Easter Term
[2013] UKSC 28
On appeal from: [2011] EWCA Civ 227

JUDGMENT

BNY Corporate Trustee Services Limited and others (Respondents) *v* Neuberger Berman Europe Ltd (on behalf of Sealink Funding Ltd) and others (Appellants)

BNY Corporate Trustee Services Limited and others (Respondents) *v* Eurosail-UK 2007-3BL PLC (Appellant)

before

Lord Hope, Deputy President
Lord Walker
Lord Mance
Lord Sumption
Lord Carnwath

JUDGMENT GIVEN ON

9 May 2013

Heard on 25 and 26 February 2013

Appellant/Cross-respondents
Gabriel Moss QC
Richard Fisher

(Instructed by Sidley Austin LLP)

2nd Respondent/Cross-appellant
Robin Dicker QC
Jeremy Goldring

(Instructed by Berwin Leighton Paisner LLP)

1st Respondent
David Allison

(Instructed by Allen & Overy LLP)

LORD WALKER: (with whom Lord Mance, Lord Sumption and Lord Carnwath agree)

Introduction

1. Sections (1) and (2) of section 123 of the Insolvency Act 1986 ("the 1986 Act") provide as follows:

> "(1) A company is deemed unable to pay its debts –
>
> > (a) [non-compliance with a statutory demand for a debt exceeding £750 presently due]
> >
> > (b) to (d) [unsatisfied execution on judgment debt in terms appropriate to England and Wales, Scotland and Northern Ireland respectively]
> >
> > (e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.
>
> (2) A company is also deemed 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."

A company in the situation described in subsection (1)(e) is often said to be "cash-flow" insolvent. A company in the situation described in subsection (2) is often said to be "balance-sheet" insolvent, but that expression is not to be taken literally. It is a convenient shorthand expression, but a company's statutory balance sheet, properly prepared in accordance with the requirements of company law, may omit some contingent assets or some contingent liabilities. There is no statutory provision which links section 123(2) of the 1986 Act to the detailed provisions of the Companies Act 2006 as to the form and contents of a company's financial statements. This appeal is concerned with the construction and effect of section 123(1)(e) and (2) as incorporated into the documentation of an issue of loan notes.

2. The statutory provisions were incorporated, with some small modifications, into the conditions applicable to loan notes issued in the course of a securitisation transaction comprising a portfolio of non-conforming mortgage loans secured on residential property in the United Kingdom. The issuer is Eurosail-UK 2007-3BL plc ("Eurosail"), one of many similar single purpose entities ("SPEs") set up by the Lehman Brothers group (but off the balance sheet of any of that group's companies) not long before its collapse. Eurosail is the principal respondent to this appeal, and it has a cross-appeal on a subsidiary issue. The other respondent appearing before this court, BNY Corporate Trustee Services Ltd ("the Trustee") is part of the BNY Mellon Group. It is the trustee for the holders ("Noteholders") of loan notes of various classes issued by Eurosail. It has adopted a neutral attitude in the proceedings (as explained in its written case), and has not appeared by counsel before this court. But it will, in the event that the appeal succeeds and the cross-appeal fails, have an important judgment to make as to material prejudice to the Noteholders' interests.

3. In 2007 Eurosail (described in the documentation as "the Issuer") acquired a portfolio of mortgage loans, secured on residential property in England and Scotland and denominated in sterling, to the principal amount of approximately £650m. Most of the mortgages were regarded as "non-conforming" in that they did not meet the lending requirements of building societies and banks. This purchase was funded by the issue on 16 July 2007 of loan notes in five principal classes (A, B, C, D and E) comprising 14 different subclasses, some denominated in sterling, some in US dollars and some in euros. In the designation of the classes "a" indicated that the loan was denominated in euros, "b" US dollars and "c" pounds sterling. The senior (class A) notes were divided into three sub-classes, denominated in one of the three currencies, designated and issued as follows:

A1b	US$200,000,000
A1c	£102,500,000
A2a	€64,500,000
A2b	US$100,000,000
A2c	£63,000,000
A3a	€215,000,000

A3c	£64,500,000

The B, C, D and E Notes were issued in smaller amounts, with variations in currency but no subclasses having different priorities as between themselves. There were also some notes designated as ETc "revenue-backed" notes. The total sum raised was just under £660,000,000. After payment of costs and expenses of the issue the initial surplus of assets over prospective liabilities (if taken at face value) was quite small.

4. The provisions of section 123(1) and (2) of the 1986 Act are incorporated into an important provision in the conditions of issue of the Notes ("the Conditions"). Condition 9(a) (events of default) provides that the Trustee may on the occurrence of any of five specified events (an "Event of Default") serve on Eurosail a written notice (an "Enforcement Notice") declaring the Notes to be due and repayable. In some circumstances the Trustee is obliged to serve such a notice. In the absence of an Event of Default the A1 Notes were repayable in 2027 at latest (in fact they have already been repaid, as have the revenue-backed notes). All the other Notes are repayable in 2045 at latest.

5. The Events of Default include (Condition 9(a)(iii)):

> "The Issuer, otherwise than for the purposes of such amalgamation or reconstruction as is referred to in sub-paragraph (iv) below, ceasing or, through or consequent upon an official action of the Board of Directors of the Issuer, threatens to cease to carry on business or a substantial part of its business or being unable to pay its debts as and when 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…"

Under a proviso to Condition 9(a), an occurrence falling within sub-paragraph (iii) counts as an Event of Default only if the Trustee certifies to Eurosail that it is, in the Trustee's sole opinion, materially prejudicial to the interests of the Noteholders.

6. The service of an Enforcement Notice would have immediate and far-reaching consequences for all the Noteholders (other than the A1 and ETc Noteholders, whose Notes have already been fully redeemed). As described in more detail below, an Enforcement Notice shifts their rights from the regime prescribed in Condition 2(g) (priority of payments prior to enforcement) to the regime prescribed in Condition 2(h) (priority of payments post-enforcement). Under the latter regime Noteholders of Class A3 ("A3 Noteholders") rank pari passu with Noteholders of Class A2 ("A2 Noteholders") for repayment of principal. That is in contrast with the present regime,

under which A2 and A3 Noteholders rank pari passu for interest payments (clause 2(g)(vi)) but A2 Noteholders have priority over A3 Noteholders in receiving repayments of principal out of funds representing principal sums received on the redemption of mortgages in the portfolio (those funds being included in the definition of "Actual Redemption Funds" in the preamble to the Conditions): Condition 5(b)(i)(2) and (3).

7. It is in these circumstances that the construction of section 123(2) of the 1986 Act, as incorporated into Condition 9(a)(iii), has assumed such importance. Eurosail, together with those of the A2 Noteholders who appeared below, succeeded before Sir Andrew Morritt C [2010] EWHC 2005 (Ch), [2011] 1 WLR 1200, and the Court of Appeal [2011] EWCA Civ 227, [2011] 1 WLR 2524. The Court of Appeal considered that section 123(2) should be interpreted broadly and in line with standards of commercial probity:

> "A balance has to be drawn between the right of an honest and prudent businessman, who is prepared to work hard, to continue to trade out of his difficulties if he can genuinely see a light at the end of the tunnel, and the corresponding obligation to 'put up the shutters', when, by continuing to trade, he would be doing so at the expense of his creditors and in disregard of those business considerations which a reasonable businessman is expected to observe."

(That is a quotation from paragraph 216 of the *Report of the Review Committee on Insolvency Law and Practice* (1982) (Cmnd 8558), better known as the Cork Report, reflecting the view of Professor Goode; this passage is quoted in para 54 of the judgment of Lord Neuberger MR in the Court of Appeal). The appellant A3 Noteholders say that this passage is not in point. They have argued for a much stricter construction. They have emphasised that a company's inability to pay its debts is no more than a precondition to the exercise of the court's jurisdiction, which is discretionary, to make a winding up order or an administration order. The precondition to be satisfied should be, they have argued, transparent and certain, leaving scope for the exercise of discretion on the hearing of the petition. There has also been argument as to whether the statutory text (as incorporated in an amended form, and also allowing for possible future legislative amendment) must bear the same meaning as it would in actual winding-up proceedings, or whether it can and should, as incorporated, take account of the commercial context of the Conditions.

8. Those, in outline summary, are the positions of the opposing parties on the appeal. The cross-appeal, which is relevant only if the appeal is successful, is concerned with the so-called Post-Enforcement Call Option ("PECO") which is a subsidiary (but technically important) part of the securitisation transaction.

9. Before going further into the complexities of the appeal I would comment that the image invoked by Professor Goode of an honest and prudent trader working hard to turn his business round relates, as was pointed out by Mr Moss QC for the appellants, to the law of insolvency as it applies to individuals. Even if translated into corporate terms, it has very little bearing on the situation in which Eurosail now finds itself. Its present financial position and future prospects are not matters for which Eurosail and its managers merit either praise or criticism, since those matters are almost entirely out of their control. They depend on three imponderables: first, (since the currency and interest-rate hedging arrangements with the Lehman Brothers group have failed, leaving Eurosail with a claim in its insolvency) the movements of the US dollar and the euro relative to the pound sterling; secondly, movements in LIBOR or equivalent interest rates on loans denominated in those three currencies; and thirdly, the performance of the United Kingdom economy in general, and the United Kingdom residential property market in particular, as influencing the performance of the mortgage portfolio.

The transaction documents

10. The legal documents relating to the securitisation issue are, as Lord Neuberger MR put it, regrettably and forbiddingly voluminous. Apart from the Conditions themselves there was a formal trust deed made between the Trustee and Eurosail, a Liquidity Facility Agreement, currency swaps agreements, a Fixed/Floating Swap Agreement, a BBR Swap Agreement and other agreements relating to administrative matters (there is a full list of "transaction documents" in the definition of that expression in the preamble to the Conditions). Several expressions used in the Conditions involve a paperchase to other documents in order to find their definitions. Mr Moss opened the documents very lightly, moving rapidly from Condition 9(a)(iii) to concentrate his submissions on the construction of section 123(1) and (2) of the 1986 Act. Mr Dicker QC (for Eurosail) went into the Conditions more fully to pave the way for his contextual arguments. Without pre-judging those arguments I think it is necessary, if only in order to appreciate the consequences of the opposing arguments, to have an outline understanding of how the SPE (which counsel concurred in describing as a "closed system" or "wrapper") operated before the collapse of Lehman Brothers, of how it operates now (after the collapse of Lehman Brothers but before any Enforcement Notice), and of how it would operate after the service of an Enforcement Notice.

11. Interest is payable on all unredeemed Notes quarterly in arrears, the first payment having been made on 13 September 2007. The annual rate of interest is linked to LIBOR or its dollar or euro equivalents (Condition 4(c)(i)), exceeding that rate by a margin (the "Relevant Margin" as defined in the preamble) which varies from 0.07% for A1b Notes to 4% for E Notes.

12. Mortgage interest received by Eurosail (the principal component in the "Available Revenue Fund") cascades down the metaphorical waterfall set out in the 24

sub-paragraphs of Condition 2(g) (priority of payments prior to enforcement). The first claims on the income stream are for remuneration, charges and expenses; then (sub-paragraph (iv)) sums due to the Liquidity Facility Provider, and (sub-paragraph (v), but only until the collapse of Lehman Brothers) sums payable under or in connection with the Fixed/Floating Swap Agreement and the BBR Swap Agreement (but not any currency swaps). Payments to currency swaps counterparties were linked to interest payments to particular classes of Noteholders, so that payments to counterparties in respect of A Noteholders come into the provision for payment of interest to those Noteholders, which is made pari passu as between all the A sub-classes (Condition 2(g)(vi)). The next priority (Condition 2(g)(vii)) was for payment-off of any A Principal Deficiency (another expression defined in the preamble), but in practice such a deficiency could arise only if all the junior classes of Notes had become valueless. Next in the waterfall come similar groups of provisions for payment of interest, sums due to the currency swaps counterparties (and any B Principal Deficiency) in respect of B Notes (Condition 2(g)(viii) and (ix)) and so on for all the other classes (Condition 2(g)(x) to (xv)).

13. On 15 September 2008 Lehman Brothers Holdings Inc ("LBHI"), the guarantor of the swaps counterparty, Lehman Brothers Special Financing Ltd ("LBSF") filed for Chapter 11 bankruptcy, as did LBSF on 3 October 2008. The swaps were terminated on 13 November 2009. Eurosail has made a claim against LBHI's and LBSF's bankrupt estates for about $221,000,000. At the time of the hearings below, the claim had not been admitted and no distribution has been made in respect of it. During the last three years sterling has depreciated significantly against both the euro and the dollar, but the prevailing low level of interest rates has resulted in a surplus ("excess spread") of mortgage interest received by Eurosail, which has enabled it to continue to pay in full the interest on all the outstanding Notes of every class.

14. In the meantime, both before and after the collapse of Lehman Brothers, Eurosail received principal sums from time to time as principal secured by the mortgages was repaid, either by way of partial or total redemption by mortgagors, or by enforcement of the security against mortgagors who were in default. These sums have been and are at present applied under Condition 5(b)(i) as "Actual Redemption Funds", on each date for payment of interest, in repaying the principal of the Notes in the order of priority A1 (now fully repaid), A2, A3, B, and so on. There is a proviso to Condition 5(b) under which the order of priority may be altered. The first possible variation (proviso (A)) applies if all the A1 and A2 Notes have been redeemed and other (favourable) specified conditions are satisfied: the A3 to E1c Notes then rank pari passu. Conversely, under the other variation (proviso (B)), which applies if there is an A Principal Deficiency, priority is granted to the A Notes as a single class ranking pari passu.

15. Events of default are regulated by Condition 9. The events specified in Condition 9(a) are, apart from that already set out (para 5 above): default in payment for three business days of any principal or interest due on any of the Notes; breach by Eurosail

of any of its obligations and failure to remedy the breach (if remediable) for 14 days after notice of the breach given by the Trustee; the making of an order or resolution for the winding up of Eurosail, otherwise than for an approved amalgamation or reconstruction; and the initiation of insolvency or administration proceedings, or the levying of execution (subject to various qualifications which it is unnecessary to set out in detail).

16. If the Event of Default is an event under Condition 9(a)(iii) or a breach of Eurosail's obligations, there is a further requirement that the Trustee shall have certified to Eurosail "that such event is, in its sole opinion, materially prejudicial to the interests of the Noteholders." For this purpose the Trustee may under the trust deed (as recorded in Condition 2(c)) "have regard only to (i) the interests of the A Noteholders if, in the Trustee's sole opinion, there is a conflict between the interests of the A Noteholders (or any Class thereof) and the interests of the B Noteholders, the C Noteholders, the D Noteholders and/or the E Noteholders." This provision does not indicate how the Trustee is to exercise its discretion in the event of a conflict (such as there now potentially is) between the interests of the A2 Noteholders and the A3 Noteholders. If there is an Event of Default (and, in the cases just mentioned, it is materially prejudicial) the Trustee may at its discretion serve an Enforcement Notice on Eurosail. Moreover it is obliged to do so if requested or directed (i) by holders of at least 25% of the outstanding "Most Senior Class of Notes" (defined as meaning the A Noteholders, rather than a subclass of them) or (ii) by an extraordinary resolution of the holders of that class. This court was not shown any evidence, and did not hear any submissions, as to whether either of those requirements would be likely to be satisfied in practice.

17. On service of the Enforcement Notice the Notes become immediately due and payable and the Noteholders' security becomes enforceable (Condition 9(b)). Thereupon the order of priority shifts from that in Condition 2(g) to that in Condition 2(h). It is unnecessary to go through all the detail of Condition 2(h). The all-important change is that under Condition 2(h)(v) the available funds are applicable to pay "pari passu and pro rata (1) all amounts of interest and principal then due and payable on the A1c Notes, the A2c Notes and the A3c Notes and (2) [subject to provisions about currency swaps that have now lapsed] any interest and principal then due and payable on the A1b Notes, the A2a Notes, the A2b Notes and the A3a Notes, respectively." In practical terms, the A2 Notes would no longer have priority, in terms of principal, to the A3 Notes.

18. The opening words of condition 2(h) express the Trustee's obligation as being to make payments "to the extent of the funds available to [Eurosail] and from the proceeds of enforcement of the Security" (with exceptions that need not be detailed). The penultimate provision of Condition 2(h) provides: "The Noteholders have full recourse to [Eurosail] in respect of the payments prescribed above and accordingly are entitled to bring a claim under English law, subject to the Trust Deed, for the full amount of such payments in accordance with Condition 10 (Enforcement of Notes)". Mr Dicker

did not challenge Mr Moss's submission that the opening words do not contradict the penultimate provision, and that seems to be correct. The opening words are directed to the Trustee's obligations, not to those of Eurosail.

19. Condition 5(j) contains the PECO (Post Enforcement Call Option) which is the subject of the cross-appeal. This option (which has been given effect to as a separate written agreement between the Trustee and a company named or referred to as OptionCo) is regarded in the industry as a means of achieving the effect of limited recourse without the adverse tax consequences that would then have followed from a simple express non-recourse provision. The operative part of Clause 5(j) is as follows:

> "All of the Noteholders will, at the request of the holder of the Post Enforcement Call Option, sell all (but not some only) of their holdings of the Notes to the holder of the Post Enforcement Call Option, pursuant to the option granted to it by the Trustee (as agent for the Noteholders) to acquire all (but not some only) of the Notes (plus accrued interest thereon), for the consideration of one euro cent per Euro Note outstanding, one dollar cent per Dollar Note outstanding and one penny per Sterling Note outstanding (and for these purposes, each Global Note shall be one Note) in the event that the Security for the Notes is enforced, at any time after the date on which the Trustee determines that the proceeds of such enforcement are insufficient, after payment of all other claims ranking higher in priority to the Notes and pro rata payment of all claims ranking in equal priority to the Notes and after the application of any such proceeds to the Notes under the Deed of Charge, to pay any further principal and interest and any other amounts whatsoever due in respect of the Notes."

Bankruptcy remoteness

20. "Bankruptcy remoteness" was the expression used by Standard & Poor's credit-rating agency, and generally in the industry, to describe one criterion for a SPE to obtain a satisfactory credit rating for its loan notes (see "European Legal Criteria for Structured Finance Transactions" published by Standard & Poor's (28 August 2008), and the comments of the Chancellor [2011] 1 WLR 1200, para 8 and Lord Neuberger of Abbotsbury MR [2011] 1 WLR 2524, para 28). This is not the place to consider either the reliability of the credit-rating agencies' judgments on Notes secured by sub-prime mortgages, or the influence that their judgments seem to have had in the market (caused, some have suggested, by the industry's general inability to comprehend the risks inherent in its own creations). But the notion of "bankruptcy remoteness", even if imperfectly understood, underlay many features of the Conditions and the arrangements of which they formed part.

21. In developing his contextual argument that this court should (if necessary) mould the meaning of section 123(1) and (2), as incorporated into Condition 9(a)(3) so as to take account of commercial realities, Mr Dicker drew particular attention to five features of the arrangements. They are set out and discussed in section B2 of Eurosail's case. Most of them have been mentioned already, at least in passing, but it may be helpful to bring them together in summary form. They are relevant not only (arguably) to the issue of construction but also (without room for argument) to determining the likely length of deferment of Eurosail's long-term liabilities under the Conditions, in the absence of an Event of Default which triggers an Enforcement Notice. These points are covered at some length in the witness statements of Mr Mark Filer, a director of Wilmington Trust SP Services (London) Ltd, Eurosail's corporate services provider.

22. The five salient features of the Conditions and the supporting documentation bearing on the likely deferment of Eurosail's obligations in respect of principal and interest are as follows:

(1) Condition 2(g) defines Eurosail's obligations for payment of interest on the Notes (after remuneration, charges and expenses) in terms of the Available Revenue Fund (see para 12 above). If that source is insufficient for payment of interest on any of the Junior Notes (that is, those which are not A Notes) the obligation is deferred (while accruing interest) under Condition 6(i) and (j), if necessary until the final redemption date in 2045.

(2) Temporary shortages of income can be provided for by the Liquidity Facility (reimbursements to which have a high order of priority under Condition 2(g)(iv)).

(3) As to principal, redemption of Notes (other than the redeemed A1 Notes and the revenue-backed Notes) is not due until 2045. Until then redemption is limited to the Actual Redemption Funds (as defined in the preamble) which are applied in the appropriate order of priority under Condition 5(b) (see para 14 above).

(4) Any loss of principal resulting from default on mortgages is termed a 'Principal Deficiency' and is recorded in the Principal Deficiency Ledger (the detailed provisions as to this are found not in the Conditions but in Clauses 8 and 9 of the Cash/Bond Administration Agreement). If there is surplus income from the mortgage payments, the 'excess spread' can be used to reduce or eliminate any Principal Deficiency on whatever is the highest-ranking class of Notes with a deficiency. Recoupment of a Principal Deficiency takes priority to the payment of interest on lower-ranking Notes (see para 12 above).

(5) Finally there is the PECO, which is intended to produce the same, or a similar result as an express limited-recourse provision (see paras 18 and 19 above).

The legislation

23. This court was taken to the legislative history of sections 122 and 123 of the 1986 Act, and it will be necessary to refer to it in some detail. But it may be better to start with the sections themselves. The 1986 Act was a consolidating statute which gave effect to the amendments made by the Insolvency Act 1985. Section 122(1), as amended, provides seven cases in which a company may be wound up by the court, of which the most important are the last two:

> "(f) the company is unable to pay its debts,
>
> (g) the court is of the opinion that it is just and equitable that the company should be wound up."

Section 123(1) then sets out five cases (stated or summarised in para 1 above) in which a company "is deemed unable to pay its debts."

24. The four cases in paragraphs (a) to (d) of section 123(1) are true deeming provisions. A company's non-compliance with a statutory demand, or non-satisfaction of execution of a judgment debt, is a matter that can be proved quite simply, usually by a single short witness statement. If proved, it establishes the court's jurisdiction to make a winding up order, even if the company is in fact well able to pay its debts. If however a debt which has been made the subject of a statutory demand is disputed on reasonable grounds, the petitioner is adopting what has been called a high-risk strategy, and the petition may be dismissed with indemnity costs: *In Re a Company 12209 of 1991* [1992] BCLC 865, 868 (Hoffmann J).

25. Section 123(1)(e) is significantly different in form:

> "if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due."

This is not what would usually be described as a deeming provision. It does not treat proof of a single specific default by a company as conclusive of the general issue of its inability to pay its debts. Instead it goes to that very issue. It may open up for inquiry a much wider range of factual matters, on which there may be conflicting evidence. The

range is wider because section 123(1)(e) focuses not on a single debt (which under paragraphs (a) to (d) has necessarily accrued due) but on all the company's debts "as they fall due" (words which look to the future as well as to the present).

26. The words "as they fall due" did not appear in the legislation until the Insolvency Act 1985. Similarly the express reference in section 123(2) to the test of "the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities" did not appear before the Insolvency Act 1985. In the present case both the Chancellor and the Court of Appeal treated the present legislative provisions as materially different from those previously in force: [2011] 1 WLR 1200, para 24; [2011] 1 WLR 2524, para 53. Yet when this point was raised during the passage of the Insolvency Bill in 1985, the government spokesman in House of Lords, Lord Lucas of Chilworth, stated:

> "Commons Amendment No 458 gives effect to the way in which the courts have interpreted section 518 of the Companies Act [1985]; that was previously section [223] of the 1948 Act. We are not seeking to amend the law by this amendment; merely to give effect to that interpretation by the courts, namely, that section 518 contains both a cash flow and a balance sheet test." Hansard (HL Debates, 23 October 1985, col 1247)

In these circumstances it is necessary to look quite closely at the legislative history. In considering it I have derived great assistance from a variety of academic commentary, including an article by Dr Peter Walton, "Inability to pay debts": beyond the point of no return? [2013] JBL 212.

27. The starting point is sections 79 and 80 of the Companies Act 1862 (25 & 26 Vict, c 89), the general structure of which is similar to that of sections 122 and 123 of the 1986 Act. Section 80(4) of the 1862 Act stated the test simply as:

> "Whenever it is proved to the satisfaction of the court that the company is unable to pay its debts."

However, it is to be noted that under section 158, once a winding up order had been made, "all debts payable on a contingency, and all claims against the company, present or future, certain or contingent, ascertained or sounding only in damages, shall be admissible to proof against the company, a just estimate being made, so far as is possible, of the value of all such debts or claims as may be subject to any contingency or sound only in damages, or for some other reason do not bear a certain value." So a contingent or prospective creditor could not present a petition, but if another creditor

presented a petition and secured a winding up order, contingent and prospective liabilities were admitted to proof.

28. In *In Re European Life Assurance Society* (1869) LR 9 Eq 122 Sir William James V-C dismissed a petition for the winding up of a company which had issued large numbers of life policies and annuity contracts, and appeared to be in financial difficulties. In an extempore judgment he decided, with very little reasoning, that (p 127) "inability to pay debts must refer to debts absolutely due." He then proceeded to consider at greater length, but to dismiss, the alternative "just and equitable" ground in section 79(5) of the Companies Act 1862. As to this ground he said at p 128:

> "And in my view of the law of the case it would be just and equitable to wind up a company like this assurance company if it were made out to my satisfaction that it is, not in any technical sense but, plainly and commercially insolvent – that is to say, that its assets are such, and its existing liabilities are such, as to make it reasonably certain – as to make the court feel satisfied – that the existing and probable assets would be insufficient to meet the existing liabilities. I take it that the court has nothing whatever to do with any question of future liabilities, that it has nothing whatever to do with the question of the probability whether any business which the company may carry on tomorrow or hereafter will be profitable or unprofitable. That is a matter for those who may choose to be the customers of the company and for the shareholder to consider."

So here, it seems, the Vice-Chancellor was applying a balance-sheet test, but only to existing liabilities, in the context of the "just and equitable" ground. He did not refer to any of the authorities that had been cited. It may be unfortunate that his judgment has come to be regarded as a leading case.

29. Shortly afterwards the law was changed in relation to life offices by the Life Assurance Companies Act 1870 (33 & 34 Vict, c 61), which was effectively the beginning of the modern statutory regulation of life assurance. There was no general change until section 28 of the Companies Act 1907, which made an amendment which was then consolidated by the Companies (Consolidation) Act 1908. The latter provided in section 130(iv) that a company should be deemed to be unable to pay its debts:

> "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."

The amendment made by the Companies Act 1907 was introduced on the recommendation of the Loreburn Committee (Report of the Company Law Amendment Committee) (1906) (Cd 3052), para 43, which was influenced by section 21 of the Life Assurance Companies Act 1870. The amendment is described by Dr Walton [2013] JBL 212, 228 as an abbreviated version of section 21. But there is not a very close parallel, since section 21 referred to a life office being insolvent (meaning, apparently, balance-sheet insolvent) rather than its being unable to pay its debts. But the admission of contingent and prospective liabilities, and especially long-term liabilities, must tend to focus attention on balance-sheet considerations. Thus in *In Re Capital Annuities Ltd* [1979] 1 WLR 170, 185, Slade J observed:

> "From 1907 onwards, therefore, one species of 'inability to pay its debts' specifically recognised by the legislature as a ground for the making of a winding up order in respect of any company incorporated under the Companies Acts was the possession of assets insufficient to meet its existing, contingent and prospective liabilities."

Essentially the same wording appeared in section 223(d) of the Companies Act 1948 and in section 518(e) of the Companies Act 1985. Two cases decided under section 223(d) call for mention.

30. The first is *In Re a Company* (also referred to as *Bond Jewellers*) [1986] BCLC 261, decided by Nourse J on 21 December 1983. Like *In Re European Life Assurance Society*, it was an extempore judgment given without citation of authority, in order to avoid delay, but it has been much cited. It was referred to in both Houses of Parliament during the committee stages of the Insolvency Bill. It concerned a tenant company with a propensity for postponing payment of its debts until threatened with litigation. Nourse J felt unable to make an order under section 223(d), and considered, but ultimately did not make an order, on the "just and equitable" ground in section 222(f). The case is of interest as illustrating (at p 263) that the phrase "as they fall due", although not part of the statutory text, was understood to be implicit in section 223(d). It is also of interest for the judge's observation on the second point in section 223(d) (now embodied, in different words, in section 123(2) of the 1986 Act):

> "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."

31. The second case, *Byblos Bank SAL v Al-Khudhairy* [1987] BCLC 232, was a considered judgment of Nicholls LJ (with whom Slade and Neill LJJ agreed) delivered after 11 days of argument. It concerned the disputed validity of the appointment of a receiver in June 1985, before either the Companies Act 1985 or the Insolvency Act 1985 was in force. The ostensible ground for appointment of the receiver was not made out, but the bank relied on a new ground, section 223(d). Nicholls LJ observed (p 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 suffice 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."

Nicholls LJ then referred to the judgment of James V-C in *In Re European Life Assurance Society* LR 9 Eq 122, including the passage quoted at para 28 above, and commented (p 248):

> "In my view the exercise described by James V-C is the exercise required to be done under section 223 (now section 518 of the 1985 Act)."

He also referred to the decisions of Slade J in *In Re Capital Annuities Ltd* [1979] 1 WLR 170 and Nourse J in *In Re A Company* [1986] BCLC 261 as consistent with the views he had expressed.

32. In my view these authorities go quite a long way to establishing that neither the notion of paying debts "as they fall due", nor the notion of balance-sheet insolvency, was unfamiliar before the enactment of the Insolvency Act 1985. But petitions by

contingent or prospective creditors have been rare even after the repeal in 1986 of the standard requirement for such a creditor to provide security for costs. One reason for that is no doubt the difficulty of quantifying contingent and prospective liabilities to the satisfaction of the court. Another may be the fact that well-advised commercial lenders will insist on contractual conditions under which deferred liabilities are accelerated in the event of the borrower getting into financial difficulties.

33. The far-reaching reforms effected by the Insolvency Acts of 1985 and 1986, together with related subordinate legislation, were influenced by the report of the Cork Committee, published in 1982. One of its recommendations (para 535) was that "the sole ground upon which the court may make an insolvency order in respect of a debtor, whether individual or corporate, will be that the debtor is unable to pay his or its debts." The Committee proposed three cases in which the debtor would be deemed to be insolvent and unable to pay his or its debts. The first two corresponded to the cases in section 123(1)(a) to (d) of the 1986 Act. The third case was:

> "(c) Where the applicant is a contingent or prospective creditor to whom the debtor is or may become indebted in a sum of not less than the prescribed amount, being a debt not yet presently due and payable, and it is proved to the satisfaction of the court that the ultimate repayment of the debt is in jeopardy because the debtor's liabilities, including contingent and prospective liabilities, exceed the debtor's assets."

This proposal limited the balance-sheet insolvency test to applications by contingent or prospective creditors whereas the *Byblos Bank* case suggested that it was also relevant to the payment of debts "as they fall due". That point was noted by Briggs J in his perceptive judgment *In Re Cheyne Finance plc (No 2)* [2008] Bus LR 1562. He referred at paras 42-43 to similar language ("as they become due") used in Australian companies' legislation, which until 1992 had a single test based on an inability to pay debts "as they become due" – a phrase which looks to the future, as Griffith CJ said in *Bank of Australasia v Hall* (1907) 4 CLR 1514, 1527. There is a good deal of later Australian authority, mentioned in the judgment of Briggs J, to the same effect.

34. *In Re Cheyne Finance Plc (No 2)* was concerned with a security trust deed which (in contrast to Condition 9(a)(iii) in the present appeal) incorporated into its definition of "insolvency event" the terms of section 123(1), but not section 123(2). It was therefore necessary to consider how far section 123(1)(e) was concerned, not only with debts that were immediately payable, but also with those that would be payable in the future. Briggs J decided, rightly in my view, that that is what section 123(1)(e) requires (para 56):

> "In my judgment, the effect of the alterations to the insolvency test made in 1985 and now found in section 123 of the 1986 Act was to replace in the commercial solvency test now in section 123(1)(e), one futurity requirement, namely to include contingent and prospective liabilities, with another more flexible and fact sensitive requirement encapsulated in the new phrase 'as they fall due.'"

Briggs J considered (para 35), again rightly in my view, that the *Byblos Bank* case was a case about ability to pay debts as they became due, but that the Court of Appeal recognised that balance-sheet insolvency is not irrelevant to that issue.

The practical effect of section 123

35. There is no doubt that, as a matter of form, the statutory test for a company being unable to pay its debts is materially different (as the Chancellor and the Court of Appeal observed) from the position under the Companies Act 1985. Section 123(1)(e) introduced the words "as they fall due" and section 123(2) has introduced a direct reference to a company's assets and liabilities. These two provisions, both labelled as "deeming" provisions (though neither is obviously of that character) stand side by side in section 123(1)(e) and section 123(2) with no indication of how they are to interact.

36. It seems likely that part of the explanation lies in the history of the passage through Parliament of the Insolvency Bill in 1985, and the lengthy and interrupted process of review and consultation which had preceded it. This process began as long ago as October 1976 when the Secretary of State announced his intention of setting up what became the Review Committee chaired by Mr (later Sir) Kenneth Cork. It produced an interim report in October 1979 (after a change of government) and its final report in 1982. The whole protracted process is described by Professor Ian Fletcher QC in his *Law of Insolvency* 4th ed (2009), pp 16-22. He explains how there was no official reaction to the final report until a spate of financial scandals early in 1984:

> "At relatively short notice the government White Paper, referred to above, was published in February 1984 together with an indication that legislation was imminent. In consequence, very little time was allowed for interested parties to submit comments before the drafting of the Insolvency Bill was embarked upon, and the Bill itself was introduced in the House of Lords on 10 December 1984. This regrettable mishandling of the period of preparation for the first major overhaul of insolvency law for over 100 years cannot but be lamented. The inadequate manner in which consultation was conducted, coupled with the near-total lack of any form of public debate about the issues of policy and principle at the heart of any radical recasting of

> insolvency law, were an inauspicious prelude to what was to become a most contentious and confused episode of legislative history. Thereby, what ought to have been a largely non-controversial, non-Party Bill became the subject of highly dramatic proceedings before both Houses, and also in Committee, and damage was unquestionably inflicted upon the ultimate quality of a highly technical piece of legislation whose detailed provisions were but vaguely understood by all but a minority of those participating in its enactment, but whose social and economic importance was nonetheless immense. The Bill's deficiencies, due to haste in preparation, together with the vicissitudes of the parliamentary process, resulted in a quite exceptional number of amendments being tabled to the Insolvency Bill, estimated to have approached 1,200 by the time of Royal Assent. A high proportion of these amendments were tabled by the Government itself, and many were adopted virtually without debate during the closing stages of proceedings." (para 1-034)

37. Despite the difference of form, the provisions of section 123(1) and (2) should in my view be seen, as the Government spokesman in the House of Lords indicated, as making little significant change in the law. The changes in form served, in my view, to underline that the "cash-flow" test is concerned, not simply with the petitioner's own presently-due debt, nor only with other presently-due debt owed by the company, but also with debts falling due from time to time in the reasonably near future. What is the reasonably near future, for this purpose, will depend on all the circumstances, but especially on the nature of the company's business. That is consistent with *Bond Jewellers, Byblos Bank* and *Cheyne Finance.* The express reference to assets and liabilities is in my view a practical recognition that once the court has to move beyond the reasonably near future (the length of which depends, again, on all the circumstances) any attempt to apply a cash-flow test will become completely speculative, and a comparison of present assets with present and future liabilities (discounted for contingencies and deferment) becomes the only sensible test. But it is still very far from an exact test, and the burden of proof must be on the party which asserts balance-sheet insolvency. The omission from Condition 9(a)(iii) of the reference to proof "to the satisfaction of the court" cannot alter that.

38. Whether or not the test of balance-sheet insolvency is satisfied must depend on the available evidence as to the circumstances of the particular case. The circumstances of Eurosail's business, so far as it can be said to have a business at all, are quite unlike those of a company engaged in normal trading activities. There are no decisions to be made about choice of suppliers, stock levels, pricing policy, the raising of new capital, or other matters such as would constantly engage the attention of a trading company's board of directors. Instead Eurosail is (in Mr Moss's phrase) in a "closed system" with some resemblance to a life office which is no longer accepting new business. The only important management decision that could possibly be made would be to attempt to arrange new hedging cover in place of that which was lost when Lehman Brothers

collapsed. To that extent Eurosail's present assets should be a better guide to its ability to meet its long-term liabilities than would be the case with a company actively engaged in trading. But against that, the three imponderable factors identified in para 9 above – currency movements, interest rates and the United Kingdom economy and housing market – are and always have been outside its control. Over the period of more than 30 years until the final redemption date in 2045, they are a matter of speculation rather than calculation and prediction on any scientific basis.

39. At first instance the Chancellor started with three propositions derived from the case law (paras 29 to 32): that the assets to be valued are the present assets of the company; that "contingent and prospective liabilities" are not to be taken at their full face value; and that:

> "'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." (para 32)

He then set out four reasons (paras 34 to 37) for concluding (para 38) that the value of Eurosail's assets exceeded its liabilities, "having taken account of its contingent and prospective liabilities to such extent as appears to be necessary at this stage."

40. In the Court of Appeal Lord Neuberger MR did not disagree with anything in the Chancellor's judgment so far as it related to statutory construction. He did however go further in his detailed discussion of section 123(2). He observed (para 44):

> "In practical terms, it would be rather extraordinary if section 123(2) was satisfied every time a company's liabilities exceeded the value of its assets. Many companies which are solvent and successful, and many companies early on in their lives, would be deemed unable to pay their debts if this was the meaning of section 123(2). Indeed, the issuer is a good example of this: its assets only just exceeded its liabilities when it was formed, and it was more than possible that, even if things went well, it would fall from time to time within the ambit of section 123(2) if the appellants are right as to the meaning of that provision."

41. Lord Neuberger MR developed this at paras 47 to 49 of his judgment:

> "47. More generally, I find it hard to discern any conceivable policy reason why a company should be at risk of being wound up simply because the aggregate value (however calculated) of its liabilities exceeds that of its assets. Many companies in that position are successful and creditworthy, and cannot in any way be characterised as 'unable to pay [their] debts'. Such a mechanistic, even artificial, reason for permitting a creditor to present a petition to wind up a company could, in my view, only be justified if the words of section 123(2) compelled that conclusion, and in my opinion they do not.
>
> 48. In my view, the purpose of section 123(2) has been accurately characterised by Professor Sir Roy Goode in *Principles of Corporate Insolvency Law*, 3rd ed (2005). Having referred to section 123(1)(e) as being the 'cash flow test' and to section 123(2) as being the 'balance sheet test', he said this, at para 4-06:
>
>> 'If the cash flow test were the only relevant test [for insolvency] then current and short-term creditors would in effect be paid at the expense of creditors to whom liabilities were incurred after the company had reached the point of no return because of an incurable deficiency in its assets.'
>
> 49. In my judgment, both the purpose and the applicable test of section 123(2) are accurately encapsulated in that brief passage."

42. Toulson LJ agreed with Lord Neuberger MR but expressed himself in a more guarded way. He agreed that Professor Sir Roy Goode had "rightly discerned the underlying policy" (para 115) but added (para 119) that Professor Goode's reference to a company having "reached the point of no return because of an incurable deficiency in its assets" illuminates the purpose of the subsection but does not purport to be a paraphrase of it. He continued:

> "Essentially, section 123(2) requires the court to make a judgment whether it has been established that, looking at the company's assets and making proper allowance for its prospective and contingent liabilities, it cannot reasonably be expected to be able to meet those liabilities. If so, it will be deemed insolvent although it is currently able to pay its debts as they fall due. The more distant the liabilities, the harder this will be to establish."

I agree with what Toulson LJ said here, and with great respect to Lord Neuberger MR I consider that "the point of no return" should not pass into common usage as a paraphrase of the effect of section 123(2). But in the case of a company's liabilities that can as matters now stand be deferred for over 30 years, and where the company is (without any permanent increase in its borrowings) paying its debts as they fall due, the court should proceed with the greatest caution in deciding that the company is in a state of balance-sheet insolvency under section 123(2).

Reasoning in the courts below

43. Sir Andrew Morritt C, having set out some general propositions as to the effect of section 123 (1)(e) and (2) (in paras 29 to 32 of his judgment, summarized above), rejected the A3 Noteholders' submission that Eurosail was plainly insolvent for the purposes of section 123(2) as applied by Condition 9(a)(iii). He relied on four points, set out in paras 34 to 37 of his judgment. First, Eurosail's claims in the insolvencies of LBHI and LBSF, though not admitted, could not be ignored. The secondary market indicated that the claim was worth 35% to 37% of US$221m (that is, a value of the order of £60m). Second, a large part of the total deficiency that was claimed to exist was due to conversion into sterling at the prevailing spot rate of liabilities not due for payment until 2045. Third, the future liabilities were fully funded in the limited sense that deficiencies resulting from mortgage defaults reduced Eurosail's liability to the Noteholders through the operation of the Principal Deficiency Ledger. Fourth, the Chancellor was able to infer that a calculation of the then present values of assets and liabilities would not show a deficiency, since Eurosail was well able to pay its debts as they fell due, there was no deficiency on the Principal Deficiency Ledger, and projected redemptions of each class of A Notes were in advance of the maturity dates.

44. In the Court of Appeal counsel appearing for the A2 Noteholders did not feel able to give complete support to the Chancellor's second point, and Lord Neuberger MR accepted (para 67) the submission of counsel for the appellants:

> "As Mr Sheldon [then appearing for the A3 Noteholders] said, one has to value a future or contingent liability in a foreign currency at the present exchange rate. By definition, that is the present sterling market value of the liability."

I would also respectfully question the Chancellor's third point. The Chancellor had earlier in his judgment, at para 13, referred to clause 8 of the Cash/Bond Administration Agreement, which provides for the maintenance of Principal Deficiency Ledgers. That seems to be the basis of his point about liabilities being self-cancelling. But clause 8 seems to be concerned with no more than an accountancy exercise, not with a permanent extinction of liabilities. It operates to defer liabilities for principal until the final

redemption date, if circumstances require, and provided that an Enforcement Notice is not given in the meantime. But Condition 2(h) provides for Eurosail to be liable on a full recourse basis post-enforcement, as already noted (para 18 above).

45. Lord Neuberger MR did not accept that a forecast deficiency based on then current exchange rates could be dismissed as entirely speculative. He started (para 63) from Eurosail's audited accounts for the year ending 30 November 2009, which showed a net liability of £74.557m. He noted (paras 63 to 74) that this figure required two substantial amendments (one for the Lehman Brothers claim, and the other for the full recourse factor) "which, ironically and coincidentally, virtually cancel each other out" (para 69). So his final discussion and conclusion (paras 75 to 83) starts with an assumed deficiency of the order of £75m.

46. Against that Lord Neuberger MR set three factors. The first was that a deficiency of £75m, with an aggregate principal sum of just over £420m outstanding on the mortgages, was less than 17% of the assets. Secondly, the deficit was largely based on the assumption that exchange rates would remain constant (para 76):

> "Of course, they are as likely to move in an adverse direction as they are to move in a favourable direction, but the volatility of those rates tell against the appellants given that they have to establish that the issuer has reached the point of no return."

Thirdly, the court was looking a long way ahead (para 78):

> "Not only do all the unredeemed notes have a final redemption date in 2045, but it appears from the evidence that the weighted average term of the remaining mortgages is in the region of 18 years, and the rate of early redemption has slowed significantly and is likely, according to expert assessment, to remain low for the time being."

47. Lord Neuberger MR accepted that there was a real possibility that, if no Enforcement Notice was served, events might turn out to the disadvantage of the A3 Noteholders (para 79):

> "However, as mentioned, a future or contingent creditor of a company can very often show that he would be better off if the company were wound up rather than being permitted to carry on business. In a commercially sensible legal system that cannot of itself justify the creditor seeking to wind up the company."

Toulson and Wilson LJJ agreed with this reasoning. Toulson LJ emphasised the importance of the liabilities being distant in time (para 119, quoted in para 42 above). The appeal was therefore dismissed, as was the cross-appeal.

Conclusions

48. The crucial issue, to my mind, is how far the Court of Appeal's conclusion depended on the "point of no return" test. For reasons already mentioned, I consider that that is not the correct test, if and in so far as it goes beyond the need for a petitioner to satisfy the court, on the balance of probabilities, that a company has insufficient assets to be able to meet all its liabilities, including prospective and contingent liabilities. If it means no more than that, it is unhelpful, except as illuminating (as Toulson LJ put it) the purpose of section 123(2).

49. In my view the Court of Appeal would have reached the same conclusion without reference to any "point of no return" test; and I would myself reach the same conclusion. Eurosail's ability or inability to pay all its debts, present or future, may not be finally determined until much closer to 2045, that is more than 30 years from now. The complex documentation under which the loan notes were issued contains several mechanisms (identified in para 22(1) to (4) above, the PECO being disregarded for present purposes) for ensuring that liabilities in respect of principal are, if necessary, deferred until the final redemption date, unless the post-enforcement regime comes into operation. The movements of currencies and interest rates in the meantime, if not entirely speculative, are incapable of prediction with any confidence. The court cannot be satisfied that there will eventually be a deficiency.

50. I would therefore dismiss the appeal. I would also dismiss the cross-appeal, for the same reasons as were given by the Chancellor and the Court of Appeal. It is not necessary to consider Mr Dicker's arguments based on supposed inconsistencies and commercial realities, except to say that they would have encountered serious difficulties in the light of this court's decision in *Enviroco Ltd v Farstad Supply A/S* [2011] UKSC 16, [2011] 1 WLR 921: see the judgment of Lord Collins of Mapesbury, with which the other members of the court agreed, at paras 51 and 52. The loan notes documentation did indeed contain some provisions (identified in paras 128 to 134 of Eurosail's case) which are inconsistent with the post-enforcement regime being triggered by a temporary deficiency of assets. But the court might well have taken the view, on documents of such complexity, that the draftsman had simply failed to grasp all its many and various implications, and that it was not for the court to rewrite the documents for the parties.

LORD HOPE:

51. I would dismiss the appeal for the reasons given by Lord Walker. I would also dismiss the cross-appeal, which concerns the effect of the PECO on the application of section 123(2) of the 1986 Act as incorporated into Condition 9(a)(iii). The question which it raises no longer needs to be answered as the Noteholders' appeal on the question whether Eurosail ("the Issuer") was unable to pay its debts was not successful. But Sir Andrew Morritt C [2011] 1 WLR 122 gave his view on it in paras 39-44 of his judgment, and so too did Lord Neuberger MR in the Court of Appeal [2011] 1 WLR 2524 in paras 84-100. A PECO is widely used in securitisation transactions of the kind that was entered into in this case, and we have been told that the question is of some importance to the securitisation market more generally. So it is appropriate that we should give our reasons for agreeing with the Chancellor and the Court of Appeal that it has no effect on the way the liability of the Issuer to the Noteholders for the purposes of the default provision in Condition 9(a)(iii) is to be calculated.

52. The Trustee entered into a PECO Agreement on behalf of the Noteholders on 16 July 2007, which is the same date as that on which the Notes were issued. By Clause 3.1 it granted an option to a company called Eurosail Options Ltd (referred to in the Agreement as "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 an 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."

53. Clause 3.1 has to be read together with Condition 5(j) (see para 19, above), which provides that each Noteholder will, on the exercise of the option conferred on OptionCo, sell to the company the whole of his holding of notes for the nominal consideration for which the PECO provides. It also has to be read together with the Event of Default described in Condition 9(a)(iii): see para 5, above. Under that provision a default occurs, among other things, in the event of the Issuer:

> "being unable to pay its debts as and when 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".

54. The Prospectus at p 26 contains this explanation of the effect of these provisions, under the heading "Considerations related to the Instruments", for prospective purchasers:

> "Although the Instruments will be full recourse obligations of the Issuer, upon enforcement of the security for the Instruments, the Trustee … will, in practice, have recourse only to the Loans and Collateral Security, and to any other assets of the Issuer then in existence as described in this document…"

55. The purpose of a PECO is to achieve bankruptcy remoteness for the issuer. Its aim is to prevent the issuer from being susceptible to insolvent winding up proceedings by ensuring so far as possible that, if its assets prove to be insufficient to meet its liabilities, a director of the issuer will not instigate bankruptcy proceedings in respect of it. Bankruptcy remoteness is one of the criteria used by the rating agencies which issuers of notes seek to satisfy so that their instruments will achieve the highest possible credit rating. That criterion is satisfied in other jurisdictions by provisions which limit the rights of noteholders against the issuer to the value of the issuer's assets. Until recent tax legislation altered the position, limited recourse provisions of that kind gave rise to UK stamp duty reserve tax at the rate of 1.5% of the amount subscribed for them. As the Chancellor explained in para 40, the PECO is designed to achieve the same result as limited recourse provisions, but without the adverse tax consequences.

56. The Issuer accepts that, as a matter of contract, the liabilities were unlimited in recourse. But it maintains that the commercial reality was that the liabilities alleged to be the debts that the issuer was unable to pay to the Noteholder were liabilities which it would never have to meet. In the event that the assets of the Issuer were exhausted, any claim that the Noteholder had against the Issuer would be assigned to the option holder. That, it is said, would bring an end to the claim. So it would be wrong to treat the Issuer as falling within section 123(2) as incorporated into Condition 9(a)(iii) on the ground that it was unable to pay its debts, as in practice it was never intended or expected that the liabilities would be paid except out of the underlying assets available to the Issuer.

57. The soundness of this approach depends however on whether, in law, the PECO affects the liability of the Issuer to the Noteholder. In answering this question it is important to appreciate that the question is not whether the Issuer should actually be

wound up on the grounds described in section 123(2), but whether its financial position is such that it falls within that subsection for the purposes of the default provision in Condition 9(a)(iii). The answer to that question is to be found by examining the wording of the Condition in the context of the provisions of the transaction documents as a whole. Does the PECO in any way alter the conclusion that would otherwise be drawn that the Issuer's assets were less than its liabilities and that it was unable to pay its debts?

58. The Chancellor based his judgment that it did not on the wording of section 123(2), as amended for the purposes of Condition 9(a)(iii). He held that if, in the application of that subsection the court concluded that the value of the company's assets was less than the amount of its liabilities, taking into account its contingent and prospective liabilities, the PECO had no effect on those liabilities at all: para 43. As he put it, 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. Unless and until the option holder releases the Issuer from all further liability, which it is under no obligation to do, the liability of the Issuer is unaffected.

59. Lord Neuberger reached the same conclusion, but for fuller reasons: see paras 92-97. He said that, reading the relevant provisions of the documents together, they established that the Issuer's liability to the Noteholders was to be treated as a liability of full recourse at least until the security was enforced and, arguably, until the option was exercised and the transfer to the option holder was completed. There was the statement in the Prospectus mentioned in para 54, above. It suggested a two-stage process, under which the Issuer's liability was treated initially as full recourse and liability would become limited recourse only on enforcement of the security. There was the closing part of clause 6.7 of the Deed of Charge which, having restricted the ability of the Trustee to enforce the Noteholders' rights on enforcement of the Security beyond the Issuer's assets, provided that this "shall not apply to and shall not limit the obligations of the Issuer to the [Noteholders] under the Instruments and this Deed." And there was the provision in Condition 2(h), which stated in terms that the Noteholders had full recourse to the Issuer in respect of payments due and that they were entitled to bring a claim under English law for the full amount of such payments.

60. Finally Lord Neuberger referred to the wording of Condition 9(a)(iii) itself. It was hard to see why any reference should be made in that Condition to section 123(2) if the Noteholders' rights against the Issuer were not to be treated as full recourse until the enforcement of the security. He also said that there was nothing commercially insensible in the conclusion that, for the purpose of Condition 9(a)(iii), the Noteholders' rights against the Issuer were treated as being of full recourse, notwithstanding the PECO: para 100.

61. The A3 Noteholders submit that the key operative provision is Clause 3.1 of the PECO itself. It makes it plain that it does not have the effect of limiting the liability of

the Issuer in respect of the Notes to the value of the Issuer's assets. Its reference to there being an "insufficiency" of assets after enforcement to meet whatever is "due in respect of the Notes" is a clear indication that it contemplates that the amount of the liabilities that the Notes have created must be capable of exceeding the value of the assets of the Issuer. Then there is the time at which the option is exercisable. It is not said to have any operative effect at all prior to enforcement of the security. So at all times prior to its exercise the Noteholders remain entitled to payment in accordance with the Conditions. And even when exercised all it does is provide a mechanism by which the right to be paid under the Notes is assigned to OptionCo.

62. As the Issuer relies on commercial reality rather than legal form, the legal effect of the documents is not really in dispute. The common intention of the parties is said by the Issuer to be quite different. Its argument is that, as inclusion of a PECO rather than a contractual limited recourse provision was done solely for tax reasons, it was not intended or understood to alter the commercial nature, effect and operation of the asset-backed securitisation. As a matter of contract the liabilities were unlimited in recourse. As a matter of commercial substance and in practice, they were the equivalent of a provision by which the rights of Noteholders were expressly limited. The Issuer's case is that its future obligations to pay principal under the Notes should be taken into account only to the extent that its assets were sufficient to pay for them. As Mr Dicker QC for the Issuer put it at the end of his argument, legal form should not triumph over commercial substance.

63. I do not think that it is possible to distinguish the intended commercial effect of these provisions from their legal effect in this way. The exercise that Condition 9(a)(iii) predicates is the quantification of the amount of the Issuers' assets and liabilities in order to determine whether there has been an Event of Default. The legal effect and the commercial effect of the PECO, on its true analysis, both point in the same direction. It has no effect, for the purpose of that quantification, on the amount of the Issuer's liabilities. To limit those liabilities as the Issuer contends would contradict the parties' clearly expressed commercial intention as found in the contractual documents. The fact that the economic result of the PECO may be the same as if the Noteholders' right of recourse had been limited to the Issuer's assets is beside the point. It can be expected to achieve bankruptcy remoteness as effectively. But it would not be in accordance with the true meaning of the documents to treat the two methods as if they had the same effect in law.

64. The ultimate aim in construing provisions of the kind that are in issue in this case, as it is when construing any contract, is to determine what the parties meant by the language that they have used. Commercial good sense has a role to play when the provisions are open to different interpretations. The court should adopt the more, rather than the less, commercial construction: *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [2011] 1 WLR 2900. But, for the reasons given by the Chancellor and Lord Neuberger MR, the meaning to be given to the language that the parties used in this

case is not open to doubt. The suggestion that to give effect to that meaning is to surrender to legal form over commercial substance amounts, in effect, to an invitation to depart from the settled role of commercial good sense. Its role is to find out what the parties meant when they entered into the arrangement, not to replace it with something which is not to be found in the language of the documents at all.