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CASE REVIEW SECTION

Balance Sheet Insolvency: A Commercial Approach

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Introduction

In *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL Plc & Ors* [2011] EWCA 227 the Court of Appeal was called on to consider for the first time:

i) The test for whether a company is unable to pay its debts set out in section123(2) of the Insolvency Act 1986 ('section 123(2)') (the so-called 'balance sheet insolvency test') and, in particular, the requirement that a company's contingent and prospective liabilities are taken into account; and

ii) The relevance of a post-enforcement call option ('PECO') to the assessment of balance sheet insolvency under section 123(2).

Upholding the Chancellor's first instance decision, the Court of Appeal held that, notwithstanding that Eurosail's audited accounts showed it to have net liabilities, Eurosail was not unable to pay its debts within the meaning of section 123(2); it was not balance sheet insolvent. The Court of Appeal's decision on this first issue meant that it did need to address the relevance, if any, of the PECO, but it did so in any event, agreeing with the Chancellor that, although the effect of the PECO was to render Eurosail bankruptcy remote, it would not necessarily follow that it was not unable to pay its debts within the meaning of section 123(2).

Background

Notes ('the Notes') were issued to various classes of noteholders by Eurosail, a special purpose vehicle incorporated in England. The Notes provide that an 'Event of Default' occurs in the event of Eurosail being 'unable to pay its debts as they fall due, or within the meaning of Section 123(1) of (2) (as if the words 'it is proved to the satisfaction of the court' did not appear in Section 123(2)) of the Insolvency Act 1986 (as that Section may be amended from time to time), being deemed unable to pay its debts'.

The Notes also featured a PECO which gave a company under common control with Eurosail the option, following the realisation and distribution of Eurosail's assets, to acquire the remaining Notes for a nominal sum.

The Notes were denominated in sterling, euros and US dollars, with Eurosail hedging its currency exposure through swap agreements with Lehman Brothers Special Financing Inc ('LBSF'). Following the collapse of Lehman Brothers in 2008, payments ceased to be made by LBSF under the swaps and a dispute arose between various groups of noteholders as to whether Eurosail was unable to pay its debts within the meaning of section 123(2), meaning that an Event of Default had occurred.

If an Event of Default had occurred, and was deemed by the trustee for the noteholders ('the Trustee') to be 'materially prejudicial' to the noteholders' interests, the consequence would be the service of an Enforcement Notice and, crucially, a change in the order of priority in which the noteholders were to be paid.

In order that this dispute could be resolved, proceedings were issued by the Trustee, with the relevant noteholders being added as parties, and the Trustee taking a neutral position. The key issues between the various groups of noteholders were firstly whether, without regard to the PECO, Eurosail was unable to pay its debts within the meaning of section 123(2) and secondly, whether, if without regard to the PECO Eurosail was unable to pay its debts, the existence of the PECO meant that in fact Eurosail was not unable to pay its debts within the meaning of the same section.

The balance sheet insolvency test under section 123(2)

Section 123(2) provides that a company is 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'.

The Court of Appeal noted that there was no previous case law addressing the interpretation of section 123(2), although this is perhaps not that surprising given that what normally concerns creditors is whether they are being paid and, if they are not, they are able to rely in presenting a winding-up petition on the so-called 'cash-flow insolvency test' contained in section 123(1)(e) of the Insolvency Act 1986 ('the company is unable to pay its debts as they fall due'). Helpful

guidance as to the interpretation of section 123(2) was however found in the Report of the Review Committee Insolvency Law and Practice Cmmd 8558m, 1982 ('the Cork Report') and a later white paper entitled 'A revised framework for insolvency law, Cmmd 9175'.

Consideration of the history and purpose of section 123(2), and in particular of the Cork Report, led the Court of Appeal to reject the argument put forward by some of the noteholders to the effect that section 123(2) simply required an offsetting of a company's assets against its liabilities, with the company's assets and liabilities being taken at their values as set out in the company's accounts. Section 123(2) did not represent a 'wholly new, relatively mechanical 'assets-based' basis for seeking to wind up a company' (per Lord Neuberger), otherwise there would follow the 'extraordinary' consequence that many companies early on in their lives, and indeed many successful companies, would not be able to pay their debts within the meaning of section 123(2). The only protection for such companies would be the Court's discretion not to making a winding up order but, as the presentation of a winding up petition itself can have serious detrimental consequences for a company, such protection would be inadequate.

As such the Court of Appeal clearly took a commercial approach in rejecting the assets-based interpretation of section 123(2) and this commercial approach also underpins its positive account of what the test contained in section 123(2) does amount to, it being stated that section 123(2) applies to a company whose assets and liabilities (including contingent and future liabilities) are such that it has reached 'the point of no return, 'the end of the road' or in respect of which 'the shutters should be put up'. Such a conclusion, Lord Neuberger MR says, is supported by commercial common sense.

As to when a company can be said to have reached 'the point of no return', Lord Neuberger admits that the test is imprecise, judgment-based and fact specific. Indeed, whilst he states that the decision 'is to be determined with a firm eye on commercial reality and on commercial fairness', he goes on to say that it would be 'positively dangerous' to give much further guidance as to the approach to be adopted by a court in deciding whether section 123(2) applies to a set of facts. That said, it is clear from the judgment that a company's audited accounts are a starting point and should be given weight, although that is it, such accounts showing only one true and fair view of a company's financial situation (being an historical view, based on accounting conventions). Further the length of time before a debt will become due and the likelihood or otherwise of a contingency occurring are also factors which may need to be taken into account in assessing whether section 123(2) applies on a particular set of facts.

On the facts before the Court of Appeal, Eurosail's audited accounts showed a net deficit. Further taking into account Eurosail's claim in LBSF's bankruptcy, which was not provided for in its audited accounts, was in effect cancelled out by the fact that its net liabilities were understated in its audited accounts as they were prepared on the basis that the PECO rendered the Notes limited recourse. Crucially though, Eurosail's deficit was, for the most part, the result of the cost of currency following the failure of its currency swap agreements with LBSF. As many of Eurosail's liabilities would not fall due until well into the future, there was potential for significant changes in Eurosail's position due to currency fluctuations. As such, taking a commercial approach to assessing Eurosail's financial situation, it could not be said that it has reached 'the end of the road' and it was not therefore unable to pay its debts within the meaning of section 123(2); it was not balance sheet insolvent.

Effect of the PECO

In order that issuers of notes can satisfy rating agency requirements, they need to be 'bankruptcy remote', by which is meant that they will not be put into insolvency proceedings. One way of satisfying such requirements is to limit claims against the issuer to whatever proceeds are realised on the enforcement of security, so-called 'limited recourse'. However, in light of concerns as regards the tax consequences of limited recourse structures, PECOs have in some cases been used as an alternative, the effect of the PECO being that in practice noteholders would never have recourse against the issuer save to the extent of its assets.

The question that was raised in the present case was whether, if without reference to the PECO Eurosail was unable to pay its debts within the meaning of section 123(2), the existence of the PECO, which in effect meant that the noteholders would never have recourse against Eurosail, save to the extent of its assets, entailed that Eurosail was not in fact unable to pay its debts within the meaning of section 123(2). The Court of Appeal having decided that section 123(2) did not apply, even without reference to the PECO, it was not necessary for the Court of Appeal to address this issue, though the arguments having been made it chose to do so in any event.

The view taken by the Court of Appeal was that the PECO did not have the same effect as limited recourse provisions in that, although the PECO renders Eurosail bankruptcy-remote, it does not follow that it is insolvency-remote or, in other words, that it cannot be unable to pay its debts within the meaning of section 123(2). The key point is that the PECO does not limit the recourse of noteholders prior to the option being enforced.

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Conclusion: a commercial approach

Given the dearth of case law as to the interpretation of section 123(2), the Court of Appeal's decision is a welcome clarification that the test contained in that section is not an assets-based test but a test of whether a company has reached the end of the road, to be approached with a firm eye on the commercial reality. This would appear to be good news for debtors generally, as well as issuers of notes more specifically, as it gives more scope for companies trading out of financial difficulties than might otherwise have been the case.

That said, as it readily acknowledged, the Court of Appeal did not provide much by way of guidance as to how the balance sheet insolvency test set out in section 123(2) is to be applied in other cases. At least in the structured finance context then, it may be that we see customised provisions replacing references to section 123(2) in order that the uncertainty that the Court of Appeal's decision entails can be remedied.

Finally, it is worth considering, in light of the Court of Appeal's decision, the relationship between the tests for balance sheet and cash flow insolvency. It would still seem to be the case that a company can be balance sheet insolvent without being cash flow insolvent in that it is still able to pay its debts as they fall due, but the Court of Appeal's decision would also seem to have had the effect of bringing these tests closer together, even to the extent of the tests becoming blurred at the edges, though looking at matters with a firm eye on commercial reality and commercial fairness, as Lord Neuberger MR urged, this consequence might be welcomed.

At the time of writing it is not known whether there will be an appeal to the Supreme Court.

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International Corporate Rescue

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