Case No: 6972 of 2002
Neutral Citation No: [2002] EWHC 2815 (Ch)

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 20 December 2002

Before :

THE HONOURABLE MR JUSTICE JACOB

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Between :

In the matter of Colt Telecom Group plc
- and -
In the matter of the Insolvency Act 1986

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John Brisby QC, Richard Hill and Malcolm Davis-White (instructed by Cadwalader, Wickerham & Taft) for the Petitioner
Richard Sheldon QC and Hilary Stonefrost (instructed by Slaughter & May) for the Respondent

Hearing dates : 6, 9, 10, 11, 12, 13, and 17 December 2002

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Judgment Approved by the Court for Handing Down (subject to editorial corrections)

Robin Jacob
....
THE HON MR JUSTICE JACOB

Mr Justice Jacob:

1. Section 8(1) of the Insolvency Act 1986 provides as follows:

> "Subject to this section, if the court –
> (a) is satisfied that a company is or is likely to become unable to pay its debts (within the meaning given to that expression by s.123 of this Act), and
> (b) considers that the making of an order under this section would be likely to achieve one or more of the purposes mentioned below
> the court may make an administration order in relation to the company".

2. Of the statutory purposes set out in s.8(3) the following are said to come into play here: the survival of the company and the whole or some part of its undertaking and/or a compromise under s.425 of the Companies Act 1985.

3. Section 123 defines two sorts of insolvency, which in jargon are called "cash-flow" and balance sheet" insolvency. It says:

> "(1) A company is deemed unable to pay its debts -
>
> (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.

4. It is s.9 of the Act which provides for who may make an application for an administration order. It says:

> "An application to the court for an administration order shall be by petition presented either by the company or the directors, or by a creditor or creditors (including any contingent or prospective creditor or creditors), [...] or by all or any of those parties, together or separately."

5. In this judgment I borrow directly (but with minor modifications of my own) and with gratitude some of the summary of facts by Lawrence Collins J in his procedural judgment about disclosure and cross-examination. The company the subject of this petition is called Colt Telecom Plc. ("Colt"). The petitioners are two companies, collectively called Highberry.

> "This petition is unusual in that Highberry claim that Colt is or is likely to become insolvent notwithstanding that Colt is a constituent member of the FTSE mid-250 index and has a market capitalisation of in excess of £550 million, that its latest balance sheet shows net assets of £977 million, and that the various series of Notes issued by Colt are not in default and do not fall due for repayment until the period 2005 to 2009. Against that, Highberry have in their proposals to Colt have relied on the dramatic fall in its share price since the year 2000, and on its substantial operating losses and negative cash-flows."

6. The figure of market capitalisation before Lawrence Collins J was just over £550m. The share price rose significantly after that with the result that the capitalisation when this hearing started was about £750m. It has since fallen back somewhat - possibly due to this case itself, though there has been a general stock market fall. Mr Brisby QC for Highberry at one point, at the prompting of his clients, suggested the rise might be the result of a share support operation by Colt's majority shareholder, a vast investment fund called Fidelity. There was no substance in the suggestion.

7. Highberry has made other suggestions with no substance and which should not have been advanced in the context of or relating to this case. Thus Mr Gordon Singer of Highberry gave evidence to the effect that the Financial Services Authority were investigating a complaint made by Highberry about a Colt press release concerning this dispute. The impression given to the Court (and obviously intended to be given) was that the FSA thought there was a case to answer. Actually all that had happened is that Highberry had made a complaint. They had no idea whether it would be taken up by the FSA. Mr Singer (upon my instance) made a witness statement correcting the false impression conveyed. I do not regard it is satisfactory nonetheless - I am afraid the original statement must have been intended to convey more than merely that a letter of complaint had been sent to the FSA. If that were all then there would have been no point in mentioning it in evidence. In any event, so far as I can see (though of course it is not really for me) the complaint was trivial.

8. Likewise, on the 10th October 2002, Highberry issued a statement to the market containing the following passages:

> "Having sought detailed analysis and advice from of the big "four" accounting firms, Highberry Ltd. believes it has legitimate concerns that even after the asset-write down a announced on 27 September 2002, Colt Telecom's balance sheet does not properly reflect the true current value of Colt's business and in particular its network assets.
> ...
>
> Highberry believes that insolvency is inevitable."

9. The clear innuendo from this is that Highberry's belief is a result of what "one of the big four" had advised them. They were never so advised - see below. The statement was calculated to bring pressure on the company. It is particularly difficult to accept the "belief" given that Highberry were buying more Colt notes only a month or so before. Mr Brisby says that the statement from Highberry was a response to a statement to the market by the company and somehow that excused it. I do not see why. Mr Brisby also submitted that if the company had taken up the invitation to bring proceedings for an injunction they would have been heard in private with the result that there would have been no publicity in the market. That is unrealistic given the high profile nature of the case. The existence of the application would very likely have crept out. It would then have seemed that Colt were frightened of publicity. It made entire sense for Colt to get its public blow in first.

10. Yet another example of pressure being brought to bear is contained in Highberry's solicitors' long letter (also of 10th October) sent to each Colt director at home also on 10th October 2002. It contained the following passage:

"We should add that our clients do not consider that the present conduct of the Company can be in the best interests of the Company or its creditors. We are bound to remind you of your duties as a director and of the consequences that may result in the event that the Company enters insolvency proceedings. In this context directors may in appropriate circumstances be held personally accountable, and/or required to compensate creditors if they permit a company to trade to the detriment of its creditors notwithstanding its insolvent position. Equally a director will not be protected from personal liability simply because the Company has, for the time being sufficient cash to meet its current obligations in circumstances where those cash reserves are evaporating, and where there is no realistic proposal for reversing the Company's fortunes before the time when it becomes unable to pay its debts as they fall due. You will of course understand that in the unfortunate event that our clients are obliged to procure that the Company be placed in some sort of insolvency regime, they will be constrained in the interests of creditors to ensure that the liquidator or other office-holder undertakes a thorough investigation of the conduct of the directors in the period leading up to the relevant insolvency order being made."

11. During the hearing Mr Brisby back-pedalled on any suggestion of wrongful trading by the directors, but that is import of the letter - which never should have been sent.

12. I return to Lawrence Collins J:

"5. Colt is the holding company of a group of companies ("the Group") whose trading operations are carried on by its subsidiaries. The Group's business was established in 1992 and Colt became the holding company in 1996. The business of the Group comprises the provision of advanced telecommunications services to business and government customers across Europe.

6. The Group employed just under 5,000 people as at the end of September 2002. Its annual turnover is in excess of £1 billion. Colt's balance sheet as at September 30, 2002 shows assets totalling £2.6 billion, creditors totalling £1.5 billion, net assets of £977 million and cash balances of £455 million. At that date, the Group had aggregate cash balances of £978 million.

7. Colt's assets consist primarily of cash held by it and investments in its subsidiaries comprising shareholdings in, and long term funding to, those subsidiaries. Colt's liabilities consist principally of its indebtedness on the nine series of Notes issued by it between 1996 and 1999. Colt's business has also been funded by raising equity capital totalling over £2 billion, the most recent being of about £500 million in December 2001.

13. This point is not unimportant – shareholder support of £500 million only a year ago is not a trivial investment. It at least suggests that more support could well be available, should it prove necessary. On any view none is needed now or in the near future.

8. Highberry Ltd is an English company which was incorporated in November 2001, and Highberry LLC is a Delaware corporation which was incorporated in September 2002. Colt says that the Petitioners are part of an American group called the Elliott Group, which is controlled by Mr Paul Singer, the father of Mr Gordon

Singer, a director of Highberry Ltd and the person who verified the Petition. According to Colt, the Elliott Group is a "vulture fund," which specialises in the taking of "short" positions in shares of a company (in the expectation of a drop in their value) and acquiring debt securities at a discount (in the hope that their price will rise)."

14. Mr Brisby objected to the epithet "vulture fund", preferring that of "hedge fund". It is not for me to chose between the two. What is not issue is that a key object of the proposed administration is to achieve what Highberry call "a restructure." What they actually mean is a transfer of value in the company from the shareholders to the bondholders – either by conversion of debt to equity or simply by payment from Colt's cash or both. The initial approach to Colt suggested a 100% payment of the face value of the Notes, even though repayment of capital was years away and Highberry had obviously bought the notes at a discount. They were obviously after a large and quick profit. It is accepted that companies associated with the Elliott group have also taken a short position in the shares.

15. I return to Lawrence Collins J:

> 9. Colt says that Highberry have acquired Notes in the market at various times as recently as September of this year at a discount from their initial principal value. There are no outstanding sums due on the Notes held by the Petitioners and the earliest date (in the absence of a declaration of default) on which the principal sum is due to be repaid on Notes held by the Petitioners is 2006. Colt says that it believes that the administration petition is part of the strategy of the Petitioners is to make a speculative profit from its acquisition of Notes at a discounted price, and also from their (or their affiliated companies') short position on Colt's shares and that the Petitioners are seeking to achieve the profit by forcing an unjustified transfer of value from shareholders to noteholders".

16. Currently Highberry have about 7% in value of the Notes. There is no indication of any support for this petition from the holders of the remaining 93%. The nearest one comes to "support" is a letter written by Linklaters on behalf of an anonymous client asking about Colt's solvency. I pay no attention to it. There is no support from any trade creditors who are being paid in the normal course of business.

The Issues

17. There are six issues for decision:

(1) Must a petitioner prove that the company is "likely to be unable to pay its debts" on a balance of probabilities or is it sufficient for it to prove that that there is a real prospect of that being so?

(2) Is the ability to present a petition forbidden by a clause (the "no action" clause) in the terms of the Notes and their associated Indenture – a question of New York Law?

(3) Even if the no action clause is effective as a matter of New York Law, does English law public policy override its effect?

(4) Is Colt cash-flow insolvent?

(5) Is Colt balance sheet insolvent?

(6) If the answer to either (4) or (5) is yes, should I exercise the court's discretion to make an administration order?

Procedural matters

18. Lawrence Collins J was asked to order wide-ranging disclosure by Colt about essentially all its financial affairs. He refused it as speculative and disproportionate ("breathtaking") - if Highberry had a case of insolvency on published figures (including audited figures) then they could prove it on those figures. He also refused cross-examination of Mr Akin, Colt's CEO. He further observed that an administration petition is not a trial and should not be treated as such. He said:

> "The consideration of the issues is not intended to be done by way of a very detailed and protracted investigation as in a trial.

19. It was Highberry's case that insolvency could be made out on published information - that was what to be tried. He further indicated that he would have refused an application for cross-examination of Colt's expert witnesses from Ernst & Young but for the fact that the parties had agreed they should be present at the hearing for that purpose. On that basis he left the question of cross-examination of these witnesses until the hearing. He did order cross-examination of New York law expert witnesses. Lawrence Collins J was also faced with an application by Highberry for permission to call an expert in the telecommunications industry. They requested that the application be adjourned. Lawrence Collins J asked for identification of the issues to which the evidence would go. None was given. No adjournment was granted and no order was made on the application. Mr Brisby made a fresh application before me for introduction of expert evidence from a telecommunications industry expert. For that reason I was invited to read a 58-page closely typed report of a Mr Heany. I refused the application for the reasons I gave at the time. It suffices to say here that the report was devoted to masses of material which should have been dealt with in chief. It would have been quite unfair to admit it.

20. I did, however, permit cross-examination of the Ernst and Young expert witnesses, Mr Halkes and Mr Hughes and of Mr Heis of KPMG, (Highberry's expert) notwithstanding Lawrence Collins J's indication to the contrary. I agree with Lawrence Collins J's view that an administration petition is not to be treated as a trial. I only permitted cross-examination because Mr Sheldon QC for Colt indicated such severe criticisms of Mr Heis' report that it would not have been fair to proceed without Mr Heis having an opportunity to answer those criticisms. I turn to the first of the six issues.

Issue 1 – The Jurisdictional threshold – "likely"

21. The meaning of the word "likely" which is used in two places in s.8(1) has been considered in a number of cases. It began with the meaning of the word "likely" in s.8(1)(b). Peter Gibson J in *Re Consumer and Industrial Press* [1988] BCLC 177 at 178 held that the word "likely" meant "more probably than not". He was followed by Harman J in *Re Manlon Trading* [1988] 4BCC 455. But in *Re Harris Signs Construction* [1989] BCLC 202

Hoffmann J declined to follow that. He held "likely" in s.8(1)(b) is satisfied if the court considers there is a "real prospect that one of the more state of purposes may be achieved". Subsequently Peter Gibson J accepted Hoffmann J's view of the sub-section, see *Re SCL Building Services* [1990] BCLC 98.

22. Mr Brisby submitted that the word "likely" in both sub-sections had the same meaning. So, if the court is satisfied that there is a real prospect that the company is or is likely to become unable to pay its debts that is sufficient to bring into play the jurisdiction to make an administration order. He accepted the court may not make such an order if the prospect, although real, was not substantial enough to be more probable than not but that, he said, went to discretion. I do not agree. Firstly, Mr Brisby had to get over the difference between the two sub-sections of "satisfied" and "considers". That was an important part of the reasoning of Hoffmann J in *Re Harris*:

> "Second, the section requires the court to be "satisfied" of the company's actual or likely insolvency but only to "consider" that the order will be likely to achieve one of the stated purposes. There must have been a reason for this change of language and I think it was to indicate that a lower threshold of persuasion was needed in the latter case than in the former."

23. Moreover, I am particularly persuaded by the reasoning of Vinelott J in *Re Primlaks* [1993] BCLC 734 at .741. He said:

> "Paragraph (a) of s.8(1) sets out a condition that must be met before the court can enter into an enquiry as to whether an administration order would serve any useful purpose. The court must be satisfied that the company is or is likely to become unable to pay its debts. Clearly in this context, the test prescribed must be whether a company currently able to pay its debts as they fall due will probably be unable to pay them in the future. It would be unjust to a company's creditors to impose on them the regime of an administration order so as to improve and perhaps expand the company's business if the probability is that the company will be able to pay its debts as they fall due."

Here Vinelott J is using the word "probability" in the sense of more likely than not.

24. I am not persuaded that the judgment of Chadwick LJ in *Three Rivers DC v Bank of England (No 4)* [2002] 4 All ER 881 is intended to alter that view. Although the case was concerned with the meaning of the word "likely" in CPR 31.17(3)(a) Chadwick LJ drew some assistance from the above cases on administration. He said this:

> "But the decisions on s.8(1)(b) of the 1986 Act to which we have referred illustrate the point – which may, perhaps, need no authority – that "likely" does not carry any necessary connotation of "more probable than not". It is a word which takes it meaning from context and, where the context is jurisdictional threshold to the exercise of a discretionary power, there may be good reason to suppose that the legislature – or the rule making body, as the case may be – intended a modest threshold of probability."

25. Mr Brisby seized upon that last sentence. He submitted that s.8(1)(a) was indeed a jurisdictional threshold. It followed that only a modest threshold of probability was necessary. I do not agree. To put a company into administration is a serious matter. Creditors, as well as the company itself, can apply. To expose the company to all the expense, danger, and problems associated with administration is a serious matter. It is most unlikely that Parliament intended this when there was only a real prospect of insolvency rather than where insolvency was more probable than not.

26. The experience of this case fortifies my view that it is not enough to merely to show a "real prospect" of insolvency as opposed to insolvency being more likely than not. I cannot think Parliament intended that companies should be exposed to this kind of hostile proceeding where it is more likely than not that the company is not insolvent. Administration is a rescue procedure – it must be shown that rescue is probably needed before asking for a rescue team.

27. Having said that, it will appear from what I say below that I do not consider insolvency to be proved on the "real prospect" test either. That is not to say insolvency is impossible. Colt is in the telecoms business. That in the last few years has been highly volatile – even more so than markets in general. Colts own shares have gone from a high of £40, down to 22p. and now to about 40p. So in a sense, anything can happen – to Colt or many other companies in the business. But that is not the same thing as a real prospect of insolvency. Even on the lesser test, the "real prospect" must be tangible.

Issue 2: The no action clause

28. This is clause 6.6 of the Indenture which applies to the Bonds. It reads as follows:

Limitation on suits.

A holder may not pursue any remedy with respect to this Indenture or the Notes unless:

a. The Holder gives to the Trustee written notice of a continuing Event of Default;
b. The Holders of at least 25% in aggregate principal amount at maturity of Outstanding Notes make a written request to the Trustee to pursue the remedy;
c. Such Holder or Holders offer the Trustee indemnity satisfactory to the Trustee against any costs, liability or expense (including the reasonable fees and expenses of its Council);
d. The Trustee does not comply with the request within 60-days after receipt of the request and the offer of indemnity;
e. During such 60-day period the Holders of a majority in principal amount at maturity of the Outstanding Notes do not give the Trustee a direction that is inconsistent with the request.

A Holder may not use this Indenture to prejudice the rights of another Holder or to obtain a preference or priority over such Holder.

29. Colt say this clause bars any action by a Note Holder otherwise than in accordance with the procedure set out in clause 6.6. They say that the seeking of an administration order amounts to "pursuit of any remedy with respect to the Indenture or the Notes." Highberry say otherwise. New York law governs the question. So each side has called an expert on New York law.

30. Highberry called Professor Kahan of New York University. He has degrees in economics, management and law, the last of these being conferred by Harvard University in 1988. He teaches, amongst other things, the subject of corporate bonds. He has had only a brief period in practice in the years 1989-90. Colt called Mr Brownwood, a partner in a substantial Manhattan law firm called Cravath Swaine & Moore. He has been with the firm for 34 years and a partner for nearly 30. He has very considerable experience in the field of corporate finance, particularly securities in market transactions. He too has a distinguished academic career, having graduated from both Stanford and Harvard.

31. The experts were agreed that there is no direct New York authority in point. Therefore I have to, instructed by their evidence, try to work out what it is that a New York court would do faced with the current problem. Professor Kahan's evidence runs like this:

> "1. The no action clause only comes into play once there is an Event of Default;
>
> 2. It has no application prior to an Event of Default;
>
> 3. In any event the clause only applies to "contractual claims," i.e. claims based on the terms of the Indenture or Notes. It would not apply to claims such as for the appointment of a receiver, or a claim equivalent to this claim such as the appointment of an administrator.

32. Although New York law does not have an exact analogy with administration, it was common ground that an application for an administration order should be treated as equivalent to New York procedures such as the appointment of a receiver.

33. So there are two points: no application to events pre-default and no application to non-contractual remedies.

34. Mr Brownwood said that the clause applied to all remedies, whether pre or post an event of default. Moreover, it applied to remedies whether for breach of the terms of the Indenture or in terms of the Note, or any other remedy arising out of the Indenture of the notes. He says a New York Court would read the words "with respect to this Indenture or the Notes" widely.

35. I turn to consider the Professor's reasons in more detail. I begin with the limited-to-contractual-claims point. His views are expressed in an article which he wrote published in 77 New York University Law Review 1040 in October this year. It is headed "Rethinking Corporate Bonds: The Trade Off between Individual and Collective Rights". He says this on p.1050:

> "As interpreted by courts, the no action clause also applies to most non-contractual claims (such as fraudulent conveyance claims, certain fraudulent misrepresentation

claims, RICO violations, and actions to appoint a receiver or to impose a constructive trust; to suits brought by former bond holders; and to suits against defendants other than the company."

36. In describing the typical bond he concludes by saying:

> "The right cannot be modified without the holder's consent but it can be enforced only by the trustee or by holders of 25% of the outstanding bonds if the other requirements are satisfied. Most non-contractual rights, which fall under the purview of the no-action clause, are also in this category".

37. Later on in the article the Professor expresses his views as to the current position. Amongst other things he says this:

> "Fifth, whatever the proper balance of individual and collective bond holder rights with respect to amendment, the balance with respect to enforcement should be tilted more towards individual rights."

38. And a little later:

> "In other respects, however, the enforcement structure does not accord with the analysis; bond holder rights in the enforcement context are collected to a greater extent and in the amendment context; the enforcement regime does not take account of the fact that some bond holders may lack incentive to pursue violations of other holders' rights: and the enforcement regime imposes unreasonable barriers to the collective enforcement by bond holders."

39. The Professor then goes on to say this, under the heading "flaws in the present structure of individual and collective rights".

> "The structure of individual collective enforcement rights established by typical bond Indenture provisions and the court's interpretation of these provisions is flawed in four ways …"

> "Second, the broad interpretation courts have given to the no action clause makes the enforcement system for some claims unworkable. Courts have held that holders must comply with the no action clause to vindicate those with non-contractual rights. But if violation of these rights cannot result in a "effect of default" and compliance with the no action clause is therefore impossible. Moreover, courts have denied the trustees standing to assert non-contractual rights of bondholders. As a result it would appear that neither bond holders nor the trustee can bring such non contractual claims."

40. The Professor's fourth conclusion is as follows:

> "The present structure of individual and collective enforcement rights is imprudent. The system places excessive reliance on enforcement by the trustee – a party that is not well suited to play the role accorded to it – and excessive limits on enforcement by bond holders."

41. Under the heading "a. The present system is inconsistent", the Professor says this:

> "With respect to enforcement, the no-action clause requires bond holders to comply with its requirements before they can "pursue a remedy with respect to the Indenture or the bonds". The only exception for which bond Indentures provide is that the individual right of the holders to bring a "suit with enforcement of [payment of principal and interest], after [the] respective [due] dates" expressed in the bond. The no-action clause severely limits the ability of individual bondholders to enforce their rights. If the trustee is not on its own inclined to take enforcement measures, a bond holder would have to assemble a group holding at least 25% of the principal amount of bonds, request the trustee to pursue a remedy, and offer to the trustee indemnity against any loss, liability or expense. Even if this is done – or, for that matter, even if the trustee is willing to bring the claim – holders of a majority of the principal amount of bonds may direct the trustee not to pursue the claim. If so, the claim cannot be brought."

42. Next, under the heading "the present system is unworkable", the Professor says this:

> "The no action clause as construed by the court applies to a wide variety of claims. Some of these claims are contractual; others are rooted in statutory or common law, such as fraudulent conveyance law, state corporation law and the law of fraud".

43. Shortly after the Professor says this:

> "Since bond Indentures do not incorporate into themselves provision of fraudulence, conveyance law, state corporation law, blue sky law or the law of fraud, violations of these laws do not result in an event of default. Similarly violations of bondholder rights by persons other than the company generally will not result in a breach of the bond Indenture since these persons are not party to the Indenture. With respect to these violations it is therefore impossible for bondholders to give the trustee the notice required by the no action clause. Nevertheless, courts have on multiple occasions dismissed bond holder claims, asserting such violations for failure to comply with the no action clause."

44. This passage was not quoted in the Professor's opinion before this court. It is a little unfortunate since he quotes the passages in his article either side of it.

45. The upshot of all this is that in the article the Professor is saying that courts have been doing the wrong thing in applying the no-action clause to non-contractual claims. This is why he later says in another passage not quoted in his opinion:

> "Inasmuch as courts have interpreted the no action clause to encompass non-contractual claims and claims against third parties, the enforcement mechanism envisioned by the clause is unworkable".

46. There are further passages to a similar effect. Towards the end of his article, the Professor says this:

"To reduce the flaws in the present structure of bond holder rights, courts should accord a narrower scope to the no action clause which limits individual enforcement by bond holders. The broad interpretation courts have given to the clause is responsible for the unworkability of the enforcement regime in respect to certain claims".

47. It is the Professor's view that the New York courts when faced with his reasoning would accept it. Moreover the Professor criticises the reasoning in the court decisions which he referred to in his article by which the courts had given broad interpretations to no action clauses.

48. It is common ground that in some of the cases the reasoning is succinct and that in a number of cases the full terms of the bond are not known. In one or two cases it is not clear whether or not there was an event of default. The cross-examination ranged in detail over examination of the case-law. It is not uninteresting that the cases are all, save for one old one, not New York cases. Yet Mr Brownwood told me that New York law governs nearly all corporate bonds which are issued. He also told me that clauses of this character are very common and have been so for many years. It is, to my mind, surprising, that more boldholder actions of this kind have not been brought if they were possible. Given the existence of funds such as the Elliott fund behind the present case, it is unlikely that New York lawyers would have been missed the point. It is pertinent here to observe that it is the same Elliott fund whose claims were defeated by no-action clauses in two of the cases cited.

49. I do not propose to go to all the cases. I quote from two:

Elliott Associates v Bio-Response [1989] Del.Ch. Lexis 63

"Plaintiffs argue that their remaining claims are not subject to the restrictions in the Indenture because they are non-contractual claims. Specifically, plaintiffs contend that the complaint alleges fraud, violation of the implied covenant of good faith and fair dealing, and a statutory claim for the appointment of a receiver pursuant to *8 Del. C. § 291.* This Court has recognized that debenture holders may be able to seek relief outside of the indenture where there are "special circumstances which affect the rights of the debenture holders as creditors of the corporation, e.g., fraud, insolvency, or a violation of a statute [citations omitted] However, the complaint does not adequately allege a fraud claim and I find that the other claims are subject to the restrictions in the Indenture, notwithstanding plaintiffs' arguments to the contrary. [p.4]

Finally, the plaintiffs argue that, by statute, they are entitled to seek the appointment of a receiver in light of Bio-Response's alleged insolvency and that this statutory claim is not impaired or restricted in any way by the Indenture. Pursuant to *8 Del. C § 291,* any creditor or stockholder of an insolvent corporation may apply to this Court for the appointment of receivers for the corporation. The complaint adequately alleges insolvency and, although it is not free from doubt, plaintiffs are likely to be considered creditors for purposes of this statute. *Cf. Noble v European Mortgage & Investment Corp., Del. Ch., 165 A. 157 (1933).* However, I find that plaintiffs' statutory claim is restricted by the terms of the Indenture". [p.5]

Feldbaum v McCrory Corporation [1992] Del.Ch. Lexis 113

"Absent are allegations of fraud in the inducement of the purchase. Clauses of this sort are generally applied to foreclose bondholder suits under the indenture, when plaintiff has not complied [citations, including *Elliott* omitted]. Such clauses are bargained-for contractual provisions which inure, not only to the benefit of issuers, but also to the benefit of the investors in bonds. Such clauses need not prevent the prosecution of meritorious suits[9]. They do, however, make it difficult for individual bondholders to bring suits that are unpopular with their fellow bondholders. This, in fact, is their primary purpose. As the American Bar Foundation's Commentaries on Indentures, § 5.7, at 232 (1971), notes, regarding the Foundation's proposed model no-action clause.

The major purpose of this Section is to deter individual debentureholders from bringing independent law suits for unworthy or unjustifiable reasons, causing expense to the Company and diminishing its assets. The theory is that if the suit is worthwhile, [a significant percent] of the debentureholders would be willing to join in sponsoring it ... An additional purpose is the expression of the principle of law that would otherwise be implied that all rights and remedies of the indenture are for the equal and rateable benefit of all holders".

50. Footnote 9 reads:

"This, as a practical matter, is especially true of bonds of failing or bankrupt companies whose bonds tend to move into the hands of specialists, so-called vulture funds, for whom, given their small numbers and significant holdings, collective action problems do not present the obstacle to collective action that frequently accompanies wide-spread distribution of financial interests [citation omitted.]

51. Turning back to the judgment:

"The primary purpose of a no-action clause is thus to protect issuers from the expense involved in defending lawsuits that are either frivolous or otherwise not in the economic interest of the corporation and its creditors. In protecting the issuer such clauses protect bondholders. They protect against the exercise of poor judgment by a single bondholder or a small group of bondholders, who might otherwise bring a suit against the issuer that most bondholders would consider not to be in their collective economic interest. In addition to providing protection against improvident litigation decisions, a no-action clause also protects against the risk of strike suits. Obviously the class features of any such suits make that prospect somewhat more likely and somewhat more risky to the issuer than it would otherwise be.

No-action clauses address these twin problems by delegating the right to bring a suit enforcing rights of bondholders to the trustee, or to the holders of a substantial amount of bonds, and by delegating to the trustee the right to prosecute such a suit in the first instance. These clauses also ensure that the proceeds of any litigation actually prosecuted will be shared rateably by all bondholders[11].

52. Footnote 11 reads:

> "No-action" clauses are thus consistent with, if not central to, the indentures in which they are found, for the primary purpose of such indentures is to centralize enforcement powers by vesting legal title to the securities in one trustee. See George. G Bogert & George T. Bogert, The Law of Trusts and Trustees, § 250, at 280 (rev.2d.ed. 1992) ("In the case of debenture bonds, … the issue is often made payable to a trustee in order that the power of enforcement may be centralized.")."

53. The Professor said (probably rightly) that what was said in *Elliott* was unnecessary to the decision. I do not think that matters. It is authority against his view as to what the courts should do as indeed his article acknowledged. As to *Feldbaum* the Professor said it was wrong in as far as it applied to non-contractual remedies.

54. Moreover the Professor took the view that the decision was based on the reasoning that because the Trustee could act, the individual could not. It was one or the other. In a pre-Event of Default period the Trustee could not act and was given no power so to do. So if the no-action clause applied, no-one could act. That he suggested would persuade a New York Court that the individual could act. He points to the passage in *Feldbaum* where the court said:

> "Plaintiffs have not alleged that the trustees have engaged in any impropriety or other otherwise incapable of performing their duties."

This he thought was critical.

55. Mr Brownwood did not agree. He was disposed to think that it might be possible for the Trustee to act pre-Event of Default, but did not rest his opinion on the point. His position was pragmatic and business like. There is a deal between the company and all the bondholders – the bondholders lend the money on terms that provided there is no default they will not invoke any remedies depending on their bondholding, they will not take any individual action for any sort of remedy. If there is a default, apart from a right of action for due interest and return of capital – allowed by statute) they will not take any action save collectively through the trustee and only if there is sufficient support. Only if will not act and there is enough support can they act alone. In that way there is a commercial balance.

56. I prefer the evidence of Mr Brownwood for several reasons:

(1) Unlike the Professor Mr Brownwood had very considerable practical experience of the issue of bonds. His feeling for how they worked and were meant to work in practice was borne of many years of experience;

(2) The suggestion that the clause did not apply to pre-Event of Default situations produces an illogicality – freedom for all to act at a time when the situation is not so serious as a default, but a restriction when there is a default. That makes no commercial sense, notwithstanding Mr Brisby's manful attempt to suggest otherwise. It is the Professor's underlying assumption that either the individual or the Trustee must be able to act at any one time. But that need not be so. Mr Brownwood's concept of the "deal" makes immense commercial sense if one bears in mind the policy articulated in the cases. In this connection the Professor told me that New York law, like ours, construes contracts

purposively. I can so no rational purpose for individual bondolders being able to rock the boat before default but not after.

(3) Likewise I can see no rational purpose in limiting the bar to "contractual claims". If it were so limited then individuals could undermine the policy by applying for a receiver or the sort of action taken in this case.

57. I should mention that Mr Brisby placed some reliance on clause 6.13 of the Indenture. It was never relied upon by the Professor so he is without support from his expert on the point. It was put to Mr Brownwood. He said it made no difference. That seems to me perfectly intelligible. The clause says:

> "Except as otherwise provided with respect to the replacement or payment of mutilated, destroyed, lost or wrongfully taken Notes in Section 2.11, no right or remedy herein conferred upon or reserved to the Trustee or the Holders is intended to be exclusive of any other right or remedy and every right and remedy shall, to the extent permitted by law, be cumulative and in addition to every other right and remedy given hereunder or now or hereafter existing at law or in equity or otherwise."

58. That cannot completely override the effect of clause 6.6, whether pre or post default. But that would be the consequence of Mr Brisby's argument. Clause 6.6 must, on any reasonable purposive construction prevail.

59. In the end it comes down to a question of construction. I think such US authority as there is is against the Professor's view. And I am not persuaded that the NY Courts would disregard that authority. On the contrary I think they would follow it for the pragmatic reasons advanced by Mr Brownwood.

60. There is also this important consideration: businesses from all over the world have been using New York Bond issues on a vast scale. Mr Brownwood told me, for instance. that he has been concerned with issues for companies all over Europe. So a change of interpretation by the New York courts, as recommended by the Professor, would seriously undermine the basis on which people thought the bonds had been issued. Courts do not lightly take such a step.

61. I conclude that the no-action clause applies to this claim for administration. It is a "remedy with respect to this Indenture or the Notes" as I think a New York Court would hold.

Issue 3: English public policy

62. Mr Brisby submitted that public policy overrode the no-action clause. If right, the effect is startling. It would mean that English companies could not readily issue bonds with no-action clauses - whatever the terms of the bond, and whether pre-or post default, they would be exposed to the potentiality of a single bondholder bringing an administration petition. It is not self-apparent why that should be so. Certainly such bonds are regarded as enforceable under New York law with no harm to public policy. Nor is there any evidence of harm to public by the enforceability of these clauses so far as this country or any other country is concerned.

63. I turn to consider Mr Brisby's argument in more detail. Stripped of authority Mr Brisby's point is this: that the price of limited liability is the company is liable to be put into administration or wound up upon the application of a creditor if it is insolvent. So no contractual fetter on the creditor's ability to apply for an administration order or winding up order can override that price. Moreover says Mr Brisby to put a fetter on a particular creditor may be unfair to other creditors who are not under a fetter and who may not know of or be in a position to prove the insolvency. They may unknowingly be giving credit to a company which the fettered company is in a position to show is insolvent.

64. Mr Brisby's principal authority was *Re Peveril* [1898] 1 Ch. 122. In that cases the articles of association of the company purported to forbid members from petitioning for the winding up of the company unless certain conditions (e.g. a majority resolution in general meeting, or holding not less than 1/5 of the issued capital) were satisfied. The petitioner had not satisfied those conditions and the court overrode the articles. Lord Lindley MR said this at p.131:

> "Any article contrary to these [i.e. the winding up] sections - any article which says that the company is formed on the condition that its life shall not be terminated when any of the circumstances mentioned in s.79 exist, or which limits the right of a contributory under s.82 to petition for a winding up, would be an attempt to enforce on all the shareholders that which is at variance with the statutory conditions and is invalid. It is no answer to say that the right to petition may be waived by any contributory personally. I do not intend to decide whether a valid contract may or may not be made between the company and an individual shareholder that he shall not petition for the winding up of the company. That point does not arise how. But to say that a company is formed on the condition that its existence shall not be terminated, or on the application of the persons, mentioned in the Act is to say that it formed contrary to the provisions of the Act, and upon conditions which the Court is bound to ignore."

65. Chitty LJ agreed. After also reserving the question of whether an individual could bind himself not to petition, he said (p.132)

> "In my opinion this condition is annexed to the incorporation of the company with limited liability - that the company may be wound up under the circumstances, and at the instance of the persons, prescribed by the Act, and the articles of association cannot validly provide that the shareholders, who are entitled under s.82 to petition for a winding up, shall not do so except on certain conditions.
>
> .....
>
> In the present case the clause only imposes a limitation; but if were to hold this limitation to be valid, we could not stop short of saying that the statutory condition may be dispensed with altogether."

66. Mr Brisby submitted that same principle applied to all entitled to petition, be they contributory or creditor. He further relied upon the fact that the Australian textbook "The

Law of Company Liquidation" McPherson (3rd, 1997 edition) says this, after stating the facts and result of *Peveril*:

> "Whether the principle of this decision would extend to a similar provision in a contract between a company and a creditor, is a question which has never been judicially considered, but there is little reason for doubting that this, too, would offend against the policy of the Act [p.46]"

67. The first English edition of the work (2001) is to similar effect.

68. In riposte Mr Sheldon submits that the *Peveril* principle is all about, and limited to, fetters on the internal regulation of the company. External contracts with third parties, having nothing to do with the internal regulation are perfectly lawful even if they contain a fetter of some sort on the third party's remedies. Take, for instance, submitted Mr Sheldon, a contractual clause providing that disputes about amounts due under a contract should be decided by arbitration (a *Scott v Avery* clause). Could the creditor by-pass the arbitration clause by seeking a winding up or administration order? Arbitration clauses have been common for ages, yet no one has held them contrary to public policy where they simply impose a requirement of arbitration before enforcement.

69. Mr Sheldon relies also upon *Welton v Saffery* [1897] AC 229. *Welton* was itself cited by Lord Lindley MR in *Peveril*. At p. Lord Davey said:

> "Of course, individual shareholders may deal with their own interests by contract in such way as they may think fit. But such contracts, whether made by all or some only of the shareholders, would created personal obligations, or an exceptio personalis against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties to it, or upon new or non-assenting shareholders. There is no suggestion here of any such private arrangement outside the machinery of the Companies' Acts."

70. The key point to extract here, said Mr Sheldon, was the test "would the obligation in effect become a regulation of the company?" This was in effect the principle applied by Lord Jauncey in *Russell v Northern Bank* [1992] AC 588 at p.594. So, in that case, an agreement by shareholders as to how they would exercise their voting powers was valid, but the agreement by the company not to issue its statutory powers (to create or issue shares) was not.

71. Mr Sheldon also relied upon French: "Applications to Wind Up Companies "(1993) where the author said:

> "A petition presented by a person who is contractually bound not to present a petition will be struck out"

72. The author relied upon *City Electrical* [1991] BCLC 514 where Harman J implied a term into a contract that no further winding up petition would be presented in respect of the same debt and a New Zealand case, *Peter Dynes* (1989) 4 NZLC 64,906. I get nothing from the latter case (where *Peveril* was not cited and no point about public policy appears to have been taken.

73. As regards Harman J's case, Mr Brisby said it was an example of the "personal contract" exception. He submitted that it did not apply here because the no-action clause purported to bind all holders of the Notes, including subsequent purchasers. This all depends upon what is meant by the exception. In effect Mr Brisby reads the exception as not applying to any obligation which can be transferred to third parties. But that makes little sense. Why should an original noteholder be barred from action, but a subsequent holder entitled to take action? The flaw in his position is this. The no-action clause in no way fetters the rights of the company. It is restrictive of noteholders' rights only. As Mr Sheldon put it the creditors' rights are creatures of contract, not creatures of statute as in the case of shareholder rights. The "personal exception" means a contractual or other fetter on third parties, not the company.

74. As to Mr Brisby's point about there being an overriding public policy striking down any contractual obstacle to presentation of an administration (or indeed winding) there are several answers. Firstly, if right, there would be no exception of any sort, personal or otherwise. The Companies Court would not be accepting on a regular basis (as it does) undertakings not to present a petition. Moreover it is contrary to the authorities mentioned above. Second neither *Peveril* nor any of the subsequent authorities give such a public policy reason. Third, the language of the statute does not suggest any such policy - s.9 is essentially procedural and permissive in its language, saying that an application is to be by petition and identifying the classes of permitted petitioner. It does not, for instance, say "the following ….. shall be entitled to petition" or use similar mandatory language. It is true that both Byrne J and Chitty LJ refer to the predecessor of the current statutory language in relation to compulsory winding up but that is in no way essential to the reasoning.

75. Finally Mr Sheldon makes a point based on the fact that New York law governs this contract. Rule 180 of Dicey & Morris (13edn. 2000) says:

> "The application of a rule of the law of any country specified by rules 173 to 179 may be refused only if such application is manifestly incompatible with public policy ("order public") of English law."

76. Mr Sheldon submits that even if English does take the view that no-action clauses are invalid if governed by English law, they do not have such an inherent vice that English law would not respect a foreign law which permitted such clauses. I agree. The vice, contrary to my view it is such, is one of the utmost technicality. I see no reason why English law should elevate it to the status of "ordre public" with the effect that English companies could not raise money by contracts governed by New York Law with the same freedom and on the same terms as is routinely done by US and other non-UK companies.

77. In relation to this last point Mr Brisby complains that the experts have not dealt with the question of whether New York bankruptcy law might recognise a *Peveril* type exception of the sort for which he contended. I find that complaint astonishing. It was always Mr Brisby's case that the no-action clause was inapplicable or unenforceable. It was for his expert evidence to take the point, if there was one. Actually I cannot imagine that the point could have validity. If right it would mean that Prof. Kahan in his article, and the army of US

lawyers concerned with bond issues, would each have missed a major reason as to why no-action clauses are unenforceable.

The expert witnesses

78. Before I came to issues 4 and 5 I must say something about the expert witnesses. Highberry relied upon that of a Mr Heis an insolvency partner in the firm of KPMG. He supported the application with a report given under Rule 2.2 of the Insolvency Rules 1986. Rule 2.2 provides:

> (1) There may be prepared, with a view to its being exhibited to the affidavit in support of the petition, a report by an independent person, to the effect that the appointment of an administrator for the company is expedient;
>
> (2) The report may be by the person proposed as administrator, or by any other person having adequate knowledge of the company's affairs, not being a director, secretary, manager, member or employee of the company.

79. Rules 7.51 of the Insolvency Rules 1986 (as amended) says:

> "The CPR, the practice and procedure of the High Court ...apply to insolvency proceedings in the High Court .. with any necessary modifications, except so far as inconsistent with these Rules.

80. An insolvency practitioner giving a report under Rule 2.2 is subject to the general rules applicable to the High Court unless the Insolvency Rules required otherwise. It follows, since they do not provide otherwise, that Part 35 ("Experts and Assessors") of the CPR applies to Rule 2.2 Reports. This is important. Mr Heis well knew, as a partner in a well-known and important firm, that this application would be opposed: that his report under s.2.2 was not only likely to be fiercely opposed but would be tested in every possible way. For that reason alone, Mr Heis ought (as he did not) to have considered very carefully, specifically for the purposes of this case, not only Part 35 of the Practice Direction, but also the Code of Guidance on Expert Evidence of the Working Party of the Civil Justice Council. He said he had a general knowledge of the duty of experts. That is not good enough. Any expert in a case that is likely to be contested ought to re-read the Rules and Code. In this case Mr Heis was not helped by his instructing solicitors, who failed to send him a copy of Part 35 or the Practice Direction or the Code of Guidance. If Mr Heis had read and properly applied the Code of Guidance where it says:

> "In providing a report experts:
>
> (c) where there is a range of opinion in the matters deal with in the report [must] give
>
> (i) a summary of the range of opinion; and
>
> (ii) the reasons for his own opinion
>
> (e) if such opinion was not formed independently should make clear the source of the opinion"

he could not have prepared the report which he did. I regret to say that I conclude, without hesitation however, that Mr Heis failed in his duties to the court. Unconsciously I think he espoused his clients' cause. Moreover I think he was prepared to act for Highberry when there was a clear conflict between his firm and that of a client, namely Colt. Of course I do not say these things lightly and must give detailed reasons. Some of these emerge in my detailed consideration of the allegations of insolvency. But some matters stand out particularly so I set these out now:

(1) Mr Heis and his firm were prepared to act for Highberry even though his firm had acted for Colt recently. A key question in these proceedings is Colt's WACC (current weighted average cost of capital). KPMG had recently given tax advice concerning transfer pricing. That advice involved the WACC for an important Colt asset, namely its long distance network. Mr Heis did not. I will allow, know that when he wrote his initial rule 2.2 report. But that is because neither he nor anyone at KPMG concerned with possible conflict of interest made any specific inquiries as to what was involved in the tax advice. Evidence from Mr Akin of the company was given on this point. It was to the effect that the WACC, on KPMG's advice, was 8.5%, - to be contrasted with Mr Heis's figure of 24.67% for the assets as a whole. Mr Heis sought to brush that aside on the basis that he did not have access to the advice given by KPMG. He said "I would not expect the WACC calculations for the purpose of agreeing tax computations with the Inland Revenue and tax authorities in other countries to be equivalent to FRS11 (Impairment of Fixed Assets and Goodwill) calculations." He does not set out how those calculations would be done. He added, , that "Mr Akins' witness statement makes it clear that they are not equivalent." I do not think it does. That is the wrong question in any event: the real question is whether KPMG's tax advice concerning WACC is relevant to these proceedings. It could be relevant either as an exact equivalent or as a comparable (if there were differences between WACC for FRS11, and WACC for tax purposes - a matter which remains unresolved). Mr Heis should not have been entering any such dispute as a partner in KPMG - they were potentially speaking with forked tongues.

In relation to this point I do not blame Mr Heis. For Colt complained to KPMG about both a conflict of interest and the risk of improper use of confidential materials. The reply was not from Mr Heis but from another partner in KPMG, a Mr Lerner. It can fairly be termed a "brush off". It in no way considered the fact that KPMG were espousing two widely different WACCs. It did not consider the fact that Mr Heis was giving expert evidence in which KPMG had an interest in the result. It solely addressed the questions of whether there would be a conflict if KPMG were appointed administrators and whether there would be a breach of confidence.

(2) Mr Heis' firm stood to make a lot of money if his expert evidence was accepted. Yet he did not bring this out in his Rule 2.2. report. All that contained was the routine statement that he and another partner were prepared to act as administrators. This is not a case where the expert had an indirect or subordinate interest in the result. Or a case where KPMG was merely carrying out a detailed investigation of facts. On the contrary KPMG had a very great direct interest in the court accepting Mr Heis's expert opinion as to insolvency. He should never have offered to be the administrator. It astonishes me that the possibility of a problem in this regard never crossed Mr Heis's mind (or that of anyone else at KPMG) until Mr Heis was asked about it. Only then did he offer to stand down.

I hasten to add that what I have said has only marginal application to a routine, run- of-the mill, petition for administration in which the insolvency practitioner routinely offers to act as administrator. Petitions are generally presented in uncontroversial cases, normally initiated by the directors. Even in those cases an insolvency practitioner has a bit of a conflict of interest and must be particularly careful to be objective in giving his advice to the directors as to the need for and purpose of an administration order. Contested petitions are significantly different. They are rare birds. I think that an insolvency practitioner asked to give expert evidence to support such a case should not propose himself as the administrator. Otherwise the Court is faced with an expert giving highly contested evidence in a case where he has a direct interest in his evidence being accepted. Mr Sheldon did not go so far as to submit that such a conflict made the evidence inadmissible. I think he was right about that (for instance employees of a company quite often give expert evidence for their company). But the fact of such a conflict clearly goes to weight. And it is also obvious that the fact of the interest should be explicitly and fully brought out in the expert's report under Rule 2.2.

(3) The key area in relation to balance sheet solvency relates to the valuation of the company's assets. FRS 11 relates to this. It applies when "fixed assets need to reviewed for impairment when there is some indication that impairment has occurred." In other words when there is reason for looking again at an earlier valuation of fixed assets, a revaluation job should be done. No one suggests that the job is easy. It is not to be done on a forced sale basis - the general idea is to value the assets on a going concern basis. FRS 11 impairment reviews are carried out by specialist accountants. They involve a considerable degree of judgment and experience. It is common ground that a small difference in initial assumptions can make a great difference to the result (a point not mentioned in Mr Heis's initial evidence as it should have been).

Now Mr Heis was an insolvency practitioner. So far as the value of fixed assets are concerned insolvency practitioners normally turn to expert valuers in the relevant field. If the asset is a factory then they go to a factory valuer and so on. But in this case Mr Heis set himself up as the relevant expert valuer. It turned out that he had no expertise in FRS 11. He was essentially giving evidence second-hand. He said he had spoken to experts on FRS11 in KPMG who knew about FRS 11 and he understood the exercise. That is far from being an expert in the field himself. Saying, "I know a man who knows and he has explained it to me" is not expert evidence. So at the outset I would reject his evidence on FRS11 simply on the ground that he is not an expert on that subject.

The approach of Colt's experts was very different. They called two, both partners in another of the "big four" accountants, Ernst & Young. One was on FRS11 (Mr Halkes), a man with great experience of the standard from its introduction in 1998. He was also particularly experienced in auditing telecom companies. The other (Mr Hughes) was an insolvency practitioner (Mr Heis' expertise) who gave evidence on cash-flow insolvency. Of course in both cases the experts checked with other members of the firm, and, in some cases, got them to do some of the "donkey work", namely ascertainment and checking of detail. Moreover, at least in the case of Mr Halkes, he checked his opinion with another partner expert in FRS11. But the big difference was this: Mr Heis was giving the opinion of others who could not be cross-examined and who had not, so far as I know, read the CPR or its Practice Direction or the Code of Guidance. Colt's experts were true experts in their respective fields.

(4) Quite extraordinarily Mr Heis thought that even if a case were made out for it, no administration order would be made. It was a point he volunteered at the end of his evidence:

> A. I thought the chance of an administration order necessarily arising even if the court were minded to make one, would be tempered. As Mr Hughes quite rightly pointed out, some form of solvent scheme or whatever, which presumably would not involve us, would be an answer if the court were minded to make that administration order anyway. So I think our view of the chances of our being appointed were probably quite low.
>
> MR JUSTICE JACOB: Sorry, you put the 2.2 report in and you thought the chances of an administration order being made were low?
>
> A. Because my conjecture was that the company would suggest some form of alternative procedure such as a scheme as Mr Hughes has made the point --
>
> MR JUSTICE JACOB: In advance of the court hearing?
>
> A. No, on the basis that the court signified that it was minded to grant an order.

I was amazed by this: I cannot imagine why Mr Heis did not say in his 2.2 report that he thought the prospects of an order being made were low even if the court was minded to make it.

(5) In his reply, Mr Brisby drew my attention to a number of passages in the Rule 2.2 report where Mr Heis expressed reservations or caution. The general theme was that he only had limited public information available and was doing the best he could with that. I reject that "excuse". If the information was not good enough to use, then there should have been no report. There would have been nothing wrong in Mr Heis saying "I do not have enough to form a reliable conclusion"

81. Before passing from these general points I should mention one other. It disturbed me though in the end I am not prepared to make a finding because Mr Heis was not specifically asked about it. It will be recalled that Highberry issued a statement to the market which contained the innuendo that one of the big four had given advice giving rise to Highberry's belief "that insolvency is inevitable." Mr Heiss was asked about it:

> Q. The last bullet point: "Highberry believes that insolvency is inevitable." You are not suggesting that, are you, Mr Heis?
>
> A. No, I am not.
>
> Q. So you knew when you signed the 2.2 report that it was going to get into the press and be relied upon by Highberry to make allegations of insolvency against the company?
>
> A. Yes, that was not the principal purpose of the report. [The rest of the answer does not matter]

82. So Highberry were in effect making a statement to the market which was not backed by KPMG as though it was. What I do not know is whether anything was done about it. For

it seems to me vital that accountants (and other professionals for that matter) should never allow clients publicly to misrepresent their opinions.

Issue 4: Cash flow insolvency

83. This was Mr Brisby's lesser plank. The case runs like this: there is no risk of cash flow insolvency (inability to pay debts as they fall due) until 2006. But by then some of the capital due on the notes will be repayable and the company will not, if things carry on as they are, have the wherewithal to do it. In particular it is not clear it will be generating enough cash flow from its assets. Nor is it clear that anyone would be willing to re-finance the company in 2006.

84. I can deal with this case quite briefly for it fell apart when Mr Heis was cross-examined. It went like this:

> Q. Your conclusion is as follows: "As can be seen above, based on publicly available information, it is reasonable to conclude that the company will not be able to meet its bond redemptions in 2006 without a re-financing. Given its current share price, bond prices and financial position, it is unclear how this can be achieved. It therefore appears reasonable to conclude, on the basis of public available information, that the company is likely to become unable to pay its debts as they fall due in 2006." The first point, Mr Heis, is you are not making any allegation of cashflow solvency prior to 2006, are you?
>
> A. No.
>
> Q. In your second report, I think you state that uncertainty as to future events prevents you from forming a definitive conclusion?
>
> A. That is right.
>
> Q. You say that brokers reports are speculative?
>
> A. I have quoted the word used by Mr Hughes but "speculative", I think, is a word that can be used on any uncertain prediction into the future. I think we are both speculating as are the brokers.
>
> Q. So you accept your view is also speculative?
>
> A. It is based on the brokers' reports, which are in themselves speculative.

85. The remarkable thing is that not one broker suggests that Colt will be unable to pay its debts in 2006 or later. Yet they were all working on the same facts as Mr Heiss. It is said that a broker would not say such a thing. Yet if that is the conclusion a broker reached it seems to me inconceivable that they would not at least shout "get out!" As it happens the share price has risen during the last few months which suggests that investors place some value on the company and its future. That is in accordance with the brokers' reports, some of which are more favourable to the company than others, no more.

86. I refer to some other passages in the evidence:

Q. Do you still maintain that it is your view that it is more likely than not that this company will be cashflow insolvent in 2006?

A. It is my view, but I accept that that view is not necessarily definitive or all that reliable.

Q. I will put it to you, Mr Heis, that it is simply untenable?

A. Well, I would not say it is untenable but because the cashflow issue is something that is a feature of 2.2 reports I have dealt with it, but obviously I accept that there are limitations in the way I have dealt with it.

Q. You are in no [obviously missing from the transcript] different position from the brokers on this point, are you not, whatever the position may be on other matters, you are clearly in no different position from the brokers?

A. No, probably a slightly worse position.

Q. Let me just slightly rephrase the question. When I use the phrase "more likely than not", I mean more probable than not. Is it your view that it is more probable than not that the company is going to be cashflow insolvent in year 2006?

10 MR JUSTICE JACOB: Or [the transcript wrongly says "why"] are you unable to say?

A. I think if I can deal with that and answer it, Mr Sheldon, you could say that it is not possible to form a conclusion. I would certainly say it is not my view that it is more likely than not that the company will be able to re-finance successfully because the objective evidence does not support that. But if you are saying is my opinion valid at all, then I would say that there are significant limitations and you may query whether that is a worthwhile opinion to form. My view is that it is, but obviously I have made the point that it is limited, it is of limited reliance that one can place on it.

87. Such a shaky, tentative, and speculative peering into the middle distance is no basis for forcing a company into administration. I do not think Mr Heis, given those answers, should ever have espoused this point. After all an allegation of insolvency is a serious matter. It needs a solid foundation.

Issue 5: Balance Sheet insolvency

88. This was Mr Brisby's primary allegation. It was founded on the application of FRS11. Relevant passages of this read:

"<u>Summary</u>"

"Financial Reporting Standard 11 'Impairment of Fixed Assets and Goodwill' sets out the principles and methodology for accounting for impairments of fixed assets and goodwill"

....

"It would be unnecessarily onerous for all fixed assets and goodwill to be tested for impairment every year. In general, fixed assets and goodwill need to be reviewed for impairment only if there is some indication that impairment has occurred. (Requirements for additional impairment reviews of goodwill and intangible assets in certain circumstances are included in frs 10 'Goodwill and Intangible Assets').

Where possible, individual fixed assets should be tested for impairment. However, impairment can often be tested only for groups of assets because the cash flows upon which the calculation is based do not arise from the use of a single asset. In these cases, impairment is measured for the smallest group of assets (the income-generating unit) that produces a largely independent income stream, subject to constraints of practicability and materiality.

Impairment is measured by comparing the carrying value of the fixed asset or income-generating unit with its recoverable amount. The recoverable amount is the higher of the amounts that can be obtained from selling the fixed asset or income-generating unit (net realisable value) or using the fixed asset or income-generating unit (value in use).

Net realisable value is the expected proceeds of selling the fixed asset or income-generating unit less any direct selling costs. Value in use is calculated by discounting the expected cash flows arising from the use of the fixed asset or assets in the income-generating unit at the rate of return that the market would expect from an equally risky investment."

....

"Cash flows

36 The expected future cash flows of the income-generating unit, including any allocation of central overheads but excluding cash flows relating to financial and tax, should be based on reasonable and supportable assumptions. The cash flows should be consistent with the most up-to-date budgets and plans that have been formally approved by management. Cash flows for the period beyond that covered by formal budgets and plans should assume a steady or declining growth rate. Only in exceptional circumstances should:

(a) the period before the steady or declining growth rate is assumed extend to more than five years; or
(b) the steady or declining growth rate exceed the long-term average growth rate for the country or countries in which the business operates."

...

"*Discount Rate*

"41. The present value of the income-generating unit under review should be calculated by discounting the expected future cash flows of the unit. The discount rate used should be an estimate of the rate that the market would expect on an equally risky investment. It should exclude the effects of any risk for which the cash flows have been adjusted and should be calculated on a pre-tax basis.

89. That is the basic rule. FRS 11 then adds the following explanatory notes:

"Estimates of this market rate may be made by a variety of means including reference to:

(a) the rate implicit in market transactions of similar assets;
(b) the current weighted average cost of capital (WACC) of a listed company whose cash flows have similar risk profiles to those of the income-generating unit; or
(c) the WACC for the entity *but only if* adjusted for the particular risks associated with the income-generating unit.

43 If method (c) is used the following matters are of note.

- Where the cash flow forecasts assume a real growth rate that exceeds the long-term average growth rate for more than five years, it is likely that the discount rate will be increased to reflect a higher level of risk.

- The discount rates applied to individual income-generating units will always be estimated such that, were they to be calculated for every unit, the weighted average discount rate would equal the entity's overall WACC.

44. The WACC will be a post-tax rate from the entity's point of view, whereas the required discount rate will be a pre-tax rate. Some of the issues that need to be considered in adjusting from a post-tax rate to a pre-tax rate are discussed in Appendix I.

45. Using a discount rate equal to the rate of return that the market would expect on an equally risky investment is a method of reflecting the risk associated with the cash flows in the value in use measurement. It is likely that this method will be the easiest method of reflecting risk. However, an acceptable alternative is to adjust the cash flows for risk and to discount them using a risk-free rate (e.g. a government bond rate). Whichever method of reflecting risk is adopted, care must be taken that the effect of risk is not double-counted by inclusion in both the cash flows and the discount rate."

.....

"Appendix I – Determining pre-tax discount rates

The discount rate reflects the rate of return required on the assets being reviewed, not the way in which they have been financed. Hence it is not affected by any tax relief available on the cost of financing the asset or by any tax paid by the provider of finance."

90. FRS 11 thus involves some key features. In the case of a going concern and a value in use calculation, these particularly include the expected life of the asset and the appropriate WACC. Necessarily estimates and assumptions have to be made. And small differences in these can have a big effect - for instance in this case the difference between a 13 and a 20-year asset life for all of Colt's assets is the difference between £200 million and £2.1 billion - a factor of 10.

91. Because of the downturn in the telecoms market, Colt's auditors, PriceWaterHouse Coopers (another of the "big four") actually carried out an FRS11 impairment review for the third quarter of this year. It was done at the behest of the directors, who asked for it prior to any approach by Highberry, as part of their duties as directors. It was not done for the purposes of this case. Naturally PWC had access to much up-to-date detail of Colt's financial affairs include estimates of cash flow, capital expenditure and so on. Across the summer Colt carried out a detailed review of its business, following completion of its pan-European network. PWC had access to all that when they conducted the FRS11 review. So they would have used Colt's latest estimates of capital requirements (which have been lessening following completion of important networks), latest actual cashflow, and latest projected cashflow. PWC's impairment review was completed on 24th October 2002, just after Mr Heis' rule 2.2. report (22nd September). After impairment it estimates total assets as £2.6b and creditors as £1.5b. The Financial statements say this about the impairment review:

> "On 27th September 2002, the Company also announced that given the recent downturn in the telecommunications industry and in the overall economic environment that it was prudent to take further action to ensure that its asset base remained aligned with the realities of the market. As a result, the operating exceptional items of £508m. shown under network depreciation and £43m. under other depreciation and amortisation in the three and nine months ended 30th September 2002 represent a non-cash impairment charge to write down the book value of fixed assets. This charge resulted from a review covering all of the Group's tangible fixed assets and goodwill and was computed in accordance with the requirements of FRS 11 'Impairment of fixed assets and goodwill'
>
> It is the Group's accounting policy to review its tangible and intangible fixed assets for impairment whenever events or changes in circumstances indicate that carrying amounts may not be recoverable. An impairment loss is recognised to the extent that the carrying amount of an asset exceeds its recoverable amount, being the higher of its value in use and net realisable value. In computing the impairment charge above in accordance with this policy and the requirements of FRS11, the carrying amounts of the relevant assets were compared to recoverable amount, represented by the present value of discounted cash flows projected to arise from their use."

92. Although PWC had access to much later, detailed and inherently better information than Mr Heis, and although it was conducted by experts experienced in FRS 11, Mr Heis did not, in the face of this review, withdraw his allegation of balance sheet insolvency. He was asked about this:

> Q. Now, you do not suggest anywhere in your 2.2 report or in your second report that PriceWaterhouseCoopers have been in any way negligent. Is that correct?

A. I think that's correct, but I would draw your attention to the fact that the 2.2 report was submitted before the PWC statement was issued.

Q. But that was submitted on the basis, amongst other things, of the December 2001 results, which were audited.

A. Yes, that's right.

Q. And there is no suggestion that PricewaterhouseCoopers were negligent in connection with that audit?

A. I clearly did not have the information about the nature of the audit they did, nor the personal expertise to say that, although, in my report, I have drawn very heavily on the relevant specialisms within the firm on both FRS and the application of it. So, I would not like to make any comment in relation to PWC.

Q. So, you are not suggesting that PWC have been negligent?

Q. No. The only things I know about PWC's involvement are: one, there was an audit which was done last year; secondly, there was a statement which was issued after the submission of the 2.2 report; and thirdly, it has emerged that the discount rate was 13.7 percent. Those three factors I don't think allow one to pass judgement.

93. This strikes me as being willing to wound but not to kill. Acceptance of Mr Heis' evidence would necessarily mean that PWC were not merely wrong, but that they were miles out, that they had made a gross error. Mr Heis could not bring himself to say that, yet I am invited to accept his view, based on much less up-to-date, detailed or complete evidence. It is particularly important to observe that Mr Heis said "one could not pass judgment" on the 13.7% figure. For it was crucial to his opinion as to insolvency that the figure should be nearly double that. If there was any real substance to his figure of 24.67% I cannot understand his answer.

I said "his view" but really it is the view of others as the following passage shows:

MR JUSTICE JACOB: So, you are not saying there is anything wrong with what PWC did?

A. Because there is no information to enable one to do so. But what I --

Q. Just help me with that. And if they got it right, then this company is not insolvent on a balance sheet basis, is that right?

A If they got it right, that's certainly true.

Q. So, you are saying something is wrong with PWC?

Q. We're saying that we have done the analysis on the public information and that leads to a different conclusion.

Q. When you say 'we', what do you mean 'we'? You mean you or somebody else?

A. I mean myself and the relevant colleagues with whom I've consulted extensively.

Q. Do you mean some of your report is not your own?

A. I have taken advice from other experts, which is necessary. There are a number of factors that need to be considered in a report such as this, and I have not all of those pieces of expertise myself, as indeed I wouldn't have thought anybody has. I have made sure that all of the advice that I have received I have completely understood, at length through meetings and discussions.

Q. Am I right that you have not even named the people who gave you that advice?

A. I haven't named them in the report. There are quite a large number.

94. What then was Mr Heis' view based upon? The answer is simply brokers' analysts' reports on Colt. Extraordinarily, as I have said, none of them reach the same answer as Mr Heis, in reports made both before and after the PWC impairment review.

95. Nor is possible to reconcile Mr Heis' view with that of the market - which has exactly the same information as he had. If he is right, this company has assets worth less than zero. Yet the market capitalisation is £700 million. Mr Brisby submitted that this was not surprising - for share values can never be negative. That is of course true - and there such things as penny shares bought or held simply as an outside bet. But this case is miles from that. The fact that the company was valued at much more a few years ago does not mean it is worth nothing now.

96. I do not intend to go through all the points in Mr Heis' evidence. I will concentrate just one major ones. I begin with the fact that what FRS11 is trying to do, when going by the value in use parameter, it to value discrete "income generating units" (IGUs). You are supposed to identify any unit or group of units which produces an identifiable income stream and value that separately based on its income stream and expect life. Mr Heis could do not do that because he only had information for Colt as a whole. So he treated Colt as a whole as a single IGU. In his 2.2. report he recognised that this might involve an error, either up or down. What he did not go on to say is that his conclusions might be right or wrong and he did not know which. As it happens, Mr Heis' assumption about a single IGU was favourable to the company, but he did not know that at the time.

97. Next Mr Heis took asset life of 13 years in his worked example. Asset life is a technical fact (barring supercession by some unforeseeable technology). A lot of Colt's assets, being a fibre-optic network, are literally buried in the road. Mr Heis had no real idea of asset life. He took a figure of only 13 years as his worked example. It is true he said it could be 20 years, but by taking the lower number for the example he gave emphasis to the lower number which made things look even worse. When challenged he said this:

> Q. Mr Heis, you say that you refer to the £2 billion figure, but why didn't you give the company the benefit of the doubt and put that figure into your calculations?
> A. Because it wouldn't have made any difference.

98. That is an astonishing answer - it is no reason for choosing a figure more adverse to the company. Actually it could make a difference. The lower the figure here, the less error was needed in Mr Heis' WACC before an "insolvent" answer was produced.

99. In the end Mr Heis virtually conceded that the 13-year period was inappropriate:

> A. So, Mr Heis, you selected a figure of £217 million, even though you have projected that the company is going to spend an average of £327 million in the preceding five years leading up to what you say will then result in a disposal of only £217 million. That is absurd, is it not, Mr Heis?
> A. It's one range of £217 to £2026 million. I mean I've pretty much -- I mean I worked out the number myself. I broadly conceded that £2 billion is a fair number, as opposed to £217 million. The whole thing depends on the discount rate.

100. I turn finally to the discount rate. Mr Heis took his figures for cash-flow from brokers' reports. But he ignored all the brokers' analysts' WACCs for Colt, (ranging from 10 to 13%). He also ignored all the publicly available WACCs of UK quoted telecom companies in their impairment reviews. These range from the solid to the less solid company and the WACCs run from 8.8% to a maximum for 15.1% (for a comparable to Colt, a specialist subsidiary of BT called BT Ignite). Mr Heis' figure was 24.67%. So it was manifestly much higher than anything which anyone else was using. He did not bring that out in his Rule 2.2. report as I think he should have done.

101. Now it is of course possible that if one man walks out of step with the rest of mankind it is because he hears a different beat. But that is not the sort of thing appropriate for accountancy where uniform objective standards are the desired and aimed-for norm. So it necessary to examine what Mr Heis did with care to see if it has substance.

102. What he did was this. He took the current price and yield of the company's bonds. From that he calculated the cost of debt as 20.32%. He then assumed that because equity is more risky than debt it would be fair to treat equity as costing the same. He then had to make a tax adjustment which he estimated at 15% thereby getting to his 24.67%.

103. So the whole thing depended on the current price of bonds and nothing else. There was no attempt to "estimate the rate that the market would expect on an equally risky investment" which is part of rule 41. Mr Halkes (who had great experience of FRS 11) had never done it Mr Heis' way or heard of it being so done. Nor had Mr Heis - though since he had no experience of FRS 11 that hardly matters. A relevant partner at KPMG was not there to be asked the question.

104. Mr Heis chose to ignore the calculated cost of equity, which was 12.76%. I cannot see why. If he were right that the cost of equity must be at least equal to the cost of debt, that would give a WACC of 12.67% or less. It boils down to preferring to rely upon the bond price as opposed to the share price. Yet there is evidence from Mr Akin that the bond market is illiquid whereas the shares are freely traded. To that last point it is said that the company itself bought bonds, as did Highberry. However I have no more information than that - which is not enough to displace Mr Akin's statement. I do not know what the position would if someone tried to buy a substantial amount of bonds.

105. It seems to me that reliance on the bond price alone must be inherently faulty. The bond price depends on the promised yield to redemption, general yields in the market, and a factor representing the risk of default. The last matter depends not only on the company's fixed assets but other things too - how much cash it has, and what the expectations in the market are as to the company's performance. If, for instance, Colt had £10b instead of £1b, there would be negligible risk of default. The bond price would be different. Mr Heis' method would give a different WACC and so a different value in use for the assets. That is absurd. Mr Brisby said that meant the fact that the market took into account the cash of £1b was favourable to the company. I think simply shows that the instantaneous bond price alone is not a rational or fair way of going about the object of FRS 11 - the valuation over a long term of an asset in use.

106. Mr Halkes I think put his finger on the flaw. FRS11 in its notes says that the WACC for the entity may be used but only if adjusted for the particular risks associated with the IGU.

Using the bond price means taking the risks for the company as a whole, not the IGU, even if you regard the company's fixed assets as an IGU. Moreover what is taken into account in the bond price is the risk of default of the company. Mr Halkes put it this way in cross-examination:

> Q. Can I move on from there because you have accepted FRS11 says nothing in terms about eliminating default risk from the cost of debt?
> A. FRS11 only talks about eliminating the effects of financial structure.
> Q. Exactly. In fact, eliminating default risk from the cost of debt, I suggest, is contrary to the whole point behind FRS11 because you run the risk of ending up with a cost of debt that is wholly unrelated to the risk that the market would actually attribute to financing the assets in question?
> A. No, there I would take issue with you. Because FRS11 is applied to accounts that are prepared on the going concern basis. To use a discount rate that includes a default risk is counter-intuitive because you are using a rate that says this company is going bankrupt, and if you think the company is going bankrupt then you should not be preparing the accounts on a going-concern basis anyhow; you should be preparing the accounts on a break-up basis.

107. Mr Halkes did his own calculations based on publicly available information - cross-checking it three ways. He got a much lower WACC than Mr Heiss. I do not propose to go into this because it is not really necessary - and in any event the PWC exercise would have been much more precise. So all I would say is that by virtue of the cross-checking and the fact that it did not depend on a single figure of one bond price in a highly volatile market it seems to me that Mr Halkes' method is a good deal more likely to give stable and reliable figure for the valuation of an asset over the long-term.

108. I reject, without hesitation, the case for a 24% WACC advanced by Mr Heis. The case for it was so flimsy that it should never have been advanced. It follows that the company is not balance sheet insolvent.

Issue 6: Discretion

109. On my findings I have no jurisdiction to put Colt into administration. If I were wrong, however, I have no doubt that I should not do so. Here are my reasons:

(a) The making of an administration order would be an event of default under the terms of the Indenture - that would mean all the debt was repayable now. That would well destroy the entire business rather than serve the statutory purpose of the survival of the company and the whole or part of its undertaking.

(b) The Petition has very little support - no bondholder other than Highberry (holding just 7% of the notes) supports it. Mr Brisby suggested there might be silent supporters. I reject that - I can see no reason why a supporter, if there were one, could not have written a letter of support.

(c) It is premature - there is not even a suggestion of urgency given that is conceded that creditors will be paid until at least 2006.

(d) There is no indication that an administrator with no knowledge of the telecoms business could improve the current specialised management - it would almost certainly stop the business in its tracks. Normal corporate governance would be suspended for no clear or useful purpose.

(e) An administration order would simply add to the company's costs (if its business survived).

Conclusion

110. There is not, and never has been, any substance whatever in this petition. It should never have been launched. Mr Sheldon described it as an "abuse of process". Mr Brisby objected, saying there was no hidden or ulterior purpose. That is true - the purpose was very clear from the outset - cash for Highberry. I do not think it matters how the petition is characterised. Mr Brisby's submission was to avoid an award of costs on an indemnity basis. For that purpose he spent some time distancing his clients from the KPMG report. That may be relevant on the question of costs but the case has not reached that point. I will counsel on that and other matters consequential upon this judgment.