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Case No: HC10C01541

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION

Royal Courts of Justice
Strand, London, WC2A 2LL

30/07/2010

B e f o r e :

THE CHANCELLOR OF THE HIGH COURT

Between:

BNY CORPORATE TRUSTEE SERVICES LIMITED	**Claimant**
- and -	
(1) EUROSAIL-UK 2007-3BL PLC **(2) NATIXIS** **(3) NEUBERGER BERMAN EUROPE LTD (ON BEHALF OF SEALINK FUNDING LTD)** **(4) ORPINGTON STRUCTURED FINANCE I LTD** **(5) MUNICIPALITY FINANCE PLC** **(6) CARRERA CAPITAL FINANCE LTD** **(7) PATRON EMF S.A.R.L.** **(8) PAMPLONA CREDIT OPPORTUNITIES MASTER FUND**	**Defendants**

MR W TROWER QC & MR D ALLISON (instructed by Allen & Overy LLP) for the Claimant
MR R DICKER QC & MR J GOLDRING (instructed by Berwin Leighton Paisner LLP) for the 1st Defendant
MR R SNOWDEN QC & MR D BAYFIELD (instructed by Brown Rudnick LLP) for the 7th & 8th Defendants
MR G MOSS QC & MR R FISHER (instructed by Sidley Austin LLP) for the 2nd to 6th Defendants

Hearing dates: 20 and 21 July 2010

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The Chancellor

Introduction

1. On 16th July 2007 the first defendant ("Eurosail or the Issuer") issued notes to an aggregate value of £660m as part of a securitisation transaction in relation to a portfolio of UK Residential Non-Conforming Mortgage loans with a face value of £650m. The notes are of five classes, A to E, divided into subclasses 1 to 3, variously denominated in and classified as euros (a), US$ (b) and £ sterling (c). 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 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 Inc whose obligations thereunder were guaranteed by Lehman Brothers Holdings Inc. The securitisation transaction also included a Post Enforcement Call Option Agreement ("PECO") which provides that in the event that the security for the notes is enforced and found to be insufficient to pay all amounts due in respect of them then an associate company of the Issuer is to have a call option in respect of the benefit of all the notes at a nominal price.

2. As the underlying residential mortgages are redeemed or enforced the proceeds are applied in accordance with one or other of two specified priorities, namely the priority of payments prior to or post enforcement. The former applies unless and until the claimant ("the Trustee") serves an enforcement notice on Eurosail declaring the notes to be due and repayable following the occurrence of an event of default. One such event is:

   > "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."

   That subsection so amended reads as follows:

   > "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".

3. In September and October 2008 Lehman Brothers Holdings Inc and Lehman Brothers Special Financing Inc each filed for protection in the US under Chapter 11. The latter failed to pay the sums due under the swap agreements on 15th September 2008 or thereafter and the former has failed to comply with its guarantee. On 13th November 2009 the swap agreements were terminated and the Issuer has filed claims against both companies for its loss of in excess of $221m. But the failure of the Lehman Brothers Group and the termination of the swap agreements did not themselves constitute events of default in respect of the notes.

4. The second to sixth defendants ("the A3 Noteholders") contend that the consequence of the failure of the Lehman Brothers Group and the changes in both interest and currency rates since July 2007 has been that the Issuer should now be deemed to be unable to pay its debts within the meaning of s.123(2) Insolvency Act 1986 and the Trustee should recognise that such inability is materially prejudicial to the interests of the noteholders so as to constitute an event of default. Earlier proceedings were disposed of by Sales J in his judgment given on 24th March 2009. Since then, in addition to the quantification of the loss to the Issuer arising from the swap terminations, there have been published the Financial Statements and Management Accounts of Eurosail made up to 30th November 2009 indicating net liabilities of approximately £75m and £130m respectively.

5. On 7th May 2010 the Trustee issued the Part 8 claim now before me raising two specific questions, namely:

   > "(1) Whether, without regard to the PECO, Eurosail is unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986 ("the Act") for the purposes of Condition 9(a)(iii) of the Conditions; and if the answer to 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 section 123(2) of the Act for the purposes of Condition 9(a)(iii) of the Conditions."

The Trustee does not ask the Court to determine whether, if in answer to either question the Court concludes that the Issuer is, within that meaning, unable to pay its debts, that is a circumstance materially prejudicial to the interests of the noteholders.

6. Notices to noteholders drawing their attention to these proceedings have been given in accordance with the conditions under which the notes were issued on four occasions. In consequence the seventh and eighth defendants ("A2 Noteholders") have been joined. Thus the parties before me include representative A2 and A3 noteholders but not noteholders of classes A1 or B to E. Counsel for the Trustee have considered whether there are any separate arguments open to noteholders of any of those classes which I ought to consider and have concluded that there are not. In addition they have considered whether the Trustee should seek any representation orders and have decided that no such orders are necessary.

7. Accordingly the two questions for my determination are those set out in paragraph 5 above. Counsel for the Issuer and the A2 Noteholders contend that I should answer the first in the negative and the second in the affirmative. Counsel for the A3 Noteholders contends for the exact opposite, namely an affirmative answer to the first and a negative answer to the second. I will deal with the submissions on those issues in due course but first it is necessary to consider the securitisation transaction in much greater detail.

The Securitisation Transaction

8. Crucial to the success of any such transaction is the credit rating conferred on the notes by the well known credit rating agencies, such as Standard & Poor's, Fitch and Moody's. In December 2005 Standard & Poor's published criteria for the benefit of potential issuers. One criterion is called "Insolvency Remoteness". This requires, among other conditions, that the terms of the issue limit the liability of the issuer to its creditors to the value of the assets backing the notes subject to the rating. It was recognised that in the case of issuers in England and Wales such a provision might give rise to liabilities to tax and they were enjoined to implement suitable alternatives in order to mitigate the risk of a voluntary or involuntary insolvency proceeding. Other contemporary articles relating to the published criteria suggest that the PECO is a commonly used alternative.

9. The Issuer is a special purpose vehicle designed for use in this transaction but no others. It was incorporated in England and Wales on 8th May 2007 as a company limited by shares. Its share capital is held by a parent company the shares in which are held on exclusively charitable trusts. It was incorporated specifically to acquire a portfolio of residential mortgages loans held by eight named mortgagees or their associates. The first step in the securitisation transaction was the acquisition of the benefit of those mortgage loans by the Issuer. The mortgage loans so acquired had a face value of £650m less £5. The price paid by the Issuer was £646m less £5 funded from the proceeds of the issue of the notes. The note issue raised, in all, £659,750,000. £13,750,000 of that was used to pay the costs and to fund two special reserves. Accordingly the margin between assets and liabilities (£4m on £650m) was always small (0.62%).

10. As I have already indicated the notes so issued consisted of 5 basic classes with three sub-classes and a choice of three currencies. The Terms and Conditions ("the Conditions") on which they were issued were set out in the Prospectus published by Lehman Brothers, as arranger and lead manager, on 13th July 2007. Condition 1 deals with the form, denomination and title of the notes. Condition 2 covers their status, security and administration. Condition 2(a) provides for the notes of each class to constitute direct, secured and unconditional obligations of the Issuer ranking pari passu without preference or priority amongst notes of the same class. It is not disputed that this provision (and others to the like effect) provides for unlimited recourse to the Issuer by its creditors. Condition 2(b) refers to the pre and post enforcement priorities to which I have referred. Conditions 2(c)-(e) deal with certain provisions of the Trust Deed. Condition 2(f) provides that all sums due under the notes are secured on the Issuer's interest in each and every mortgage loan being acquired.

11. Condition 2(g) specifies the priority of payments prior to enforcement. It is long and complicated but I do not understand its effect to be disputed. Payments are made out of the Available Revenue Fund in the prescribed order on the quarterly interest payment dates. The first three priorities deal with remuneration, costs and prior charges, the fourth with repaying drawings on a Liquidity Facility Agreement (see paragraph 12 below) and the fifth with sums due under the swap agreements. The sixth priority is the payment:

   > "pari passu and pro rata amounts of interest due and payable on the A1c Notes and/or the A2c notes and/or the A3c notes..."

   The seventh priority is the reduction of the A Principal Deficiency, to which I shall refer later. The eighth and subsequent priorities make similar provision for the B to E notes and any B to E Principal Deficiency. Any interest on any note, other than the A notes, which is not duly paid is rolled up. There is a concluding provision to the effect that if the swap agreements have not provided enough of the relevant currency then it should be obtained by the conversion of the relevant amount in the Available Revenue Fund. One consequence of the termination of the swap agreements and the substantial depreciation in the value of sterling since July 2007 has been to crystallise losses on conversion in order to pay interest and principal on the A1 notes.

12. Before turning to the post enforcement priorities I should refer briefly to three aspects of the pre enforcement priority. The first relates to the Available Revenue Fund. That is set up under the Cash/Bond Administration Agreement with the company responsible for administering the underlying mortgage loans. The interest payable on those mortgage loans is credited to the Available Revenue Fund. As the interest receivable has exceeded the interest payable ("the excess spread") there has been sufficient cashflow to pay all interest on all notes to date. If for any reason there is not enough interest received then the Liquidity Facility exists to provide for any temporary shortfall. That is the second aspect and explains why the fourth priority is the effective repayment of any prior drawing of the liquidity facility. The third aspect relates to the A Principal Deficiency to which the seventh priority relates.

13. Clause 8 of the Cash/Bond Administration Agreement provides for the maintenance of a Principal Deficiency Ledger with five sub-ledgers called the A Principal Deficiency Ledger and so on with regard to the B to E notes. There is debited to the Principal Deficiency Ledger the amount of any loss arising on the enforcement or redemption of any of the underlying mortgage loans. That loss is then appropriated to the various classes of note in accordance with the principal amount outstanding in respect of that class but in the reverse order of priority. Thus losses are attributed first to the E notes, then to the D notes and so on so as to provide for the A notes to have the greatest security. But if in any quarter the excess spread permits, any principal deficiency relative to that class is repaid before payment of interest to the holders of the next class of note. This is why the seventh priority in the pre enforcement order is repayment of any A Principal Deficiency in priority to any interest payments to any subsequent class of note.

14. Post enforcement priorities are dealt with in Condition 2(h). The first four are essentially the same. The fifth is:

   > "to pay pari passu and pro rata..all amounts of interest and principal then due and payable on the A1c Notes, the A2c Notes and the A3c Notes.."

   There follow similar provisions in relation to the B to E notes but no requirement to reimburse the A Principal Deficiency. In a concluding paragraph it is reaffirmed that:

   > "the Noteholders have full recourse to the Issuer in respect of the payments...and accordingly are entitled to bring a claim under English law...for the full amount of such payments.."

   Thus the post enforcement priority advances the repayment of the principal amounts due on all the A notes and removes the interest priority of the earlier sub-classes.

15. Condition 3 provides for the Issuer to enter into certain covenants with the Trustee. Condition 4 deals with interest. Condition 5 deals with redemption of the notes either final or in certain cases mandatory and early and for tax reasons. Condition 5(a) provides for the redemption of the A1 notes in September 2027 and all the rest in June 2045 unless, in either case, they have been previously redeemed in accordance with that condition. In that connection I should add that the excess spread will have enabled the A1 notes to be redeemed by September 2010 and should enable early redemption of the A2 notes in June 2012 and the A3 Notes in September 2020. Condition 5(j) refers to the PECO. It provides that each noteholder will on the exercise of the option sell to the holder of the option all his holding of notes for the nominal consideration for which PECO provides. Each noteholder thereby acknowledges that the Trustee has their authority to grant the option in the first place.

16. Condition 9 deals with events of default. So far as relevant it provides:

> "The Trustee may, at the Trustee's discretion, or shall, if so requested in writing by the holders of not less than 25 per cent. in aggregate Sterling Equivalent Principal Amount Outstanding of the then outstanding Notes of the Most Senior Class of Notes, or if so directed by or pursuant to an Extraordinary Resolution of the holders of the then outstanding Notes of the Most Senior Class of Notes (subject in each case to the Trustee being indemnified and/or secured to its satisfaction), serve a notice (an "Enforcement Notice") on the Issuer declaring, in writing, the Notes to be due and repayable (whereupon the Security shall become enforceable) at any time after the happening of any of the following events (each, an "Event of Default").
>
> > (i) ...default being made for a period of three business days in the payment of the principal of or any interest on any Note when and as the same ought to be paid...;
> >
> > (ii) the Issuer failing to perform or observe any other obligation binding on it under the Notes or any Transaction Document and, in any such case such failure is continuing for a period of 14 days following the service by the Trustee on the Issuer of notice requiring the same to be remedied...;
> >
> > (iii) the Issuer…, 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;
> >
> > [(iv)
> >
> > (v)]
> >
> > **provided that**, in the case of each of the events described in sub-paragraphs (ii) and (iii) of this paragraph (a), the Trustee shall have certified to the Issuer that such event is, in its sole opinion, materially prejudicial to the interests of the Noteholders."

Subparagraph (b) goes on to provide that upon any such declaration being made the notes shall become immediately due and payable at their principal amount outstanding together with accrued interest and the security shall become enforceable as provided in the Trust Deed and the Deed of Charge.

17. Condition 10 provides for enforcement of the security to be undertaken by the Trustee. Condition 11 enables meetings of noteholders to be convened. Condition 14 authorises notices to be given to noteholders by certain prescribed methods; these were used by the Trustee to give notice of these proceedings. Condition 16 provides that the Trust Deed and Notes are governed by and to be construed in accordance with English law and confers non-exclusive jurisdiction on the courts in England.

18. It is convenient at this stage to consider the Trust Deed. It is made between the Issuer and the Trustee. By clause 3 the Issuer covenanted to repay the notes and to pay interest in the meantime

as provided for in the Conditions. Clause 5 provides for the security for the notes to be provided by a fixed charge over the Issuer's interests in the underlying mortgages to be entered into by the Issuer and the Trustee. Clause 7 comprises a number of covenants entered into by the Issuer with the Trustee. Clause 9 deals with enforcement of the security by the Trustee and clause 10 with the application of the proceeds of such enforcement in accordance with the noteholders' rights under the Conditions.

19. There are a number of other Transaction Documents, as defined in the Master Definitions Schedule, but with the exception of the PECO they do not require any further reference. The PECO itself constitutes Schedule 9 to the Master Securitisation Agreement executed by the parties described in the definition of the Master Securitisation Agreement contained in the Master Definitions Schedule. The Master Definitions Schedule also defines OptionCo as Eurosail Options Ltd. By clause 3 of the PECO it is provided that:

> "3.1 Grant of Option In connection with the issuance of the Notes, the Trustee on behalf of the Noteholders, but without any personal liability on its part, hereby grants, and the Issuer hereby acknowledges, an option (the "Option") exercisable by OptionCo, permitting OptionCo to acquire all (but not some only) of the Notes (plus accrued interest thereon) in the event that the Security for the Notes is enforced and the Trustee, after the payment of the proceeds of such enforcement, determines that the proceeds of such enforcement are insufficient, after payment of all claims ranking in priority to or pari passu with the Notes pursuant to the Deed of Charge, to pay in full all principal and/or interest and any other amounts whatsoever due in respect of the Notes. The Trustee shall promptly after the Security is enforced and the proceeds of such enforcement are paid, make a determination of whether or not there is such insufficiency. If the Trustee determines that there is such an insufficiency the Trustee shall forthwith give notice (the "Insufficiency Notice") of such determination to OptionCo and the Issuer.
>
> 3.2 Exercise of Option The Option may be exercised at any time after the Insufficiency Notice has been given to OptionCo and the Issuer and shall be exercised by OptionCo by not less than five days' notice being given by OptionCo to the Trustee and the Noteholders in accordance with Condition 14."

20. Clause 4 prescribes the nominal consideration payable on the exercise of the option. Clause 6 allows assignment novation or transfer with the prior written consent of the Trustee to be given only if the Trustee is satisfied that it will not be materially prejudicial to the noteholders. Eurosail Options Ltd is the wholly owned subsidiary of PRS 1 Ltd the shares of which are held on trust for exclusive charitable purposes. The trustee of that trust, as of the trust of the shares in the parent company of the Issuer, are held by Wilmington Trust, a large US based banking institution. To that extent therefore the Issuer and OptionCo are associated companies.

21. I have referred to some of the details of some of the relevant documents. At the risk of over simplification I venture to summarise some of the relevant underlying features. And in doing so I accept some of the submissions made to me by all the parties. First, the securitisation transaction thereby set up a long term structure for the payment of the interest and principal due on the notes out of the principal and interest of the mortgage loans. So long as interest was duly paid on the A notes and the swap agreements were duly performed by Lehman Brothers, in the ordinary course of events, there could be no default with regard to noteholders because the structure required any losses on the enforcement or redemption of the mortgage loans to be borne by the noteholders in the reverse order of priorities through the Principal Deficiency Ledger. Accordingly, the very small margin of assets over liabilities could be accommodated. Second, losses arising through the depreciation of any of the three currencies in which a note was denominated would be made up by gains made on the relevant currency swap agreements. Accordingly, once again, there could, in the normal course of events, be no default in respect of any noteholder. But, third, the termination of the swap agreements and the depreciation of sterling has given rise to actual losses when sterling has been converted to pay interest and early redemption thereby creating a potential deficiency in assets to meet the ultimate liability on the redemption of the notes. This loss is not attributable to any particular class of noteholder through the operation of the Principal Deficiency Ledger and is not, by definition, offset by swap agreement gains. Ultimately the issue between the parties appears to me to depend on how this third circumstance is to be regarded.

The First Question

22. The first question, as set out in paragraph 5 above, is whether, without regard to the PECO, Eurosail is now unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986 ("the Act") for the purposes of Condition 9(a)(iii) of the Conditions. That depends on how the requirement to 'take into account [the company's] contingent and prospective liabilities' is to be interpreted and applied when determining whether the value of the company's assets is less than the amount of its liabilities. Counsel for the A3 Noteholders submits that prospective liabilities must be taken into account at their face value irrespective of their maturity date or the rate of interest payable in the meantime. In support of that proposition he relies on the decision of the Court of Appeal in **Byblos Bank SAL v Al-Khudhairy** [1987] BCLC 232.

23. Before I refer to that case it is necessary to trace the changes in the relevant section of the Insolvency Act. That task was recently performed by Briggs J in **Re Cheyne Finance plc** [2008] 2 AER 987 paras [30]-[36] which I gratefully quote and adopt. Briggs J said:

> "30. Section 80 of the Companies Act 1862 provided to the extent relevant as follows:
>
> > "A Company under this Act shall be deemed to be unable to pay its Debts…
> >
> > Whenever it is proved to the satisfaction of the Court that the Company is unable to pay its debts."
>
> 31. In *re European Life Assurance Society* (1869) 9 LR Eq 122, it was held that 'debts' in s.80 meant only those actually due. Furthermore, prospective creditors had no *locus* to petition.
>
> 32. Section 28 of the Companies Act 1907 both permitted prospective creditors to petition and required the court to have regard to contingent and prospective liabilities when applying the 1862 Act. That new provision was consolidated in the Companies (Consolidation) Act 1908 in s.130 in the following form:
>
> > "A company shall be deemed to be unable to pay its debts –…
> >
> > (iv) if it is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company."
>
> 33. No substantive change occurred in 1929 in s.169(4) of that Act; or in 1948 in s.223(d) of that Act; nor indeed in the 1985 Companies Act in s.518(1)(e), despite slight changes in the language.
>
> 34. During the long period from 1907 to 1985 English courts addressed the questions posed by, for example, s.223(d) of the 1948 Act, without any rigid distinction between commercial and cash flow insolvency on the one hand and balance sheet insolvency on the other. The submission that commercial insolvency could not be established by reference to future debts could not have succeeded. This is reflected, for example, in the decision of the Court of Appeal in *Byblos Bank SAL v. Al-Khudhairy* [1987] BCLC 232, in which inability to pay debts within s.223 of the Companies Act 1948 was incorporated into a debenture as a trigger for the appointment of Receivers. Nicholls L.J. said this (at 247):
>
> > "Construing this section first without reference to authority, it seems to me plain that, in a case where none of the deeming paras (a), (b) or (c) is applicable, what is contemplated is evidence of (and, if necessary, an investigation into) the present capacity of a company to pay all its debts. If a debt presently payable is not paid because of lack of means, that will normally be sufficient to prove that the company is unable to pay its debts. That will be so even if, on an assessment of all the assets and liabilities of the company, there is a surplus of assets over liabilities. That is trite law.

> It is equally trite to observe that the fact that a company can meet all its presently payable debts is not necessarily the end of the matter, because para.(d) requires account to be taken of contingent and prospective liabilities. Take the simple, if extreme, case of a company whose liabilities consist of an obligation to repay a loan of £100,000 one year hence, and whose only assets are worth £10,000. It is obvious that, taking into account its future liabilities, such a company does not have the present capacity to pay its debts and as such it 'is' unable to pay its debts. Even if all its assets were realised it would still be unable to pay its debts, viz, in this example, to meet its liabilities when they became due."
>
> 35. [Counsel] described this as a case about balance sheet insolvency. I disagree. Nicholls L.J. is speaking about the ability of the company to meet its liabilities when they became due. What is striking, and for present purposes persuasive, is his explanation that the phrase "is unable to pay" is a reference to the company's present capacity, not to the date upon which relevant debts will fall due."

24. Accordingly, this appears to be the first time the proper interpretation of the requirement in s.123(2) to "[take] into account [the company's] contingent and prospective liabilities" has required such close consideration. But it follows that I reject the submission of Counsel for the A3 Noteholders to the effect that the decision of the Court of Appeal in **Byblos Bank SAL v Al-Khudhairy** [1987] BCLC 232 is binding on me. It cannot be binding given that it was a decision on legislation in materially different terms. Accordingly it seems more appropriate to regard it as a decision of a persuasive nature to be regarded chronologically with the others.

25. The first of those to which I was referred is the decision of Slade J in **Re Capital Annuities Ltd** [1979] 1 WLR 170 but I do not find that to be of any help on the point I have to decide. The second is **Re a Company** [1986] BCLC 261, a decision of Nourse J. In that case the petitioner was the original lessee of property of which the company was a subsequent assignee. As the company had failed to pay the rent the petitioner had been called on to do so as the original covenantee and had then to recover the rent it had paid from the company. The petition was based on a present liability in respect of rent actually paid by the petitioner and a contingent liability to pay it in the future if it was first paid by the petitioner. The present debt was paid but the petition proceeded in relation to the contingent liability.

26. At page 263 Nourse J said:

> "I must now consider the second part, which requires me to take into account the contingent and prospective liabilities of the company. Counsel for the petitioner submits, correctly, that every time the company borrows money from somebody else to pay off the petitioner or the supporting creditor, or whoever, that borrowing increases its prospective liabilities, because it incurs a further debt prospectively due to the lender. Counsel says that if I take into account the contingent and prospective liabilities of the company, it is clearly insolvent in balance sheet terms. So indeed it is if I treat the loans made by the associated companies as loans which are currently repayable. However, what I am required to do is to 'take into account' the contingent and prospective liabilities. That cannot mean that I must simply add them up and strike a balance against assets. In regard to prospective liabilities I must principally consider whether, and if so when, they are likely to become present liabilities. As to that, I have evidence from a director of the company, to the effect that there is no question of those loans being withdrawn. He has exhibited four loan agreements under which the loans are expressed not to be repayable until 30 June 1985. He adds that, although all of them bear interest, interest has so far been waived by the lenders and that they intend to continue to waive it. It seems to me, on the basis of that evidence, that if I take account of the prospective liabilities, I must approach the company's financial position on the footing that those loans will not be called in until 30 June 1985, and possibly until later.
>
> In those circumstances, I am in the end satisfied that the petitioner has not established that the company is unable to pay its debts, even taking into account its contingent and prospective liabilities."

27. In that case Nourse J was clearly considering the likelihood of the intercompany loans having to be repaid in the context of whether the company was able to pay its debts as they fell due. Those loans were prospective liabilities of the company. And, as Nourse J said, they could not just be added up and added to the other liabilities but must be evaluated as to when they were likely to become actual liabilities. Counsel of the A3 Noteholders contends that the views of Nourse J are inconsistent with and must yield to the views of Nicholls LJ in **Byblos Bank SAL v Al-Khudhairy** [1987] BCLC 232.

28. The passage on which counsel for the A3 Noteholders relies is that which Briggs J quoted in **Re Cheyne Finance plc** to which I have referred in paragraph 23 above. But that was said in the context of a contention that in considering the assets of the company regard should be had to the likelihood of a further cash injection. Immediately after the passage quoted by Briggs J, Nicholls LJ added:

    > "It might be that, if the company continued to trade, during the year it would acquire the means to discharge its liabilities before they became presently payable at the end of the year. But in my view para (*d*) is focusing attention on the present position of a company. I can see no justification for importing into the paragraph, from the requirement to take into account prospective and future liabilities, any obligation or entitlement to treat the assets of the company as being, at the material date, other than they truly are. Of course a company's prospects of acquiring further assets before it will be called upon to meet future liabilities will be very relevant when the court is exercising its discretion: for example, regarding the making of a winding-up order or the granting of short adjournments of a winding-up petition."

    Later, Nicholls LJ referred to the decision of Nourse J in **Re a Company** as consistent with the views he had expressed. That, with respect, seems to me to be an entirely apt description; I reject the submission of counsel for the A3 Noteholders to the effect that it was a euphemism for disagreement.

29. I return then to the wording of s.123(2), as amended for the purposes of Condition 9(a)(iii). It reads:

    > "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".

    Having regard to how that sub-section has developed, as described by Briggs J in **Re Cheyne Finance plc,** such guidance as is afforded by **Re a Company** and **Byblos Bank SAL v Al-Khudhairy** and the wording of the subsection, I derive a number of propositions.

30. First, 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. Thus the conclusion of the Court of Appeal in **Byblos Bank SAL v Al-Khudhairy** is as applicable to s.123(2) as it is to s.123(1)(e). The subsection provides no guidance as to the basis of that valuation. As the assets in question are those of the company presumably they are to be assessed at their value to the company but whether on a going concern or break-up basis is unclear. That problem does not arise in this case due to the nature of the Issuer's business and its assets. What does arise is the question whether the claims of the Issuer in the liquidation of Lehman Brothers are present assets and if so their value. In my view they are clearly existing assets notwithstanding that they have not been admitted. Their present value may be more debatable but the evidence suggests that unadmitted claims are being traded on a secondary market at 35%-37% of their face value (subject to recourse requirements to the seller). I can see no reason why they should not be included in the assets of the Issuer at that value.

31. Second, 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; 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". Given that simple aggregation of present and prospective liabilities is not required then the conversion of prospective liabilities denominated in some currency other than sterling into sterling at the present spot rate is not required either.

32. Third, subject to the foregoing, the subsection is silent as to what 'taking account of' a prospective liability involves. On the one hand a prospective liability cannot simply be added at its face value to the present liabilities of the company; on the other it cannot be ignored. In my 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. This 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.

33. Counsel for the A3 Noteholders submits that the Issuer is plainly insolvent for the purposes of s.123(2) as applied by condition 9(a)(iii). He points to the successive deficits revealed in its annual financial statements. Counsel for the Issuer and the A2 Noteholders dispute this proposition on a number of grounds. I prefer the submissions for the latter. The deficit on which the A3 Noteholders rely comprises a number of elements which, whilst appropriate for drawing up the annual financial statements, go beyond what s.123(2) requires.

34. First, the value of the claim in the liquidations of the two Lehmans companies involved in the currency swap agreements was omitted from the financial statements. Their existence was disclosed but no amount was included in the value of the aggregate assets. The reason is that it is normal accounting practice not to recognise in an annual balance sheet sums that may be recovered from ongoing litigation but have not yet been recovered. But the exercise required by s.123(2) is not the production of an annual balance sheet but a comparison of the value of assets with the amount of liabilities in order to ascertain solvency. There is no doubt that the claim in the liquidations of the Lehmans companies is a present asset of the Issuer. Similarly there is no doubt that it is of considerable value, whether admitted or not. If the secondary market is indicative of value it is worth some 35%-37% of $221m. This asset and its value should not be ignored.

35. Second, a substantial, but unquantified, proportion of the total liabilities of £663m shown on the financial statements for the year ended 30th November 2009 is due to the conversion into sterling of future liabilities on notes denominated in $s or €s at the spot rate prevailing at the balance sheet date. But those liabilities are not, subject to early redemption out of the excess spread, due for payment until 2045. Currency rates continuously fluctuate. It appears to me that this part of the liabilities shown in the financial statements is entirely speculative. Who knows how much and in which direction currency rates will fluctuate in the next 35 years? And why should it be assumed that in that period it will prove to be impossible or uneconomic to enter into further hedging currency swaps? I do not consider that this element of the liabilities shown in the financial statements is a liability at all. It is not prospective because it is not certain. It is only contingent because it may or may not occur, **Stonegate Securities Ltd v Gregory** [1980] 1 Ch.576, 579, but given its nature I do not think that, at this stage, account should be taken of it for the purposes of s.123(2) at any material value.

36. Third, the future liabilities to noteholders are fully funded in the sense that losses in the underlying mortgage pool which might reduce the amount of the Issuer's assets also reduce the liabilities of the Issuer to the noteholders through the operation of the Principal Deficiency Ledger. To that extent they are self-cancelling. That is the purpose of the long term structure of the notes. It follows that it is only extraneous losses, such as a liability to an unconnected third party, for example, HMRC, or crystallised currency losses, for example, arising on conversion for payment of interest or early redemption which reduce assets or increase liabilities so as to be capable of producing a deficiency for the purposes of s.123(2). But any such extraneous losses would have to be set against the increase in extraneous assets consisting of the excess spread, which appears to have been considerable.

37. 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. There is no evidence before me to suggest that any such calculations have been made. But I am entitled to infer that it would not show any deficiency in assets because the Issuer is well able to pay its debts as they fall due. Thus all interest due to all noteholders has been paid in full. There is no deficiency on the Principal Deficiency Ledger. The projected redemptions of each class of the A notes is in advance of their respective maturity dates (A1 September 2010 rather than 2027, A2 June 2012 rather than 2045 and A3 2020

rather than 2045). If there were a deficiency of present assets over present liabilities (or over present liabilities and such prospective liabilities as should be taken account of at a material amount) pressures would be expected to show in either the Available Revenue Fund or the Principal Deficiency Ledger. There are none.

38. I conclude from all these factors that the value of the assets of the Issuer exceeds the amount of its present liabilities having taken account of its contingent and prospective liabilities to such extent as appears to be necessary at this stage. That this is so appears to be confirmed by paragraphs 59-63 of the witness statement of Mr Edge made on behalf of the A3 Noteholders. In those paragraphs he accepts that the A3 notes will be repaid in full, but later than originally anticipated. He considers that classes B to E may not be because of the crystallisation of loss on currency conversion required for early redemption. But, for the reasons given in the foregoing paragraphs, I consider that to be speculation and not indicative of a present deficiency in assets such as to satisfy s.123(2). For all these reasons I will make a declaration in answer to the first question in the negative.

The Second Question

39. Given my conclusion on the first question the second question, namely the effect of the PECO on the application of s.123(2), does not arise. But, as this case may go further and such agreements appear to be commonly used in note issues governed by English law, I should express my views shortly.

40. As indicated in paragraph 8 above, issuers of notes are concerned to comply with the criteria published by the rating agencies so that their instruments may attract the highest possible rating. One of those criteria is colloquially called 'insolvency remoteness' by which is meant the practical impossibility of the issuer being subjected to any insolvency process. In other jurisdictions this is achieved by provisions which limit the rights of noteholders against the issuer to the value of its assets, but in England and Wales that produced adverse tax consequences. The PECO is designed to achieve the same result by ensuring, so far as practically possible, that if the assets of the issuer prove to be insufficient the noteholder to whom a balance is due will not take steps to wind up the issuer. It appears that both the leading auditors and the major rating agencies treat the two methods of achieving insolvency remoteness as commercially equivalent.

41. But it does not follow that they are equivalent for the purposes of s.123(2) as applied by condition 9(a)(iii). Counsel for the A3 Noteholders contends that they are not. He points out that the PECO has no effect on the liability of the issuer to a noteholder. Unless and until enforcement of the security for the notes has been completed and found to produce insufficient to pay all claims against the Issuer the option is not even exercisable. And when it is exercisable and exercised it has no effect on the liability of the issuer to the noteholders' assignee. Only if thereafter the assignee releases the issuer will the liability of the issuer be affected.

42. This is contested by counsel for the Issuer and the A2 Noteholders. They contend that having regard to commercial practicalities the existence of the call option has the result that no amount of further liability should be taken into account for the purposes of s.123(2). Accordingly, they submit that if, contrary to my view, the first question was answered in the affirmative the second question should also be answered in the affirmative because the PECO has removed any asset deficiency.

43. I prefer the submissions of counsel for the A3 Noteholders. It is necessary to return to the wording of s.123(2) set out in paragraph 29 above. If in the application of that subsection the court concludes that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities, then the question arises as to what effect the PECO has on those liabilities. In my view it has no effect at all. 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. It is assumed that the option company will release the issuer from all further liability, but it is under no obligation to do so and, until it does, the liability of the issuer is unaffected.

44. That is not to conclude that the PECO has failed in its purpose of rendering the issuer 'insolvency remote'. Far from it, the existence of the PECO renders the presentation of a petition to wind up the Issuer that much less likely. A noteholder would be a secured creditor at any time before the security for the Issuer's obligations had been fully enforced. Thereafter, though an unsecured creditor, the right of the noteholder to present a winding up petition would be subject to the call option and liable

to be divested accordingly. 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.

Conclusion

45. For all these reasons I will make a declaration that, whether or not the PECO formed part of the securitisation transaction, Eurosail is not unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986 ("the Act") for the purposes of Condition 9(a)(iii) of the Conditions. I will hear counsel on any issues as to the form of my order and any other matters arising from it.

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