WHITE & CASE

Insight: Financial Restructuring & Insolvency

November 2013

Bankruptcy remoteness – a remote prospect?

Lawyers and investment bankers involved in setting up structured products such as asset backed commercial paper, CDOs, CMBS and CLOs often strive to achieve "bankruptcy remoteness" for the vehicle issuing the product (typically a bond) purchased by the market.

Investors in such products want to ensure that the issuer of the bonds is removed from the potential liabilities of originators and sponsors. In addition, any bankruptcy of the issuer may interrupt or delay the pass through of cash flows to third party investors. A bankruptcy trustee's or liquidator's costs are likely to be considerable and will erode some of the recoveries to the investors. Issuers are therefore generally structured to avoid bankruptcy. If a default occurs, the payments of the bonds will usually continue in accordance with a waterfall to reflect the agreed seniority of the bonds until all the assets have been expended – or at least, that is the theory.

Two recent decisions, one at first instance in the UK's Chancery Court, (*ARM Asset Backed Securities S.A. [2013] EWHC 3351 (Ch) (9 October 2013))* taken together with an earlier decision this year, in the Supreme Court, (*BNY Corporate Trustee Services Ltd and others v Eurosail-UK 2007-3BL PLC and others [2013] UKSC 28 (9 May 2013))*, have cast doubt on whether the procedures put in place to achieve "bankruptcy remoteness" work in practice. These decisions are important as they are likely to have an impact on the rating agencies' approach to rating structured products.

Rating Methodology

Each ratings agency develops its own methodology to enable it to make a ratings decision. The specific methodology that an agency will apply may depend upon the type of debt being rated, the nature of the debtor, and the geographies involved in the transaction. However, in the context of structured financings, ratings agencies are likely to consider factors such as the following to be important to any rating awarded:

- remoteness of an SPV issuer from any insolvency of a parent entity and/or the originator of any assets being securitised;
- restrictions on the SPV taking on further indebtedness;
- limitations on the SPV voluntarily filing for insolvency proceedings;
- provisions limiting creditors' recourse to only the assets of the SPV, with the intention of preventing the SPV from being wound up for insolvency.

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The ARM Decision (discussed immediately below) has a direct bearing on the effectiveness of measures designed to satisfy the last two of these criteria.

The ARM Decision

In October 2013 an application was made by ARM Asset Backed Securities S.A., a Luxembourg company (ARM) to the English High Court for provisional liquidators to be appointed. The Judge, Mr Justice David Richards, had two determinations to make. Firstly, can a Luxembourg company be subject to an English insolvency procedure and, secondly, can a company which has issued debt on a limited recourse basis be subject to an insolvent liquidation procedure – is it in effect solvent, even though its liabilities may exceed its assets, when its creditors are limited in the actions they can take against it?

On the first question, although ARM was Luxembourg registered, the Court determined that it retained jurisdiction to wind up the company under the European Regulation on Insolvency Proceedings (2000) (the EC Regulation). The court accepted that an insolvency process could be opened in England as the EC Regulation provides that a company may file for insolvency proceedings, covering all of its assets and liabilities, in the jurisdiction where its centre of main interest (COMI) is located. There is a rebuttable presumption that COMI is located in the member state where it has its registered office unless there is evidence to contrary. The evidence established that the COMI of the company was located in England and not in Luxembourg. The test for determining COMI was established by *European Court of Justice in Eurofood IFSC Ltd*, C-341/04 [2006] Ch 508. The court referred to recital 13 to the EC Regulation, which states that the COMI "should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." The court found that "the decisions which govern the administration and management of the company are taken in London with the director based in London being primarily involved in the affairs of the company".

On the second question, whether the company could be subject to winding up on the grounds of insolvency notwithstanding limited recourse language, the judge considered the circumstances under which a company which is not registered in England can be wound up by the English Court. There are three such grounds or circumstances, namely:

a. if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;

b. if the company is unable to pay its debts;

c. if the court is of opinion that it is just and equitable that the company should be wound up.

ARM made its application on the basis of ground (c) i.e. that it would be just and equitable for it to be wound up. This was because it had been refused a licence in Luxembourg which it needed to carry on its business, and so was unable to trade. As the EC Regulation relates to insolvency proceedings, there was some doubt as to whether the court would have jurisdiction in relation to a winding up on such grounds.

However, the court decided that ARM could be wound up on the basis of ground (b) i.e. that it was unable to pay its debts. The court determined that:

> "... if a company has liabilities of a certain amount on bonds or other obligations which exceed the assets available to it to meet those obligations, the company is insolvent, even though the rights of the creditors to recover payment will be, as a matter of legal right as well as a practical reality, restricted to the available assets, and even though, as the bonds in this case provide, the obligations will be extinguished after the distribution of available funds... A useful way of testing this [whether it is unable to pay its debt] is to consider the amounts for which bond holders would prove in a liquidation of the company. It seems to me clear that they would prove for the face value of their bonds and the interest payable on those bonds."

Whether or not a company is able to pay its debts is a statutory test, set out in s 123 Insolvency Act 1986 (IA 1986). The term "debt" is itself defined in the Insolvency Rules 1986, rule 13.12. It is interesting to note that the judge made no reference to this test in his judgment, nor to the definition of "debt", nor to any of the case law considering when a company is insolvent – including the Eurosail Decision, discussed below.

The Eurosail Decision

In May of 2013 the Supreme Court *BNY Corporate Trustee Services Ltd and others v Eurosail-UK 2007-3BL PLC and others [2013] UKSC 28 (9 May 2013)*, brought to a close three years of litigation on the interpretation of section 123 IA 1986 which provides (among other things) that a company is unable to pay its debts when its liabilities exceed its assets. The court held that the burden of proving that a company's liabilities exceed its assets lies with the party asserting the company's insolvency. In this instance, it determined that the SPV in question was not insolvent for the purposes of the test since the claimants were not able to prove that the SPV would be unable to pay debt obligations falling due more than 30 years in the future, and where its assets and liabilities were subject to fluctuations in exchange rates, LIBOR, and broader macroeconomic conditions which were inherently uncertain over such a long timescale. Accordingly, the Supreme Court was not satisfied that the SPV was unable to pay its debts.

Although not strictly necessary for the purposes of the decision, the Supreme Court also considered the efficacy of so called "PECO" structures. Under a PECO structure, following the enforcement of the security for the notes and distribution of the enforcement proceeds, if there was a resulting shortfall and the relevant notes were not paid out in full, then an associate company of the relevant issuer had a call option in respect of the benefit of all the notes at a nominal price. It is anticipated that the associate company would exercise the call option and release any associated note claim on the relevant issuer. This was a technique which was incorporated into certain securitisation structures to commercially replicate the "bankruptcy remoteness" of limited recourse provisions. The PECO structure was used in the pre-Credit Crunch era as it had certain tax advantages during that time over "standard" limited recourse structures.

As Lord Hope described "Its [the PECO structure's] 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." He went on to ask; "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?" For a number of reasons Lord Hope went on to dismiss the possibility that a PECO would prevent a company from being considered insolvent for the purposes of the statutory insolvency test.

Conclusion

The judge in the ARM case, Mr Justice David Richards, is an experienced insolvency judge who has presided over a number of significant restructuring and insolvency cases. Whilst not binding on other High Court judges, his decision will be highly persuasive.

However, the decision was expressly made as a matter of urgency, without significant consideration of the case law, in the somewhat unusual circumstance of a Luxembourg company with its COMI in England applying to be wound up because it had not obtained a required licence from the Luxembourg authorities, and in light of some uncertainty as to the English Court's jurisdiction to grant a winding up order on the grounds pleaded. It is possible that the court would take a different approach in more familiar circumstances – for example, where one or more holders of a company's limited recourse notes applied for its winding up and this was opposed by the company itself. Following the Eurosail Decision, the creditors would have the burden of proving that the company was unable to pay its debts. As the Eurosail Decision illustrates, that can be a difficult burden to discharge where those debts are subject to contingency or uncertainty.

It is very difficult to anticipate every argument that a company might make in order to defend an application for its winding up by its limited-recourse noteholders. However, depending on the terms of the relevant notes, it may be that the noteholders would have expressly or impliedly waived any right to make such a filing. Equally, we note that the ARM decision is premised on the notion that a company can have a "liability" which it is under no obligation to pay. This seems difficult, though perhaps not impossible, to reconcile with the statutory definitions of "debt" and "liability", which refer to a "liability to pay money or money's worth." It is one thing to say that limited recourse noteholders would probably seek to prove for the face value of their notes plus interest, notwithstanding limited recourse language in the underlying debt documents. It is another thing to say that a company is actually subject to a *liability* to pay those amounts. Depending on the language of the underlying debt instruments one could characterise the limited recourse obligations as being contingent on the company's assets and capped at a certain amount, rather than as fixed obligations to pay a sum certain. In the ARM case the judge has in effect taken the latter interpretation. However, if the former interpretation is correct, then a company in ARM's position could still be solvent.

How the court would treat such an argument remains an open question. The directors of SPVs with outstanding limited recourse obligations that exceed the value of the SPV's assets will need carefully to consider whether, in light of such uncertainty and in their particular circumstances, there is any reasonable prospect of avoiding an insolvent liquidation, or if they are under a duty to file for an insolvency process; and if not, what steps they need to take to avoid liability for wrongful trading. Investors may wish to consider what steps are appropriate to prevent the directors from making filing for insolvency under such circumstances.

Unless and until the law in this area is clarified, we consider that the two decisions, and in particular the ARM case, may have a significant impact upon ratings, the structuring of products, and on the opinions lawyers are prepared to provide regarding "bankruptcy remoteness". We consider that the ARM case will have more impact on future deals as PECO structures are now less prevalent since the tax advantages have been eliminated.

It is hard to anticipate the weighting rating agencies ascribe to the efficacy of limited recourse language. As described above, there are a significant number of factors which rating agencies use to assess bankruptcy remoteness. Rating agencies may decide to adjust their methodologies as a reaction to these decisions. They may, for example, increasingly insist upon covenants and representations in the applicable bond documents to ensure (so far as possible) that an SPV Issuer's COMI remains in its jurisdiction of incorporation, and outside of England.

It is entirely possible, however, that other jurisdictions may follow the lead of the English Court's assessment that limited recourse provisions have minimal efficacy in preventing insolvency. In addition it is often not that hard to change the COMI of an issuer. It would seem that the rating agencies and investors may have to live with, and factor in to their respective rating and investment decisions, that where the assets supporting the revenue stream do not match the liabilities of the bonds, insolvency is a possible result. Bankruptcy remoteness does not mean bankruptcy proof.