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BNY Corporate Trustee Services Ltd v Eurosail UK 2007-3BL and others [2010] EWHC 2005 (Ch): The High Court Clarifies the Balance Sheet Insolvency Test

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Introduction

The recent High Court judgment of Sir Andrew Morritt in *BNY Corporate Trustee Services Ltd v Eurosail UK 2007-3BL and others*[1] considered the scope and application of the 'balance sheet test' set out in s. 123(2) of the Insolvency Act 1986 (as amended) (the 'Act').

The court stated that the balance sheet test under s. 123(2) of the Act, is a legal test requiring the consideration of all the relevant facts of the case when deciding on what value to attribute to the prospective and contingent liabilities of a company, and did not involve simply considering the accounting treatment of the assets and liabilities of a company.

Facts

The securitisation

In July 2007, Eurosail (the 'Issuer') entered into a securitisation of UK sub-prime residential mortgage loans. As part of the transaction, Eurosail issued notes with an aggregate value of GBP 660 million and used the proceeds of the issue to purchase sub-prime mortgage loans with a face value of GBP 650 million. These underlying mortgage loans were charged to BNY Corporate Trustee (the 'Trustee') to be held as security to guarantee the Issuer's payment obligations under the notes. The notes issued were of five classes (A to E) denominated in different currencies with the A1 notes maturing in 2027, and the remaining notes maturing in 2045. In order to hedge its exposure to changes in exchange rates and interest rates, the Issuer had entered into currency and interest rate swaps with Lehman Brothers Special Financing Inc. ('LBSF') whose obligations under the swaps were guaranteed by Lehman Brothers Holdings Inc ('LBHI').

The terms and conditions of the notes (the 'Conditions') provided that the notes were to become repayable upon the occurrence of certain events of default and the subsequent enforcement of security by the Trustee. Condition 9(a)(iii) included the following event of default:

> 'the Issuer being unable to pay its debts as they fall due or, within the meaning of s123(1) or (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.'[2]

It is an important aspect, for credit rating purposes, for the Issuer in a securitisation to be considered insolvency remote. In order to achieve this, the parties to the transaction are only able to proceed against the assets and cannot proceed directly against the Issuer. Such limited recourse structures have historically had uncertain tax consequences in the UK market and in this case issuer insolvency remoteness was achieved by the inclusion of a post-enforcement call option ('PECO') in the structure. The PECO entitles an independent company to purchase outstanding notes from the Issuer. Following such purchase, the holders of the outstanding notes bring proceedings against the independent company and no insolvency proceedings are brought against the Issuer directly.

The issuer's potential default

LBHI and LBSF filed for Chapter 11 bankruptcy protection in the United States on 15 September 2008 and 3 October 2008 respectively. LBSF failed to pay the sums due to the Issuer under the swaps and the swaps were

Notes

1 [2010] EWHC 2005 (Ch).
2 [2010] EWHC 2005 (Ch), para. 2.

eventually terminated on 13 November 2009. The Issuer brought claims against both LBHI and LBSF for its losses of over USD 220 million caused by the Lehman entities' failure to satisfy their obligations under the swaps. The Issuer's claims were not admitted by the US trustee in the Lehman bankruptcy.

The termination of the swap agreements was not itself an event of default under the terms of the notes, however, due to the termination of the swaps, the Issuer had no protection from fluctuations in exchange rates and interest rates. As a result, and based on liabilities which could potentially become due in 2045, the Issuer indicated net liabilities of approximately GBP 75 million and GBP 130 million in its latest financial statements and management accounts respectively.

The issues

The holders of the A3 notes (the 'A3 Noteholders') sought to enforce the notes and argued that the Trustee should declare an event of default under condition 9(a)(iii) of the Conditions on the grounds that, as a consequence of the termination of the swaps, the Issuer was unable to pay its debts within the meaning of s. 123(2) of the Act.

The Trustee did not declare an event of default and on 7 May 2010 the Trustee sought directions in the English High Court on two specific questions:

> '(1) Whether, without regard to the PECO, Eurosail is unable to pays its debts within the meaning of s123(2) of the Insolvency Act 1986 for the purposes of Condition 9(a)(iii) of the Conditions; and if the answer to [this] question 1 is in the affirmative.
>
> (2) Whether the PECO has the effect that Eurosail is [not un]able to pay its debts within the meaning of s123(2) of the Act for the purposes of Condition 9(a)(iii) of the Conditions.'[3]

In considering these two questions, the judge was required to interpret the scope of application of the balance sheet test set out at s. 123(2) of the Act. The test states that:

> 'A company is also deemed to be unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.'[4]

The A3 Noteholders argued that, if the principal amount of the notes became due and payable immediately, as a result of changes in exchange rates and interest rates and the termination of the swap agreements, the Issuer would not be able to discharge its obligations to repay these principal amounts in full. As such, the A3 Noteholders argued that the Issuer should, taking into account its prospective and contingent liabilities, be deemed to be unable to pay its debts for the purposes of s. 123(2) of the Act.

Counsel for the Issuer sought a declaration that the Issuer was not to be deemed unable pay its debts for the purposes of s. 123(2) of the Act.

The decision

In looking at the first question raised by the Trustee, the court held that the Issuer was not deemed unable to pay its debts for the purposes of s123(2) of the Act and made the following general propositions as to how the balance sheet test should be applied:

- Only the present assets of a company should be considered in applying the balance sheet test (any contingent or prospective assets of the company should not be taken into account).
- The requirement to take into account contingent and prospective liabilities does not mean that they should be attributed their face value.
- The court held that 'taking account of' contingent and prospective liabilities involves looking at all the facts that may be relevant to the case and the assessment was not to be made purely on the basis of the company's latest accounts.

In applying these principles to the particular facts of this case the judge held that:

- The Issuer's USD 220 million claim against LBSF and LBHI was a present asset, and even though it was not admitted in the US bankruptcy, some value should still be attributed to the claim as such claims are tradable on a secondary market at 35-37% of their face value.
- The net liability position in the Issuer's 2009 financial statements arose from the conversion of the US dollar and Euro liabilities of the Issuer to Sterling at the then prevailing spot rate. The court held that this contingent liability to redeem the notes would arise in 2045 and that due to the fact that it was impossible to predict with any certainty what exchange rates or interest rates would be in 2045, the value attributed to this liability was entirely speculative. The judge held that this liability should not be taken into account

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3 [2010] EWHC 2005 (Ch), para. 5.
4 S. 123(2) Insolvency Act 1986 (as amended).

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as a liability at all for the purposes of s. 123(2) of the Act.

– Furthermore, the judge held that the liabilities of the Issuer to the noteholders was 'fully funded' as under the note structure, any losses in the underlying pool of mortgage assets would result in a corresponding decrease in the Issuer's liabilities to the noteholders.

Based on these reasons, the judge held that the value of the Issuer's assets was greater than its liabilities (taking into account its contingent and prospective liabilities) and accordingly was not deemed unable to pay its debts for the purposes of s. 123(2) of the Act. As such, the Issuer was not in default under the notes.

The PECO

With the judge's findings on the Trustee's first question, it was not necessary to address the question of whether exercise of the PECO would mean that the Issuer would not be deemed unable to pay its debts for the purposes of s. 123(2) of the Act. In any case, the judge did opine on the issue in principle and stated that the PECO 'has no effect at all [on the liabilities of the Issuer]. The liabilities of the Issuer remain the same, whether or not there is a PECO or, if there is, whether or not the call option has been exercised'[5] and concluded that the PECO would not have the effect of curing any balance sheet insolvency of the Issuer.

However, the judge did confirm that the PECO would have the effect of rendering the Issuer 'insolvency remote' as it provided a mechanism whereby the noteholders are divested of their rights under the notes to bring insolvency proceedings against the Issuer directly.

Conclusion

This is a first instance decision and may be appealed. The court provided further guidance on the application and interpretation of the balance sheet test under s. 123(2) of the Act, notably, that an assessment of a company's solvency under the balance sheet test did not simply involve looking at the net liability position set out in that company's latest accounts. The court determined that 'taking into account' the contingent and prospective liabilities of a company for the purposes of the balance sheet test, did not mean that they should be attributed their face value. All the facts which may be relevant when deciding on what value to attribute to the prospective and contingent liabilities of a company should be considered when assessing a company's solvency under the balance sheet test under s. 123(2) of the Act.

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5 [2010] EWHC 2005 (Ch), para. 43.

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International Corporate Rescue

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