1989 JFL agreed at a board meeting that:

- they should not seek from ABL a "limit" to the funding they would be willing to supply, but that "AB Bank should benefit from lending to the Company, rather than a third party ..."

- they would apply to ABL to increase their credit limit to £30.

19 June 1989 M informs ABL that only £1m of the current facility is left for

use and seeking a positive reply to the request for additional

funds.

26 June 1989 ABL carry out credit analysis on JFL for 1988. Conclusion is

that pre tax profit almost reached its budgeted level and

forecasts for 1989 seem to be on target.

28 June 1989 Internal memorandum regarding the progress of the JFL

application for an increase in the facility. Talk of excess

approvals and mention of the fact that JFL was a member of the

AB Bank "family" and that consequently everything would

require head office approval.

ABL send telex to Head Office chasing progress on the

application for an increase in the JFL facility.

AB Bank legal department return suggested wording for letter

of comfort.

13 July 1989 Internal memorandum by M to the JFL board about the

progress of the application for facility increase and the fact of

ABL authorising an £2m overrun.

Memorandum sent to ABL.

Internal memorandum by M to the JFL board about the need for

the increase in the facility and to the fact of the existence of

£2/3 approved undrawn loans "awaiting take up".

July 1989 Head Office of AB Bank approves increase of JFL facility from

£17m to £30m.

26 July 1989 ABL offer to increase JFL credit facility from £17m to £30m.

1 August 1989 JFL accept increased facility.

3 August 1989 AB Bank Head Office seeks information on JFL subsidiaries.

8 August 1989 JFL memorandum entitled "The Next Four Years".

Distributed to JFL board and to members of AB Bank Head

Office.

10 August 1989 ABL grant N Leasing plc a facility of £3m.

29 August 1989 Meeting of Head Office at which reservations as to the

direction of JFL were expressed.

5 September 1989 M meets with members of Head Office.

7 September 1989 JFL board meeting at which:

- M’s meeting at Head Office was noted.
- it was agreed that there should be a slow down in the rate of growth.
- AB Bank’s view that capital injections into JFL should be suspended until 1990 was recorded.
- Provisions policy discussed.

29 September 1989 JFL apply for an increase in the facility from £30m to £45m

and anticipate that there would be a requirement for £60m by

31 December 1990. Seek a response "within a responsible

timescale".

1 October 1989 Dr E appointed General Manager of ABL.

3 October 1989 JFL resolve in board meeting to apply for an increase in its

facility from £30m to £45m. "Budget and Plan 1990" approved

by the board.

16 October 1989 LGH changes its name to AB Investment Bank Limited.

17 October 1989 Formal credit application and Credit Analysis prepared by

credit department of ABL to increase facility of JFL from £30m

to £45m.

8 November 1989 Internal AB Bank Head Office memorandum about procedure

to be adopted for submissions on the JFL loan application of

23.10.89.

28 November 1989 Internal memorandum from M to JFL board relating to the

"fiasco of protracted waiting" in relation to the consideration

of the application for an increase in the facility.

12 December 1989 AB Bank's Head Office approves increase in JFL facility from

£30m to £45m.

JFL board meeting at which credit policy/provisions and 1989

results were discussed.

19 December 1989 ABL offer to increase JFL credit facility from £30m to £45m.

21 December 1989 JFL accept increased facility.

31 December 1989 JFL annual report and accounts.

29 January 1990 AB Bank send JFL comfort letter in its final

form.

27 February 1990 JFL board meeting concentrating on issue of provisions.

28 March 1990 JFL board meeting. 1989 accounts approved. Possibility of

AB Bank selling JFL to AB Leasing mentioned.

24 May 1990 JFL produce "Information Memorandum".

18 June 1990 Formal request from JFL to increase facility to £60 million in

accordance with the 1990 "Budget and Plan".

26 June 1990 Board meeting of JFL. Dr E appointed Chairman of JFL.

28 June 1990 AB Bank's Head Office issues an instruction that there are

to be no AB Bank payments without the express approval of

one of two executives (Q or R).

1 July 1990 A "new broom" comes in as person responsible at Head Office.

AB Bank for, inter alia, JFL.

2 July 1990 Formal credit application prepared by credit department of ABL

to increase facility of JFL from £45m to £60m.

6 July 1990 ABL produce a "credit analysis" for JFL.

11 July 1990 Memorandum from internal credit department of AB Bank's

Head Office critical of JFL. Increase "not justifiable".

26 July 1990 ABL loans O Leasing plc £5m as part of a £121m syndicated loan.

31 July 1990 M of JFL writes letter to ABL warning of problems if request

for further funds rejected. Still wants to produce a budget for fast growth.

2 August 1990 Meeting at Head Office between M and others (including the

"new broom").

3 August 1990 M writes to the "new broom".

7 August 1990 AB Bank's Head Office reject application for an increase in the

JFL: facility by £15 million - increase by only £5 million with

conditions.

Mr R asked to investigate JFL.

22 August 1990 JFL consider in board meeting the possibility of acquiring

alternative funding from that provided by ABL. Discussion of

sale of JFL.

4 September 1990 AB Bank's Head Office noted that JFL had a further overdraft

of £3,750,000.

Formal credit application prepared by credit department of ABL

to add a "guarantee option" to the £50m facility.

18 September 1990 JFL problem discussed at AB Bank's Head Office. Reported

that JFL would have an additional £12m finance requirement

by year end.

19 September 1990 ABL lends £5m to P Leasing plc as part of a £100m syndicated

loan.

26 September 1990 AB Bank's Head Office approves guarantee option be added to

the JFL facility.

2 October 1990 AB Bank’s Head Office hears a special report commissioned by

them on JFL.

27 November 1990 AB Bank’s Head Office agrees steps in relation to JFL must be

taken immediately and R is to handle the reorganisation.

6 December 1990 Formal credit application for increase in facility to cover existing

drawings noting withdrawal from the leasing market.

Application is for an ABL £57m facility on a term loan basis.

7 December 1990 JFL board meeting.

January 1991 AB Bank’s Head Office approves £57 million limit.

15 January 1991 R makes presentation to AB Bank’s Head Office - identifies two

options. A buyout or a liquidation. Accepted by committee

that JFL would be liquidated unless sold by 1 February 1991.

21 March 1991 AB Investment Bank (formerly called LGH) states its intention to continue to support JFL.

9 April 1991 It is reported to AB Bank’s Head Office that no buyout is

taking place at JFL and that the process of winding up would commence.

M is removed as director and managing director of JFL.

12 June 1991 ABL carry out review of AB Bank exposure to JFL.

29 June 1991 Meeting at Head Office of AB Bank - R reports that the JFL

exposure might be as high as £15m. The reason for the increase

was the manner in which the business had been conducted at JFL which "should have been noticed by the Audit Department of AB Bank".

3 July 1991 ABL carry out credit review of JFL - Existing guarantees to JFL (and associated companies).

16 July 1991 Meeting at Head of AB Bank - R notes that earlier minuted

statement that AB Audit Department should have noticed the

goings on at JFL was incorrect. The trust officers had carried out an inspection at JFL which had not recognised just how bad

matters were.

31 July 1991 Dr E resigns as ABL General Manager - replaced by Mr F.

6 August 1991 Dr E resigns as director and chairman of JFL.

23 August 1991 AB Investment Bank transfers its 75% holding in JFL to ABL.

21 October 1991 AB Bank Loans and Holdings Committee told that internal

auditors had established a bad loan charge requirement of over £20m at JFL.

29 October 1991 AB Bank's Head Office takes note of the Audit report on JFL and recommends that it be wound up as soon as possible.

6 November 1991 AB Bank write to JFL to outline information on their future

intentions in relation to JFL and future support.

12 November 1991 AB Bank's Head Office instructs audit department to carry out further audit of JFL in April 1992.

7 February 1992 Internal memorandum from R noting R's view that the credit limit for JFL should be continuously reduced in line with the

actual utilisation.

25 March 1992 AB Bank write to JFL confirming that the existing letter of

support remained in force "as of today's date".

3 April 1992 JFL raise query on wording of most recent

letter of support

based on the auditors' observations.

30 April 1992 ABL agree to waive interest on £28m of loans as AB Bank believes that it will obtain the maximum repayment of both capital and interest from JFL if JFL is enabled to continue to trade without going into liquidation or receivership.

AB Bank provide letter of support to JFL which will "remain in force for a period of not less than 13 months from the date of this letter."

27 May 1992 F prepares submission on JFL to AB Bank's Head Office dealing, in part, with "problem" of tax deduction for loss on loan to JFL.

19 June 1992 ABL inform JFL of certain amendments to the earlier interest waiver letter.

30 June 1992 AB Bank's Head Office agrees to put £34.2 of loan to JFL on a non accruals basis from 1 January 1992.

20 July 1992 ABL internal memorandum on O Leasing Plc.

12 February 1993 AB Bank confirm waiver of interest agreement still extant.

13 June 1993 Internal memo on problem loans and on the experience of other foreign banks in the UK in "the late 80's" from Dr E to R and another.

12 August 1993 ABL internal memorandum notes that JFL's outstandings have reduced to £32,541,969 as against a provision made of £34.169.

March 1994 ABL internal memorandum recording loan outstanding to JFL of £31.9m and that some £12m had been recovered.

6 December 1994 AB Bank's Head Office resolves to sell JFL shareholding for approximately £325,000.

21 December 1994 ABL sells JFL shares.

4. We were not able to hear evidence from two of the main characters in the drama - Mr M, who was to a great extent responsible for the rise and fall of JFL, and the member of AB Bank's Head Office who was primarily responsible at the relevant time for supervising, among other companies, JFL. The former was removed as managing director in 1991; the latter has retired (possibly unaware of what happened to JFL) and it was felt it would be inhumane to call him. However, from the very helpful witnesses who did appear,

and from the voluminous documents, we feel able to draw the necessary inferences as to events and their motivation.

5. It emerged in evidence that Mr M, who had been part of AB Bank's organisation for some years, was a dominating (not to say domineering) character, impatient of criticism and of delay by others, with a considerable capacity for writing lengthy and repetitive papers, whose main aim appears to have been the expansion of JFL, and the achieving of a "critical mass" which was for ever receding into the distance, by all available means - mostly by using agents and setting up joint ventures with those agents. He prided himself on the service which JFL provided to its borrowers - giving an answer to an application on the same day wherever possible. His main failing, as will become apparent, was in under-estimating the risks inherent in

his strategy of growth and in not appreciating the importance of cashflow and credit control at a time of widespread recession.

6. We heard evidence, which we accepted, from Dr E, whose experience in LGH, ABL and JFL is set out at paragraphs 5, 7 and 12 of the statement of facts at paragraph 2 above. Part of the strategy of AB Bank at the relevant time was to enter into the leasing market indirectly by way of funding companies active in this sector, which at the time was booming. It decided to lend to leasing companies via syndicated loans and to JFL.

7. The funding of leasing activities in the 80s was highly attractive to London branches of foreign banks. It was an efficient (no distribution system had to be built up) way of indirectly accessing the British retail market, which was growing rapidly due to the booming economy in the middle of the 80s. As the leasing companies lent to a large number of customers in relatively small amounts the credit risk was deemed to be highly dispersed and therefore low, all the more as the individual loans were generally secured by the goods being leased. That promised high lending values with good margins at low credit risks.

8. As the economy entered the deep recession at the end of the 80s and the beginning of the 90s the leasing companies witnessed extreme difficulties as their retail customers were unable to pay their leasing commitments. Attempts to liquidate the given secured assets proved to be futile under those market conditions. In addition the management of many of the leasing companies proved too inexperienced in building a low risk loan book. As a result of all these factors a fair number of the leasing companies had to be liquidated with considerable ensuing loan write-offs to the financing banks. Many foreign banks active in the UK were badly shaken during those years.

9. Approvals for loan facilities to JFL were handled in the

first instance according to the standard credit procedure set up for AB Bank as a whole. There was no difference at that stage between the approval process with JFL and for other customers both as to procedures and as to Dr E's part in those procedures. He could approve £2 or £3 million locally. All applications, including those of JFL, were first analysed in the credit department of the branch on the basis of documentation supplied by customers, or in this case by JFL, and then passed on to Dr E. The credit department would then analyse JFL without direct input from him to ensure a degree of objectivity. Applications over that amount had to be submitted to one or more board members at Head Office depending on the size of the submission. All loans, irrespective of whether they were to third parties or to subsidiaries, were checked by credit group at Head Office as to creditworthiness before being sent to the respective board member. Loans to subsidiaries, under AB Bank's national banking law, have in addition to have special approval at a high level with a view to additional scrutiny. The interest rate charged throughout was such as to achieve a margin of 0.5% per annum over the funding rate; this was a market rate for revolving facilities of this type. Capital increases regarding subsidiaries were handled by a group at Head Office separate from that involved in the credit process.

10. Dr E agreed in cross-examination that the ratio of the loan to the capital base of the borrower was very different in the case of JFL from that seen in relation to other borrowers. This was because AB Bank wanted to make money in the leasing industry; it was very close to the information - it knew what was going on - and it thought, as a banker, that it was handling a situation where the size of the capital base was not a problem.

11. We heard evidence, which we accepted, from Mr R, who was asked in August 1990 to investigate both the Los Angeles branch of the bank (which, after a month, it was decided to close down) and JFL. What he found at JFL was that, although the

files were in perfect order and gave no indication that anything was wrong, once he looked at the computers it became obvious that there was inadequate control over cashflow and the payment of instalments. When a single payment of an instalment is missed, especially in a climate of recession, there should be immediate chasing and, if need be, repossession; this was not happening at JFL. For example, a haulage contractor would be given a loan of the full list price of a new truck. He would then be given a "cash-back" discount of up to 35% by the dealer, use that to pay the first few instalments, and then stop paying, having meanwhile obtained another loan on another truck, which he would deal with in the same way, so obtaining a fleet of trucks for which he had in effect paid nothing and which, when they came to be repossessed, would be worth about 20% of their original value. It was clear that neither M nor anyone else in the bank's organisation with responsibility for JFL really understood the leasing business; it was merely regarded as a useful way of making money.

12. A detailed and meticulous report and supplemental report were put in by an expert witness, Mr Paul James Lawrence Rex. These make it clear that what happened after 1988 was imprudent (which is not disputed) and in the opinion of the witness was not the behaviour of a competent banker, being so imprudent that it was outside the ordinary course of banking business and was done in the capacity of a shareholder, not of a lender. He accepted in cross-examination that, although he had referred to the approval process as being different for subsidiaries and for other corporate borrowers, that difference in fact consisted in an extra level of approval being required for subsidiaries; apart from that the process was the same. He agreed that AB Bank's Head Office had been given a vast amount of information, even if that information did not include the bit that really mattered - the cashflow.

13. A great deal of time was spent on the question of gearing - on the fact that whereas the ratio of JFL's debts to its equity was originally intended to be about 6 : 1 it rapidly increased to a very much higher gearing. This was one of the factors leading

the expert witness to his conclusion that the lending, at any rate when it went beyond the level of £17m, was outside the ordinary course of banking business. We find gearing of little relevance to the question we have to answer, for three reasons.

14. In the first place, the question of what gearing JFL should have appears to have been a highly "political" one. Mr M was continually pressing for the equity capital to be increased; it was suggested, persuasively, that this was for reasons of status - the company would be accepted as a bigger player - and because no interest would be payable on equity capital or as distinct from loans, so increasing the company's profitability. (Whether Mr M's own remuneration depended in any way on this we do not know.) AB Bank, it was suggested, equally persuasively, regarded equity capital as "gold dust" and was reluctant to let its subsidiaries have any more than what was strictly necessary; why should they have a better gearing than the parent company? What part international tax considerations may have played in the decisions we do not know.

15. Secondly, gearing ratios in AB Bank's home country are far higher than they are in the United Kingdom; a ratio of 50 : 1 would not be regarded as out of the way.

16. Thirdly, the whole question of gearing ceases to be of

much relevance when one is considering a loan to a subsidiary of a large and highly respected parent which is known to have an inflexible policy of standing by its subsidiaries and seeing to it that third parties do not lose out, whatever may have happen to the subsidiary. Examples were posited of loans to subsidiaries of Volkswagen, say, or NatWest, where the precise gearing of the subsidiary would be of little import. How much more so when the subsidiary is a subsidiary of your own, and you know that you yourself have such an inflexible policy; as Mr R said, AB Bank would always have stood behind its subsidiaries - at any rate as long as he was a member of the board. However, this is a double-edged weapon, which might equally well be used to support the argument that AB Bank was acting as a shareholder rather than as a lender; we prefer to leave it out of account and not to let it influence our decision either way.

17. Again, the inference we draw from the primary facts is that nobody knew, or even seriously suspected, anything was really wrong until Mr R sat down in front of a computer in England in late 1990. There had been unease over the rapid rate of growth (although Mr M kept insisting that such growth was necessary to achieve "critical mass"); there had been the disagreements about gearing; there may well have been over-optimism and imprudence. Bankers have been known to be uneasy, argumentative, over-optimistic and imprudent; that does not necessarily stop their actions from being the actions of bankers.

18. We had better introduce at this point the very small helping of law which was served up to us. Section 74 of the Income and Corporation Taxes Act 1988 reads, so far as is relevant:

"(1) Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of -

(a) any disbursements or expenses, not being money wholly and exclusively laid out or extended for the purposes of the trade, profession or vocation;..."

In the House of Lords case of Inland Revenue Commissioners v Hagart and Burn-Murdoch 14 TC 433 it was held that a firm of Writers to the Signet were not entitled to deduct in computing their profits a loss on a loan made to a client company; although habitual, it was no essential or necessary part of their profession. It was noted that in the House of Lords the Lord Advocate, the Attorney-General and the Solicitor-General for Scotland appeared for the Crown; there was clearly considerable interest in establishing that money-lending is not part of a solicitor's business. We need hardly point out that money-lending is an essential and necessary part of a banker's business;

bankers make money by lending money. If AB Bank had lost money in providing legal advice, that would have been a different situation. We can think of a number of other decided cases which might been cited to us; since they were not, we express no opinion on them.

19. One point which exercised us throughout, and which was never satisfactorily addressed, is this. If you have a company into which you have put £2.5m of equity capital and to which you have made loans of anything between £17m and £57m, how can it be said that either the making of those loans or any action taken to protect them was undertaken in the capacity of shareholder rather than that of lender? Before AB Bank knew that anything was wrong at JFL it continued to lend money, perhaps imprudently or even greedily, because it wanted the interest on that money; no dividend was ever paid on the equity capital and there was no thought of making any capital gain by selling JFL. The thought of sale only came in at the end of the story, when it was a question not of making a gain but of cutting losses. And once it was fully recognised that there was a serious problem - a point which was put to the expert witness in cross-examination and not really answered by him - the shares were to all intents and purposes worthless. As a shareholder AB Bank had no interest in putting new money in. As a lender, on the other hand, it had every interest in maximising the recovery, since every pound recovered reduced its loss. To risk something extra to recover that may or may not have been the best decision; it was certainly a decision which was understandable and defensible as a lending bank, while indefensible as a shareholder.

20. We find that, both before and after the figure of £17m was reached, the actions of the bank were those of a banker acting as a banker; it had wanted to enter what it saw as a lucrative and expanding market, and the way it had chosen to do so was by making loans to JFL. Its actions were not those of an owner acting as a shareholder. The appeal is accordingly allowed.

PAUL W de VOIL

T H K EVERETT

SPECIAL COMMISSIONERS

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