

## Balance sheet insolvency test clarified

### *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL Plc & others* [2011] EWCA Civ 227

The Court of Appeal has allowed companies around the country to breathe a solvent sigh of relief, as it has held that the so-called “balance sheet” test of insolvency in s123(2) Insolvency Act 1996 is intended to apply where a company has reached a “point of no return” rather than being used as a “mechanistic, even artificial, reason for permitting a creditor to present a petition to wind up a company”.

In an appeal by the noteholders of Eurosail-UK 2007-3BL Plc (“**Eurosail**”), the Court of Appeal has upheld the High Court’s earlier decision that Eurosail was not insolvent under s123(2) and provided a useful summary of how future and contingent liabilities should be considered for the purposes of that section.

### The Decision

The Court held that a company is not balance sheet insolvent solely because its liabilities exceed the value of its assets. The Court noted that, were this interpretation to be adopted, many companies would find themselves deemed unable to pay their debts and consequently unable to access investment or credit. This would not be an outcome of commercial application.

Rather, the Court decided that a company is balance sheet insolvent when its assets and liabilities (including contingent and future liabilities) are such that it has reached the “point of no return” for the purpose of addressing the ultimate question of whether the company is unable to pay its debts. That is, s123(2) applies where it becomes clear that a company, though able to pay its debts at the present time, will not be able to meet its future or contingent liabilities.

As to how such future and contingent liabilities should be valued, the Court held that the company’s balance sheet may be a helpful starting point, but cautioned against simply adopting balance sheet values without keeping “a firm eye both on commercial reality and commercial fairness”.

In the current case, the Court held that Eurosail was not insolvent under s123(2) for 3 main reasons:

- Eurosail had substantial assets, the current asset deficit being only 17%;
- as the deficit was based largely on currency costs following the loss of its currency swap arrangement on the collapse of Lehman Brothers, there was great potential for significant change in the difference between Eurosail’s assets and liabilities due to currency fluctuation; and
- many of the liabilities had a long-stop date well into the future (up to 2045), before which it was quite probable that the values would change.

Although not affecting the outcome, the Court of Appeal also found that a post-enforcement call option (“**PECO**”) entered into as part of the transaction meant that noteholders still had full recourse against Eurosail at least until service of an enforcement notice. This meant that the PECO did not prevent there being “insolvency” for the purposes of establishing an event of default, notwithstanding that Eurosail was intended to be bankruptcy-remote. Although interesting, this finding had no effect in relation to the Court’s decision that Eurosail was not insolvent under s123(2).

## Implications

This decision is likely to be welcomed by the corporate and structured finance world as a commercially sensible outcome that recognises that a company can have, on paper, liabilities exceeding assets but still can be perfectly capable of continuing to trade. The Court has reiterated that s123(2) should only apply to those entities for which it was intended; companies that have actually reached the point of no return. Many companies would find themselves without access to funding or credit and may enter unnecessarily into insolvency proceedings if an arbitrary approach was taken to the balance sheet test.

While this decision provides welcome (and long-needed) comment from the Court, the difficulty with the flexible approach taken is that it does not provide certainty and so makes the task of determining whether or not a company is balance sheet insolvent a finely balanced judgment call.

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