Eurosail - The Point of No Return: The Final Chapter

Nearly three years after the High Court decision on the case of BNY Corporate Trustee Services Ltd v Eurosail UK 2007 – 3BL PLC and others was handed down, the case has run its course in the Supreme Court. The case, which considers the correct interpretation of the balance-sheet insolvency test in section 123(2) of the Insolvency Act 1986, is of importance to insolvency practitioners, financial institutions, legal advisers, company directors and companies.

Court of Appeal decision

In 2011, the Court of Appeal held that Eurosail, the issuer of residential mortgage backed securities, was not balance-sheet insolvent. The so called "balance sheet" insolvency test under section 123(2) Insolvency Act 1986 could not be simplified into a single formula that applies to all. In order to establish if a company is balance sheet insolvent, the court had to form its own view in determining whether the company had reached the point of no return because of an incurable deficiency in its assets (taking into account future and contingent liabilities) rather than a "mechanistic, even artificial, reason for permitting a creditor to present a petition to wind up a company".

Supreme Court decision

Certain note holders, who were set to benefit if an event of default was triggered by Eurosail being deemed to be insolvent, appealed to the Supreme Court.

The Supreme Court unanimously upheld the Court of Appeal's decision but not without first clarifying the approach to be taken in the application of the balance-sheet test. The Supreme Court commented that:

1. Whether or not a company satisfies the balance-sheet insolvency test depends on the evidence available as to the circumstances of that particular case.
2. The "point of no return" test suggested by the Court of Appeal should not pass into common usage as a paraphrase of the effect of section 123(2).
3. Where the company's liabilities stand deferred over numerous years (in Eurosail's case, 30 years), the court should proceed with the greatest caution in deciding that the company is in a state of balance-sheet insolvency.
4. A petitioner should not have to go beyond satisfying the court, on "a balance of probabilities", that the company has insufficient assets to be able to meet all its liabilities, including prospective and contingent liabilities.
5. Where such outcomes are speculative rather than calculative, the court cannot be satisfied that there will eventually be a deficiency, and the more distant the liabilities the harder this will be to establish.

Comments and implications

If a company is found to be insolvent on a balance sheet basis, this can have significant implications:

1. A creditor may seek a winding up order against it and effectively kill its business;
2. This may trigger termination events in its contracts or lead to acceleration of loans due in the future;
3. It can expose the directors to liability for the company's debts; and
4. It may mean that transactions the company enters into are open to challenge by a subsequent liquidator.

The Supreme Court's judgment has clarified that the test in section 123(2) requires the exercise of judgement. Creditors wishing to rely on the balance-sheet test in winding up proceedings will find it harder to successfully establish the subjective threshold of the test.

This will provide a degree of comfort to start-up companies and businesses with large but uncertain contingent debts on their balance sheet, such as pension liabilities, in continuing to trade without fear of being wound up where they are otherwise paying their debts as they fall due.

The decision may, however, make it more difficult for liquidators or administrators to pursue transactions at an undervalue or preference claims as such claims can only be pursued if the relevant company was unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986 at the time or as a result of the transaction. It has been common practice to use the "balance sheet" test to analyse whether a transaction can be challenged, as the "cashflow" test of insolvency may well be satisfied until close to the demise of the company in question.

Last words

The Supreme Court's decision does not come as a surprise in the current precarious economic climate where promoting the "rescue culture" is a big part of government policy towards insolvency law, however, it does assist in providing clarity if not certainty in the application of section 123(2).

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