BRIEFING
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Net liabilities + post enforcement call option = balance sheet insolvency? Lessons from *Eurosail*

This briefing considers the recent High Court judgment in the case of *BNY Corporate Trustee Services Ltd v Eurosail*-UK 2007-3BL PLC & 7 Ors [2010] EWHC 2005 (Ch), and its implications for both the 'balance sheet test' of insolvency and the UK securitisation market.

KEY POINTS

- The balance sheet test of insolvency as set out in section 123(2) of the Insolvency Act 1986 requires more than simply producing an annual balance sheet giving a snap shot of the company's position at any particular time. The legal approach to the balance sheet test for the purpose of determining solvency will not necessarily mirror the accounting approach.
- The assets to be valued are the present assets of the company. There is no question of taking into account any contingent or prospective assets.
- The requirement to 'take account of contingent and prospective liabilities' does not require such liabilities to be aggregated at their face value with debts presently due.
- 'Taking account of' a prospective liability will involve consideration of all the relevant facts of the case.
- A post-enforcement call option is a valid means of preserving the insolvency remoteness of an issuer, but is immaterial when determining whather a company can be deemed unable to pay its debts in the context of the balance sheet test.

INTRODUCTION

As the judge himself acknowledged, the *Eurosail* case "*appears to be the first time that the proper interpretation of the requirement of the balance sheet test to 'take into account contingent and prospective liabilities' has required such close consideration*". The focus of previous case law regarding inability to pay debts has centred on the 'cash-flow test'. It is also the first reported case to have examined a post-enforcement call option, a provision commonly found in the many securitisations with UK incorporated issuers.

BACKGROUND

The case concerns Eurosail 2007-3, a securitisation of UK residential non-conforming residential mortgages issued in 2007 with a face value of £650 million. The notes were issued by Eurosail-UK 2007-3BL plc, a special purpose company incorporated in England and Wales, ("Eurosail") in five classes, ranking from A to E in order of seniority with each class being divided into sub-classes 1 to 3 which are denominated in different currencies. The underlying mortgages are all in sterling. The A1 notes mature in 2027, all the rest in 2045. The rate of interest payable varies according to the class, currency denomination and maturity of the notes. Eurosail had hedged its risks in relation to changes in interest and exchange rates by entering into interest and currency rate swaps with Lehman Brothers Special Financing Inc. ("LBSF"), whose obligations thereunder were guaranteed by Lehman Brothers Holding Inc. ("LBHI").

The terms and conditions of the notes ("Ts & Cs") included the following event of default, among others:

> *"the Issuer…being unable to pay its debts as they fall due or, within the meaning of Section 123(1) or (2) (as if the words "it is proved to the satisfaction of the court" did not appear in Section 123(2)) of the Insolvency Act 1986 (as that Section may be amended from time to time), being deemed unable to pay its debts;…provided that…the Trustee shall have certified to the Issuer that such event is, in its sole opinion, materially prejudicial to the interests of the Noteholders."* ("Condition 9(a)(iii)")

Section 123(2) of the Insolvency Act 1986 ("Section 123(2)"), commonly referred to as the 'balance sheet test' of insolvency, provides (as amended by Condition 9(a)(iii)) that:

> *"A company is also deemed unable to pay its debts if…the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities."*

The T's & C's also included a so-called post-enforcement call option ("PECO"). This provided that in the event that the security for the notes was enforced and found to be insufficient to pay all amounts due in respect of them, then an associate company of Eurosail had a call option in respect of the benefit of all the notes for a nominal consideration. A PECO provision has commonly been included in securitisations with a UK incorporated issuer as a method of satisfying rating agencies' requirement for insolvency remoteness (i.e. the practical impossibility of the issuer being subjected to an insolvency process). The commercial expectation behind the PECO is that an associate company would release the issuer from any further liabilities and not put the issuer into insolvent liquidation. PECO provisions were introduced as an alternative to limited recourse provisions, which limit the rights of noteholders against the issuer to the value of its assets, as there was historically a concern that such provisions produced adverse tax consequences in England and Wales.

Towards the end of 2008, the Lehman Brothers group collapsed and LBHI and LBSF each filed for Chapter 11 protection in the United States. LBSF failed to pay the sums due by it under the swap agreements on 15 September 2008 and thereafter, and LBHI failed to comply with its guarantee of LBSF's liabilities under the swap agreements. The swap agreements were subsequently terminated on 13 November 2009, which resulted in Eurosail having a substantial claim in excess of US$221 million in respect of its loss against the two Lehman entities. It also had no protection against currency and interest rate fluctuations in place.

The A3 class of noteholders contended that the consequence of the failure of the Lehman Brothers group and the changes in both interest and currency rates since July 2007 was that Eurosail should be deemed unable to pay its debts within the meaning of Section 123(2) and that the Trustee should recognise that such inability was materially prejudicial to the interests of noteholders so as to constitute an event of default in respect of the notes under

Condition 9(a)(iii). Whilst earlier proceedings were disposed of (by Sales J in his judgment given on 24 March 2009), since then, in addition to the quantification of the loss to Eurosail arising from the swap terminations, the financial statements and management accounts of Eurosail made up to 30 November 2009 had been published, indicating net liabilities of approximately £75 million and £130 million respectively.

Eurosail and the holders of the A2 notes, on the other hand, argued that taking into account all the financial circumstances (not just the balance sheet), Eurosail was not balance sheet insolvent for the purposes of Section 123(2) and the PECO provision should have the effect of reducing the amount of Eurosail's liabilities to no more than the value of its assets for the purposes of Section 123(2).

The effect of an event of default being called would be to switch the priority of payments from a pre-enforcement regime that paid principal to the A1, A2 and A3 noteholders sequentially, to a post-enforcement regime where the A1, A2 and A3 noteholders ranked *pari passu* as between themselves.

On 7 May 2010, BNY Corporate Trustee Services Ltd, as Trustee, issued a Part 8 claim seeking a determination from the court of the following two issues:

- whether (without regard to the PECO) Eurosail should be deemed unable to pay its debts within the meaning of Section 123(2) for the purposes of Condition 9(a)(iii) (Issue 1); and
- if so, whether the PECO had any effect on that finding (Issue 2).

JUDGMENT

Issue 1

On the evidence before the court, it was held that Eurosail should not be deemed unable to pay its debts within the meaning of Section 123(2).

The Chancellor of the High Court drew the following propositions concerning the interpretation and application of Section 123(2) from existing authorities and the express wording of the section.

- *"The assets to be valued are…present assets…There is no question of taking into account any contingent or prospective assets."*

  Amounts payable in the future may be included as present assets to the extent that they are certain.

- *"The requirement to 'take account of contingent and prospective liabilities' cannot require such liabilities to be aggregated at their face value with debts presently due. Such inclusion would be commercially illogical."*

  That is, it is not required to value such liabilities as if immediately due. An obligation to pay £100 today has a higher present value than an obligation to pay £100 in five years. Had the simple aggregation of present and prospective liabilities been intended the subsection would have provided that the amount of its liabilities 'include its contingent and prospective liabilities'.

- *"'Taking account of' [a prospective liability]…will involve consideration of the relevant facts of the case, including when the prospective liability fell due, whether it is payable in sterling or some other currency, what assets will be available to meet it and what if any provision is made for the allocation of losses in relation to those assets."*

> Section 123(2) is silent as to what 'taking account of' a prospective liability involves. In the Chancellor's view, the content of 'taking account of' must be recognised in the context of the overall question posed by the subsection, namely whether the company is to be deemed to be insolvent because the amount of its liabilities exceeds the value of its assets, and should take into account all the relevant facts of the case including the likelihood of the contingency arising and the possible value that the contingent asset might have. It was not to be judged solely on a snapshot of a situation at any given time.

The Chancellor rejected the argument that the deficit on Eurosail's latest audited balance sheet necessarily meant that it should be deemed unable to pay its debts under Section 123(2). Firstly, even though the US$221 million claim against LBSF and LBHI had been omitted from the financial statements (normal accounting practice is to exclude sums that may be recovered from ongoing litigation but which have not yet been recovered), the Chancellor considered it to be a present asset of considerable value which should not therefore be ignored. Although the claim had not been admitted by the US trustees of those companies, it could be valued at 35 to 37 per cent. of face value, being the value at which similar claims were currently being traded in the secondary market. Second, although a substantial but unquantified proportion of the total liabilities shown on the financial statements was due to the conversion into sterling of future liabilities on notes denominated in dollars or euros at the spot rate prevailing at the balance sheet date, the court put no material value on Eurosail's contingent liability for currency differences when it redeemed the notes, as the majority were not due until 2045. The Chancellor considered that it was not possible to predict how much and in which direction currency rates would fluctuate in the future or whether Eurosail would have entered into replacement swaps by then – that part of the liabilities shown in the financial statements was entirely speculative. They were not prospective liabilities because they were not certain, they were merely contingent. Third, the Chancellor was also persuaded by the fact that the future liabilities to noteholders were fully funded in the sense that losses in the underlying mortgage pool which might reduce the amount of Eurosail's assets also reduced its liabilities to the noteholders through the operation of the principal deficiency ledger, and to that extent were self-cancelling. Fourth, "*the exercise for which s.123(2) calls is not the production of an annual balance sheet so as to provide a snapshot of the affairs of a company at any particular point in time. No doubt it requires a calculation of present assets and present liabilities.*" As there was no evidence before the court that any such asset/liability calculation had been carried out, and given that there was no deficiency on the principal deficiency ledger, he considered that he was entitled to infer there was no deficiency in assets as Eurosail was able to pay its debts as they fell due. All interest to all noteholders had been paid in full.

Issue 2

Given his ruling on Issue 1, it was not technically necessary for the Chancellor to address Issue 2. He did, however, express his views on the issue on an *obiter* basis as he was aware the case may go further and given the prevalence of PECO provisions in note issues governed by English law. The Chancellor found that the existence of a PECO was immaterial in determining whether a company could be deemed unable to pay its debts in the context of the balance sheet test. Eurosail's liabilities remained the same, whether or not there was a PECO or, if there was, whether or not the call option had been exercised. Whilst it is assumed that the associate company will release the issuer from all further liability, it is under no obligation to do so and, until it does, the liability of the issuer is unaffected.

The Chancellor did however recognise that "*'insolvency remoteness' and the existence of an event of default are different concepts. Whilst the PECO may affect the first it can have no effect on the second*". He considered PECO provisions to be a valid means of preserving the insolvency remoteness of an issuer, even if they do not affect the balance sheet test, as well as being of assistance to directors when considering wrongful trading under section 214 of the Insolvency Act 1986.

COMMENT

Balance sheet test

The balance sheet test of insolvency arguably receives insufficient attention, especially in a restructuring context when the immediate concern is typically the cash-flow position of the company (i.e. can it pay its debts as they fall due). However, the balance sheet test cannot be ignored in its entirety. It is often a specific event of default in loan and bond documentation, for example the Loan Market Association include it in their recommended form documentation. It also serves as a warning signal to company directors of troubled times ahead and is likely to be a factor for a board determining the expediency of undertaking a debt restructuring. Any judicial guidance on the test is therefore to be welcomed.

There have always been clear differences between the legal and accounting definitions of assets and liabilities, with accounting treatment focussing on economic substance and the general law more on legal form. The Eurosail judgment reinforces that the courts are prepared to decline to follow generally accepted accounting principles where they consider it appropriate to do so. The flexibility and fact-sensitive approach favoured by the court in this case, clearly results in a number of questions which must be addressed in determining whether or not a company can be deemed balance sheet insolvent. For example, how should present assets be valued – should they be assessed on a going concern or break-up basis? At what stage should a future liability be considered and valued for Section 123(2) purposes? And what is meant, in the particular case, by "taking into account"? In this context it is interesting to note the requirements in Section 123(2) itself that the court is satisfied that the balance sheet issue has been proven.

Securitisation market

Moody's has issued an announcement (dated 19 August 2010) advising that they will assess the rating impact of the *Eurosail* judgment on a case by case basis, taking into account the probability that the issuer will become balance sheet insolvent before final maturity and the potential consequences on each class (or sub-class) of notes. Moody's has advised that where a consequence is conditional upon an action being taken by the trustee (for example, service of an enforcement notice), they will have regard to which noteholders can direct the trustee to act, whose interests the trustee is required to prioritise and all relevant incentives. Since, generally speaking, an enforcement notice will only be served if it benefits the senior class of noteholders, Moody's expects that for most transactions, the judgment will not affect the ratings of senior notes but could potentially affect the ratings of junior and mezzanine notes. Moody's also advised that they will also consider the impact of the *Eurosail* judgment when rating new UK-based transactions, unless the notes are subject to limited recourse provisions or the occurrence of balance sheet insolvency is not an event of default in any of the transaction documents.

Time will tell whether securitisations involving UK issuers will see a return to the inclusion of traditional limited recourse language (as used in other non-UK jurisdictions), especially given that there are no longer tax concerns that once necessitated the introduction of PECOs.

The parties have been granted permission to appeal (with an appeal date currently set for January 2011), so we look forward to getting further judicial clarification on both the issues discussed in this article in due course.