



High Court considers the balance sheet test of insolvency in the context of a securitisation transaction

The recent case of *BNY v Eurosail*¹ is an important modern decision on the balance sheet test of insolvency. The High Court considered whether a note issuer was unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986 and whether, if the issuer was insolvent, the existence of a post-enforcement call option agreement (PECO) entered into by the issuer would change the court's analysis. The High Court held that (1) the issuer was not insolvent, (2) 'taking account of' contingent and prospective liabilities does not require such liabilities to be aggregated at their face value, (3) the balance sheet test is not necessarily the same as the accounting test and (4) the use of a PECO does not cure balance sheet insolvency.

Facts

As part of a residential mortgage-backed securitisation transaction, the issuer issued notes with an aggregate value of £660m divided into five classes, A to E, and further sub-divided into classes one to three. The notes were denominated in pounds sterling, US dollars or euros and the rate of interest depended on the class, currency denomination and maturity of the particular note. The issuer's risk in relation to changes in interest and exchange rates was hedged by means of interest and currency rate swaps with Lehman Brothers Special Financing (LBSF) and guaranteed by Lehman Brothers Holdings (LBH). The transaction also included a post-enforcement call option agreement (PECO), which gave an associate of the issuer a call option in respect of the notes in the event that security for the notes was enforced and found to be insufficient to pay all amounts due.

The proceeds of mortgage redemption or enforcement were paid in order of priority depending on whether the payment was prior to or post-enforcement. For the payment to be prior to enforcement, it must be before the trustee had served an enforcement notice on the issuer declaring the notes to be due and repayable following an event of default. The relevant event of default for the purpose of this case was: '... 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... 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'. Section 123(2) (as amended above) states: '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.'

In September 2008, LBSF and LBH filed for Chapter 11 in the US. As a result, LBSF failed to pay sums due under the swap agreement and LBH failed to honour its guarantee. The issuer filed claims against both entities for its loss in excess of \$221m. The A3 noteholders contended (because the post-enforcement priority provisions were to their advantage) that the consequence of the Chapter 11 proceedings and changes in both interest and currency rates meant that the issuer should now be deemed unable to pay its debts within the meaning of section 123(2) and the trustee should recognise that such inability was materially prejudicial to the interest of the noteholders.

Two specific questions were asked of the High Court:

- whether, without regard to the PECO, the issuer was insolvent on the balance sheet test basis; and
- if the answer to the above is in the affirmative, whether the PECO had the effect of curing such insolvency.

¹ *BNY Corporate Trustee Services Ltd v Eurosail-Uk 2007-3bl plc and others* [2010] EWHC 2005 (Ch).

Decision on the insolvency question

The High Court held that the issuer was not insolvent within the meaning of section 123(2). This was despite the fact that financial and management accounts of the issuer showed net liabilities of £75m and £130m respectively. In coming to this decision, the High Court reviewed the case law to date and considered that:

- only present assets could be taken into account when considering the balance sheet insolvency test – no account could be taken of contingent and prospective assets;
- ‘taking account of’ prospective and contingent liabilities meant that such liabilities should not be aggregated at their face value with present debts, which would be commercially illogical; and
- ‘taking account of’ must be considered in the overall context of what section 123(2) was trying to achieve – namely whether the company is deemed to be insolvent because the amount of its liabilities exceeds the value of its assets, which will involve ‘... consideration of the relevant facts of the case, including when the prospective liability falls 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’.

In relation to the net liabilities referred to above, the Chancellor was clear that ‘... 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 a particular point in time’ and that the \$221m claim in the liquidation of LBSF should be considered as a present asset for the purpose of the balance sheet insolvency test. It was not included on the issuer’s accounts because it is normal accounting practice not to include sums from ongoing litigation. Additionally, liabilities due to conversion into sterling shown on the financial statements were not payable until 2045. Such liabilities are speculative, because currency rates continually fluctuate, and it may be possible in the interim for the issuer to enter into further hedging arrangements. The Chancellor was also persuaded by the fact that the structure of the securitisation transaction was such that future liabilities to noteholders were fully funded, because losses in the underlying mortgage pool that may reduce the issuer’s assets also reduced the liabilities of the issuer.

Decision on the PECO question

As the High Court found that the issuer was not insolvent, it was not required to consider the effect of the PECO. However, the Chancellor made some non-binding comments on this point.

The PECO was developed as an alternative to limited recourse provisions in securitisation agreements and was designed to give directors of special-purpose vehicles comfort that they were not wrongfully trading. It was assumed that giving an associate of the issuer a call option would mean that the associate company would not put the issuer into liquidation. The High Court considered that the PECO had no effect on the issuer’s contingent or prospective liabilities, because the associate company was under no obligation to release the issuer from liability and, until it did so, the liability of the issuer was unaffected. ‘The fact is 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.’

Commentary

There has been little recent judicial interpretation of the balance sheet insolvency test. The most recent case law, such as *Re Cheyne Finance*², focused on the cash flow test of insolvency, so this judgment provides welcome clarification. In particular, it emphasises the difference between the approach that should be taken for the balance sheet insolvency test and the approach used for determining solvency for accounting purposes.

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² [2008] 2 AER 987.