



# Corporate Turnaround and Insolvency

## The final word on balance sheet insolvency: Eurosail in the Supreme Court

On 9 May, the Supreme Court's decision in the *BNY Corporate Trustee Services Ltd and others v Eurosail-UK [2013]* was published. It has debunked the "point of no return" test formulated by the Court of Appeal and has introduced an element of common sense when considering balance sheet insolvency. What are the key points to take away from it?

### The background

Balance sheet insolvency (where a company's liabilities exceed its assets) is one of the ways of establishing a company is "unable to pay its debts" for the purposes of Section 123 of the Insolvency Act 1986. As such, not only can balance sheet insolvency form the basis of a winding up petition against a company, it also forms a necessary precondition for certain types of officeholder actions. These include preferences (Section 239) and transactions at an undervalue (Section 238), where the IP is required to show that a company was "unable to pay its debts" at the time of the relevant action.

Eurosail had issued certain debt securities under a securitisation structure based on mortgage loans, denominated in euro, sterling and dollars. Eurosail had hedged against market risk including currency fluctuations, but at a certain point in time was unable to obtain currency hedging. Although the note liabilities did not fall due until 2027 and 2045, accounting rules required it to use current spot rates of exchange in its accounts. This resulted in a deficiency between its liabilities under the notes and the income stream from the underlying mortgage loans. This may be cured over time as currency exchange rates move in the period prior to redemption.

A holder of certain loan notes tried to rely on the balance sheet test of insolvency to establish an event of default triggering early redemption, which put it in a better position under priorities arrangements. It asked the note trustee to serve an enforcement notice on Eurosail. Eurosail disputed that it was balance sheet insolvent under Section 123(2) of IA 1986, giving rise to these proceedings.

### The Court of Appeal decision

The Court of Appeal decided that the balance sheet test required consideration of whether the "point of no return" had been reached. This is reminiscent of the trigger point for wrongful trading under Section 214: when a director knew, or ought to have concluded there was no real prospect of avoiding insolvency liquidation. The court decided the test should not involve a strict test of the ratio of assets to liabilities (otherwise if a company is mere £1 in the red, it would be "insolvent"), especially as such an interpretation preferred short term creditors over longer term future and contingent creditors.

### What did the Supreme Court decide?

The Supreme Court disagreed with the "point of no return" concept introduced by the Court of Appeal. It considered that the test should be simply whether, on the balance of probabilities, a company has sufficient assets to meet all its liabilities, including prospective and contingent liabilities. However, in doing so the court had to take into account when those liabilities were likely to fall due, and it is for the party asserting balance sheet insolvency to prove it. In the case of Eurosail, it would not be possible to establish that position until much closer to 2045 when the final tranche of notes became due for payment.

### What does this mean for practitioners?

The Supreme Court's decision helpfully removes the uncertainty around when the "point of no return" is reached. It has taken the test purely back to the balance sheet itself as the starting point and the Supreme Court's ruling that when contingent and future liabilities will fall due has to be taken into account injects a healthy dose of common sense into the test.

Section 123(2) does not specifically allow future and prospective assets to be taken into account when considering present insolvency, whilst it does require a consideration of contingent and prospective liabilities. By requiring consideration of when such liabilities might fall due, the assessment of a company's balance sheet solvency involves an assessment of future income streams and trading conditions by default.

This is a welcome development, as it allows practitioners, banks and directors alike a degree of latitude when assessing insolvency. Consider the classic example of a project company SPV. Unless and until the project is built and income begins to be generated, the SPV's balance sheet would show its liabilities exceeding its assets. If the balance sheet insolvency test looked

no further than the balance sheet, all such start-ups would be insolvent under s 123(2) IA 1986 in their early years. The consideration of when its liabilities (such as bank facilities etc.) become due restores the balance and affords all concerned peace of mind that the company can continue its activities along the projected timescales.

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