

The Point of No Return - A Balancing Act

In *BNY Corporate Trustee Services Ltd v Eurosail UK 2007 - 3BL PLC & Ors*, the English Court of Appeal has decided that the mere fact that a company's aggregate liabilities exceed its assets may not render the company to be deemed unable to pay its debts under section 123(2) of the UK Insolvency Act 1986 (commonly referred to as the "balance sheet test"). The test is whether a company has reached a point of no return such that its state of affairs is not or is unlikely to continue having regard to its contingent and future liabilities.

The Hong Kong legislation contains a similar provision in section 178(1)(c) of the Companies Ordinance (Chapter 32). The English decision is not binding on Hong Kong judgments but it will likely be persuasive authority to be considered by the Hong Kong courts.

The matter arose from a series of notes issued by Eurosail UK 2007 - 3BL PLC (the "Issuer") to fund the acquisition of a portfolio of mortgage-backed loans. The notes were divided into classes, which were further divided into sub-classes, which were crucial in terms of priority and amounts of repayments.

Under the note documentation, it was an event of default if the Issuer was unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986. Section 123(2) provides that a company was deemed to be 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".

To hedge against interest and currency fluctuations, the Issuer entered into swaps arrangements with certain Lehman Brothers entities. As a result of the collapse of the Lehman Brothers entities and fluctuations in interest and foreign exchange rates, the Issuer's liabilities exceeded its assets.

The issue before the Court was whether the Issuer was unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986 such that an event of default has occurred under the note documentation which would entitle the noteholders to accelerate repayment.

In this case, it was clear to a subordinated group of noteholders that the company's cash may be used to reduce liabilities to other creditors potentially leaving insufficient assets to repay them. Therefore, it was in the interest of the subordinated group of noteholders to accelerate repayment because it was a term of the lending that subordination would not apply in the case of an acceleration.

There was also a second issue before the Court which was, even if the Court had decided that the Issuer was unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986, whether

the terms of the post-enforcement call option agreement (which restricted the noteholders from petitioning for the winding up of the Issuer), would prevent the Issuer from being unable to pay its debts under s 123(2) of the Insolvency Act 1986. This article will only focus on the first issue relating to the balance sheet test.

The Decision

The Court of Appeal affirmed the decision of the lower court and decided that the Issuer was not unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986, therefore an event of default did not occur.

The Court refused to adopt a mechanical approach to determine whether the balance sheet test is satisfied, as it would not be desirable from a commercial perspective for a company to be at risk of being wound up simply because its liabilities exceeded its assets.

Instead, the Court adopted a purposive interpretation and decided that the balance sheet test intends to cover situations where a company cannot be said to be unable to pay its debts as they fall due (the cash flow test), but it is clear that it will not be able to meet its future or contingent liabilities or the company “had reached the point of no return”. By the point of no return, it means where the state of affairs of the company is not or is unlikely to continue having regard to its contingent and prospective liabilities. The Court also said that section 123(2) can only be relied on by a future or contingent creditor.

In deciding whether the balance sheet test is satisfied, the Court will usually use the latest audited accounts of the company as a starting point to determine the asset and liability position and it will be necessary to consider if departure from the audited accounts is appropriate and whether any other factors should be considered.

The Court also confirmed that the future and contingent liabilities should not be taken at face amount but a valuation exercise should be carried out. There is little guidance given on how the Court will ultimately form its view on a balance of probabilities whether a company has reached a point of no return except that “the more distant the liabilities, the harder it will be to establish” and that the Court will consider how a reasonable commercial person will consider the prospects of the company.

On the facts, the Issuer had substantial assets on its balance sheet, namely the mortgaged-backed loans and there was potential for significant change in the value of the Issuer’s assets and liabilities (which were dependent on interest and foreign exchange rates fluctuations) coupled with a long period over which the Issuer’s liabilities had to be met, the Court did not think the Issuer had reached a point of no return.

Implications

The Court decided that the balance sheet test is not an exercise of simply assessing a company’s net assets and liabilities. In order to determine whether a company has “reached a point of no return”, the Court accepted that the company’s assets and liabilities will need to be considered but there will be other factors that the Court will consider depending on the commercial context.

In Hong Kong, the balance sheet test is encapsulated in section 178(1)(c) of the Companies Ordinance which provides that a company is deemed to be unable to pay its debts “*if it is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company*”. You will note that the Hong Kong legislation does not contain the phrase “the value of the company’s assets is less than the amount of its liabilities” which is in the UK legislation.

In Hong Kong, creditors often rely on the failure to comply with a statutory demand under s 178(1)(a) of the Companies Ordinance to deem a company to be unable to repay its debts. To the extent that any creditor is considering using section 178(1)(c), that is, the balance sheet test as a ground to wind up a company, which will require the creditor to prove to the court's satisfaction based on the company's assets and liabilities, the decision of Eurosail will have to be carefully considered. While the decision is not binding on the Hong Kong courts, it is likely to be considered by the Hong Kong courts when applying section 178(1)(c).

Although the Court of Appeal attempted to lay down a purposive approach to applying the balance sheet test in order to be closer to the commercial realities, the decision has created great uncertainty on how to satisfy the balance sheet test and what factors would be considered significant by the Court. It should also be pointed out that the decision arose not in the context of a winding up petition but in the construction of the note documentation which cross-referred to the legislation. It will therefore be advisable for future documentation to specifically provide for an event of default where a company's liabilities exceed assets instead of referring to the relevant legislation if that is the parties' intention.

The decision is also problematic for creditors who wish to protect their interest when it is evident that the company's assets will be reduced by satisfying current liabilities unless those creditors could satisfy the court that the company passes "the point of no return" by having regard to their future or contingent liabilities. Evidentially this may be very difficult to establish.

Lastly, it will also be interesting to see how the decision affects directors' liabilities for insolvent trading in other common law jurisdictions where the balance sheet test is often an indicator for when directors should cease trading the business.

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