ALERTS

UK Supreme Court Issues Authoritative Decision on 'Balance Sheet Insolvency Test'

9 May 2013

The UK Supreme Court today delivered an important decision on the meaning of the so-called 'balance sheet insolvency test' in s.123(2) of the Insolvency Act 1986 (UK) (*BNY Corporate Trustee Services Limited v Eurosail 2007-3BL PLC* [2013] UKSC 28 ("*Eurosail*")).

Section 123(2) provides that a company is 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*. The parameter of s.123(2) is of significance for almost all English law financing transactions (including structured financings, of which *Eurosail* is an example), since, if the debtor falls foul of it, it will invariably trigger a right on a creditor to default the transaction and enforce the debtor's security. In today's environment of strained 'Loan to Values' and lack of liquidity, an authoritative decision on the matter has anxiously been awaited by debtors and creditors alike. The investment community, whether debtor or creditor, should be breathing a sigh of relief with this decision for its pragmatic and common sense approach.

In the case of *Eurosail*, the debtor's recently audited balance sheets showed a net liability (largely due to the insolvency of a key swap counter-party to the transaction, Lehman Brothers Special Financing Inc.) and, on the strength of that, one class of its creditor's (the "Class A3") asserted that it must therefore fall foul of s.123(2). If the Class A3 were right in their argument, the triggering of an Event of Default would result in a change in

waterfall from the Pre-Enforcement Waterfall to the Post-Enforcement Waterfall, in which the Class A3 creditors have an elevated position and rank *pari passu* with another class of creditors (the "Class A2"). The debtor (an issuer of long-dated publicly tradable notes (commonly referred to as 'RMBS Notes'), that owned assets comprising a static pool of residential mortgage loans), on the other hand, argued that, in the context of this transaction and at this point in time, it was premature and inappropriate to determine that its assets are less than its liabilities. The issuer specifically pointed to the fact that the bulk of its liabilities did not fall due until 2045 and that the performance of its assets could be subject to fluctuation and that there were various factors embedded within the transaction which were difficult to predict (including foreign exchange and interest rates and the performance of the UK property market). The issuer also pointed out that it had been paying its debts as they fell due (and was, therefore, 'cash-flow' solvent). The issuer's position was supported by the Class A2.

The Supreme Court agreed with the issuer, noting that an audited balance sheet, which is drawn in accordance with technical accounting standards and rules, is not decisive on the question set out in s.123(2), which rather involves a factual enquiry based on "all the available evidence and the circumstances of the particular case." The Supreme Court stated:

> ". . . in the case of a company's liabilities that can as matters now stand be deferred for over 30 years, and where the company is (without any permanent increase in its borrowings) paying its debts as they fall due, the court should proceed with the greatest caution in deciding that the company is in a state of balance-sheet insolvency under section 123(2) . . . *Eurosail's* ability or inability to pay all its debt, present or future, may not be finally determined until much closer to 2045, that is more than 30 years from now."

The Supreme Court rejected the Court of Appeal's preferred touchstone for the test (as being whether the debtor is "beyond the point of no return"), stating rather that the court must simply be satisfied, on the balance of probabilities, that a company has insufficient assets to be able to meet all its liabilities, including its prospective and contingent liabilities.

The balance sheet insolvency test is to be distinguished from the other main test for insolvency in the Insolvency Act 1986, the so-called 'cash-flow' insolvency test. The Supreme Court affirmed past authority, that the

cash-flow test involves a consideration of the debtor's ability to pay its presently due debt and also a consideration of its ability to pay debts falling due in the reasonably near future.

The decision is to be welcomed for its good sense and refusal to be drawn into catchphrases for the parameters of s.123(2). There will, however, undoubtedly be others who will criticise it for failing to provide a precise 'check-list' style of guidance on the test. There will be others, too, who will no doubt be disappointed at the failure of a tidal wave of defaults that a contrary decision would have yielded.

Sonya Van de Graaff and Peter Declercq[1] represented the Class A2 in support of the debtor's arguments and they are currently working on the restructuring of a number of similar securitization structures.

Authored by Sonya Van de Graaff, Peter J.M. Declercq, David J. Karp and Adam C. Harris .

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Sonya Van de Graaff and Peter Declercq are business reorganization partners in the London office, where their respective practices focus on European restructuring, financing, distressed investing and debt trading, and on cross-border insolvencies, restructurings, financing and distressed mergers and acquisitions.

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