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Briefing note

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Subordinated noteholders strike sail: balance sheet insolvency in the Supreme Court

The Supreme Court has unanimously affirmed the Court of Appeal's decision on the test for balance sheet insolvency under section 123(2) of the Insolvency Act 1986 finding that Eurosail was not balance sheet insolvent. Of practical importance to borrowers and their lenders is the rejection by the Supreme Court of the "point of no return" formulation of the test enunciated by Lord Neuberger in the Court of Appeal. Lord Walker stressed that this should not be used as shorthand for what will in each case be a highly fact-specific and complex assessment of a debtor's future and contingent liabilities.

Placing a value on future and contingent liabilities

In this case, balance sheet insolvency was asserted on account of the termination of interest and currency swap agreements entered between Eurosail and certain Lehman Brothers entities which it was argued led to a significant deficiency in Eurosail's net asset position although it continued to pay its debts. Because the appealing noteholders were contractually and temporally subordinated, they argued that their position as creditors was jeopardised by this longer term structural deficiency which would likely see them go unpaid.

Critical to an assessment of the balance sheet position of Eurosail was what Lord Walker called the three "imponderable factors" (the first two arising directly as a result of the swap terminations): currency movements, interest rate movements and the United Kingdom housing market and economy. That these factors needed to be considered over a period of more than 30 years (as the final redemption date of the notes was 2045) made any present assessment of future liabilities a "matter of speculation rather than calculation and prediction on any scientific basis" with the result that the court should "proceed with the greatest caution" in determining whether Eurosail was balance sheet insolvent. This echoed the Court of Appeal's reason but in one important respect stopped short of a full endorsement.

Sailing against the wind: the "point of no return"

Although in agreement with the Court of Appeal's conclusions, Lord Walker rejected the formulation of Lord Neuberger that the balance sheet test became relevant only "at the point of no return" for a debtor. Instead, a creditor need only satisfy the court on the balance of probabilities that a company has insufficient assets to be able to meet all of its liabilities,

Key issues

- Supreme Court affirms balance sheet insolvency test not simply an accounting exercise
- Debtor may be insolvent before the "point of no return"
- The post-enforcement call option on its true construction would not operate to exclude affected liabilities from the future liabilities of Eurosail

including its prospective and contingent liabilities.

This permits greater flexibility and does not postpone a finding of balance sheet insolvency indefinitely which was a widely held concern with the "point of no return" formulation. Given the importance of the balance sheet insolvency test to other statutory provisions (such as the challenge of antecedent transactions in an insolvency and the wrongful trading legislation) and ordinary commercial contracts (as a grounds of termination), these views are to be welcomed as clarifying the timing of balance sheet insolvency for a company in distress.

For Eurosail, the test could not be finally determined until "much closer to 2045" and so by implication it would clearly have been premature for the court to conclude at the current time that Eurosail was balance sheet insolvent.

The court also addressed the effect of the post-enforcement call option (PECO) and its relevance to the balance sheet insolvency test. Because Eurosail was found not to be balance sheet insolvent this had no direct bearing on the decision but in a brief judgment Lord Hope confirmed the reasoning of the Court of Appeal that the liability of Eurosail to the noteholders on a proper construction of the PECO was not affected meaning that these liabilities needed to be brought into account in any assessment of Eurosail's future liabilities.

Plain sailing?

The Supreme Court's decision addresses only one (arguably the more straightforward) end of the commercial spectrum because, as it acknowledged, Eurosail operated a "closed system" in the sense that it was in many respects a static business working within strictly defined parameters quite unlike an ordinary trading business. Eurosail's current assets should therefore be a "better guide to its ability to meet its long-term liabilities than would be the case with a company actively engaged in trading".

The Eurosail litigation has been helpful in settling what has long been the working assumption of practitioners and academic commentators that section 123(2) is not a rigid test limited to an analysis of a debtor's balance sheet at a given time. The Supreme Court's decision has also assuaged the concern arising from the Court of Appeal's judgment that the bar for proving balance sheet insolvency had been set so high as to be commercially meaningless. What is very clear, however, is that any creditor seeking to rely on section 123(2) will need to equip itself with wide-ranging evidence of the value to be placed on future and contingent liabilities of the debtor which as a practical matter may prove challenging.

The decision is also useful in providing some practical insight into when the court should apply the different insolvency tests. Whilst recognising that the cash flow test is concerned with debts that are due and those that are due in the reasonably near future (as per the decision in *Re Cheyne Finance* [2008] BCC 182), the Supreme Court acknowledged that this test would become entirely speculative once the court has moved beyond the reasonably near future, at which point in time the balance sheet test becomes "the only sensible test".

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