TRAVERS SMITH

Finance Monthly

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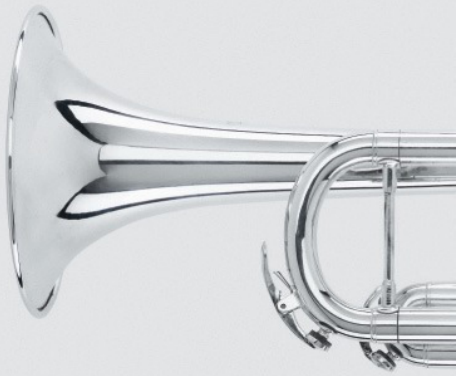

Welcome to the monthly finance bulletin from our banking and corporate recovery department. This issue contains our usual overview of some recent market developments and trends in the finance sector, including a spotlight on the *Saltri III Limited* case. Please get in touch if it raises any issues that you would like to discuss.

Jeremy Walsh, Head of Banking and Corporate Recovery Department

Balance Sheet Insolvency

In *BNY Corporate Trustee Services Limited and others v Eurosail UK 2007-3BL PLC [2013]* the Supreme Court upheld the decision of the Court of Appeal (CA) but added further thoughts on the meaning of the balance sheet insolvency test as set out in Section 123(2) of the Insolvency Act 1986 (the "**Act**").

Eurosail (the "**Issuer**") issued £660m of interest bearing loan notes to fund the purchase of a portfolio of mortgage loans, secured on residential property in the UK. The final redemption date of the lowest priority notes was in 2045. An Event of Default occurred under the loan notes if the Issuer became 'unable to pay its debts' under the terms of s.123 of the Act, and an enforcement notice could then be filed by BNY Corporate Trustee Services, the trustee of the noteholders' rights (the "**Trustee**").

The Issuer entered into swap agreements with two Lehman companies. When the latter companies became insolvent the Issuer suffered a deficiency in its net asset position, though it continued to pay its debts including debt due on maturing notes. If it was found that the Issuer was deemed unable to pay its debts, all notes would be immediately due and payable and the priority position of certain noteholders would change. The Trustee therefore sought a determination as to whether the difficulties faced by the Issuer constituted an event of default on the basis that it was unable to pay its debts under s.123 of the Act.

The Supreme Court upheld the decisions of the High Court and the CA, holding that:

- The 'balance sheet' test should not, as proposed by the CA, be construed as a test that looked at whether a company had reached "the point of no return".
- The 'balance sheet' test is whether, on the balance of probabilities, a company has sufficient assets to meet all its liabilities, including prospective and contingent liabilities.
- Although an analysis of a company's statutory balance sheet is an appropriate starting point, a net deficit on the balance sheet may not necessarily mean that a company is balance-sheet insolvent for the purposes of s.123(2).
- The 'cash-flow' test in s.123(1) is concerned with debts falling due from time to time in the "reasonably near future". However, if one moves beyond the reasonably near future, any attempt to apply the 'cash-flow' test becomes "completely speculative" and the balance sheet test "becomes the only sensible test". However, the court noted that the balance sheet test "is still very far from an exact test, and the burden of proof must be on the party which asserts balance sheet insolvency."

The Supreme Court held that on the facts, the Issuer had satisfied the balance sheet test as its liabilities could be deferred until 2045 and it was paying its debts as they fell due.

This is an important decision. The balance sheet insolvency test is often employed in event of default provisions in a wide range of finance, commercial, and property agreements. It is also key for administrators or liquidators seeking to challenge the validity of an antecedent transaction (the point at which a company becomes insolvent is often determined using the balance sheet test).

Although the Supreme Court has clarified that neither a mathematical test based on assets and liabilities nor a "point of no return" formulation is appropriate, it is not clear how the test will be applied in the future as this judgment indicates that the outcome of the balance sheet test will turn on its facts in each specific case.

Nortel Pensions case - Supreme Court

In *Bloom and others v The Pensions Regulator and others [2011]*, the Court of Appeal held that liabilities arising under a Financial Support Direction or Contribution Notice issued by the Pensions Regulator after commencement of an administration process would be treated as an expense of the administration. Amounts consequently falling due to pension schemes would rank above floating charge holders, unsecured creditors and even the administrators' remuneration entitlement. The case has been appealed to the Supreme Court and judgment is expected in July.

Spotlight on… *Saltri III Limited* and the conduct of Security Trustees

The High Court case *of Saltri III Limited v MD Mezzanine SA Sicar & Others [2012] EWHC 3025 (Comm)* has excited considerable industry comment because it analyses the extent of the duties owed by a trustee in the context of LMA senior and mezzanine facility arrangements and an Intercreditor Agreement familiar to market practitioners. The case highlighted the logical consequence of the subordinated position of mezzanine lenders, particularly where realised security proceeds are insufficient to satisfy even the senior debt in full. The court concluded that the obligations of the security trustee (itself a significant senior lender as usual) were the same as those owed by an enforcing mortgagee to its mortgagor – that is, to take reasonable care to obtain true market value or the best price reasonably obtainable for an asset subject to security at the time of sale.

The case, however, offers more than the basic principle recited above. J.P. Morgan Europe Limited, acting as security trustee had ostensibly acted in a partisan manner. It had (i) taken enforcement action over share pledges which involved a sale to investment funds linked to the senior lenders for a nominal consideration plus an assumption of certain debt; (ii) failed to put chinese walls in place which would have prevented the selective disclosure of information to the exclusion of the mezzanine lenders; and (iii) failed to act upon independent advice on the marketing or methodology of the sale. The mezzanine claimants also objected to the implementation of the enforcement release clauses of the intercreditor agreement entitling the security trustee to release shares from their pledge and also release the relevant pledgor from its facility obligations, but the court found nothing exceptional in the exercise of such contractual rights. The court held that enforcement action of a type taken in (i) above would have been unacceptable if implemented by a trustee owing fiduciary duties, but the security trustee was plainly not a fiduciary since the intercreditor arrangements did not oblige it to elevate the interests of all the lenders in preference to its own interests. The failure to implement chinese walls referred to in (ii) above was inappropriate, but not in the circumstances of this case, (and on the basis of the value of the enforced security) causative of loss, although security trustees will normally be expected to ensure a patent separation of functions in order to avoid potential problems. The failure to act upon independent advice on the marketing of the secured assets as referred to in (iii) above was excusable on the basis that five solicited bids and an independent desk-top valuation had demonstrated that following enforcement, the mezzanine lenders would be "out of the money" – the key, determining factor, in this case.

Special Administration Regime – for the good of the country

The Special Administration Regime (SAR) introduced in 2011 for investment firms was designed to address the specific problems presented by Lehman-type administrations. The aim of the SAR in the context of investment firms is to prioritise the prompt return of client assets and monies held by the investment firm in special administration. Parliament required that an independent review be conducted by the Treasury within two years of the introduction of SAR and this was conducted by Peter Bloxham, an ex-Freshfields partner. His initial report was issued by the statutory deadline of February 2013 and a more in-depth review is being conducted in co-ordination with the FCA, the results of which are expected in June 2013. The principal conclusion within the February 2013 review was that the SRA regime as applied to investment firms should be retained. However, recommendations were made to enhance the speedy return of client monies and assets including: the expansion of the statutory objective to address both the return and transfer of assets to a more viable investment firm; closer co-operation, imposed as a duty, with the Financial Services Compensation Scheme and other market infrastructure bodies; the introduction of a deadline for claims on client monies; and the ability of a Special Administrator to make distribution of client assets before the deadline for claims has passed. Special Administration regimes appear to be proliferating. The Energy Act 2011 has introduced a special administration regime to provide protection for the National Grid and electricity and gas distribution networks and a consultation process has recently concluded with respect to the gas and electricity supply companies to ensure the maintenance of energy supplies.

On 25 April the government published a consultation on a special administration regime for payment and settlement systems, to address the difficulties presented by the insolvency of a systemically important payment or settlement regime. The issue here is that in an orthodox administration, the firm would necessarily be managed in the interests of its creditors, without concern for any risk of wider systemic collapse and without regard to the efficient operation of payment and settlement systems. The consultation closes on 19 June.

In the courts

Deutsche Bank AG v Unitech Global Limited [2013] EWHC 471 (Comm) and Graiseley Properties v Barclays Bank plc [2013] EWHC 3093 (Comm)

In the *Deutsche v Unitech* case, Cooke J refused to allow Unitech to amend its defence and counterclaim to include misrepresentations relating to the alleged manipulation of LIBOR by Deutsche- which Unitech argued induced them to enter into a facility agreement and swap arrangements with Deutsche – on the basis that the amended claims had no reasonable prospect of success. The representations that Unitech sought to rely on were deemed too wide to be given effect. Cooke J stated that Unitech's plea was "unsustainable" as it did not rely on any specific pre-contractual conduct in its pleading nor statements of any kind: merely the offer of a product and/or the conclusion of a transaction by a panel member which refers to LIBOR which, in themselves, are said to give rise to the implied statements.

This may be contrasted with Mr Justice Flaux's decision to allow amendments to add claims for fraudulent misrepresentation against Barclays in relation to LIBOR in *Graiseley*. The distinction between the two cases may be that the *Graiseley* pleadings set out the relevant representations which were made in documents, emails and meetings between Barclays and the claimants. Cooke J stated that each case "will turn upon its facts when the test falls to be applied". The bank in *Graiseley* and the applicants in the *Unitech* case have been given leave to appeal and it is possible that the Court of Appeal will hear both cases in conjunction towards the end of 2013.

Recent transactions

We have recently advised:

- An investment vehicle managed by **Mountgrange Investment Management LLP** on the refinancing of a portfolio of 15 commercial properties in the UK;
- **3i Group plc** ("**3i**"), funds managed by 3i, and management on certain banking aspects of the sale of Civica to OMERS Private Equity for an enterprise value of £390m. Civica is an international market leader in specialist IT systems and business process series for the public sector;
- **Ambassador Theatre Group** on the financing of its acquisition of the Foxwoods Theatre, Broadway; and
- **Ashtead Group PLC** on certain banking aspects of its acquisition of Accession Group Plc, including its principal trading subsidiary Eve Trakway Limited, for an initial cash consideration of £29m.

Department News

We are pleased to announce that Danny Peel will become a partner in the firm's Banking and Corporate Recovery Department, with effect from 1 July 2013.

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