

## UK Supreme Court considers the 'balance sheet insolvency test'

### INTRODUCTION

The UK Supreme Court has recently considered section 123(2) of the Insolvency Act 1986 (**section 123(2)**), which is often referred to as the 'balance sheet insolvency test'. The section provides that a company will be 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'*.

### BACKGROUND

In the case of *Eurosail*<sup>1</sup> an event of default would occur under the terms and conditions of residential mortgage-backed loan notes, issued as part of a securitisation, if the issuer was deemed unable to pay its debts within the meaning of section 123(2) (with some modifications). This could lead to the notes being declared due and repayable and a change to the order in which noteholders would be repaid.

Currency and interest rate swaps that the issuer had entered into with entities in the Lehman Brothers group were terminated after those entities entered Chapter 11 proceedings in the US. The issuer submitted a claim against the estates of the relevant Lehman entities for approximately US\$221 million but did not replace the swaps and its audited accounts for the year ending 30 November 2009 recorded a net liability of £74.557 million.

Certain noteholders contended that the event of default had occurred and the security trustee sought a determination from the High Court. The court found that the issuer was not unable to pay its debts within the meaning of section 123(2) (as incorporated into the conditions applicable to the notes); the Court of Appeal upheld that decision and the noteholders appealed to the Supreme Court.

### THE DECISION

#### The 'balance sheet insolvency test'

The Supreme Court unanimously upheld the decision that the issuer should not be deemed unable to pay its debts within the meaning of section 123(2). Its findings included that:

- A company which falls within section 123(2) is often said to be 'balance sheet insolvent' but that expression must not be taken literally; the test cannot be satisfied on the basis simply that the company's statutory balance sheet shows net liabilities because that balance sheet may omit information that must be taken into account, such as some contingent liabilities.

<sup>1</sup> *BNY Corporate Trustee Services Limited & Ors v Eurosail-UK 2007-3BL PLC* [2013] UKSC 28 (9 May 2013)

- The question of whether the company has '*reached the point of no return because of an incurable deficiency in its assets*', which was the test applied by the Court of Appeal, should not pass into common usage to paraphrase the effect of section 123(2).
- The court must be satisfied, on the balance of probabilities, that a company has insufficient assets to be able to meet all its liabilities, including prospective and contingent liabilities (discounted for contingencies and deferment).
- Whether the test is satisfied will depend on the evidence as to the circumstances of the particular case.
- The burden of proof will be on the party asserting insolvency.

The court could not be satisfied, at this time, that there would eventually be a deficiency in the issuer's assets. Key to this decision was the fact that the issuer's liabilities could be deferred until the final redemption date of the notes, in 2045, and factors that would affect its financial position in the meantime, such as currency and interest rate movements and the state of the UK economy and housing market, could not be predicted with any confidence.

#### The 'cash flow insolvency test'

It was not suggested that the issuer had met the so-called 'cash flow insolvency test' in section 123(1)(e) of the Insolvency Act 1986, which provides that a company will be deemed unable to pay its debts '*if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due*'. However, in considering the interaction between the two tests, the court agreed with earlier decisions of the lower courts that the cash flow test is concerned not only with debts that are immediately payable but also with those falling due in the reasonably near future. What amounts to the reasonably near future will depend on all of the circumstances, especially the nature of the company's business.

#### The post-enforcement call option

The court also explained that if it had found that the issuer was balance sheet insolvent for the purposes of section 123(2), the existence of a post-enforcement call option, commonly used in such securitisations, would not have altered that conclusion. A cross-appeal by the issuer would therefore have been dismissed.

## IMPLICATIONS

In the leading judgment, Lord Walker acknowledged that the balance sheet insolvency test in section 123(2) is '*far from exact*'. What is clear is that whether the test has been satisfied will need to be determined on a case-by-case basis, on the balance of probabilities, and that the assessment may differ from that recorded in the company's statutory balance sheet. The nature of the company's business and the time at which its liabilities will become due will be relevant and much will depend on the evidence that the party asserting balance sheet insolvency is able to provide.

As well as being relevant when considering directors' duties, the grounds for placing a company into administration or liquidation and the pursuit of certain claims by insolvency practitioners, the judgment is also relevant to new and existing commercial agreements and financing documents that contain insolvency termination events and events of default.

*If you would like more information on any of the issues raised in this briefing, please contact [Sarah Paterson](#), [Ian Johnson](#) or your usual contact at Slaughter and May.*