# *Eurosail* Supreme Court Judgment: Delineating the Boundaries of Insolvency

## "To be solvent or not to be solvent, that is the question"

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Odd as it may seem, you have to plough through 122 sections of the UK Insolvency Act 1986 (the "Act") before you finally reach the section that sets out the criteria for establishing insolvency. Section 123 of the Act lists a series of circumstances under which a company may be deemed insolvent. Some of these circumstances are factual—for example, owing a debt of more than £750 for more than 21 days after a demand for payment—but two rely on a legal test of company insolvency. These two tests are colloquially known as the "cash-flow test" and the "balance-sheet test." Direct or indirect reference to these tests is prevalent throughout English-law finance documents, including those based on Loan Market Association standard forms, as a way of determining whether an event of default has occurred and/or termination clauses have been triggered.

The UK Supreme Court has now unanimously confirmed the test for balance-sheet insolvency under section 123 of the Act in its decision in *BNY Corporate Trustee Services Limited v Eurosail and others* [2013] UKSC 28. In particular, the court declined to follow the intermediate court of appeal's suggestion that a debtor can be insolvent only after it has reached the "point of no return." The three court rulings in this matter concluding with the recent Supreme Court judgment are the first reported cases to interpret the balance-sheet test of insolvency—namely, are the liabilities of a company greater than its assets?

### Cash Flow v Balance Sheet

The circumstances under which a company is to be "deemed unable to pay its debts" (i.e., insolvent) under section 123 of the Act include:

- if "the company is unable to pay its debts as they fall due"; or
- if "the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities."

Even a casual observer can see that many companies are balance-sheet insolvent, while still being able to comfortably meet current debts. Following a line of cases, the accepted position was that the cash-flow test took precedence over the balance-sheet test. However, courts would sometimes accept that a company, despite meeting day-to-day debts, was balance-sheet insolvent, since its long-term liabilities (very often pension deficits) were such that there was no chance that they would be repaid, however long one waited.

**In the Beginning . . .**

The first hearing in the long-running *Eurosail* case was in 2010, although the event under scrutiny occurred before that. Eurosail (as issuer) purchased a portfolio of high-risk mortgages for securitisation and issued notes. (The ones subject to the hearing were due to mature in 2045.) Although the underlying mortgage payers paid only in pounds sterling, Eurosail issued notes in various currencies, entering into swap arrangements with two Lehman Brothers entities to reduce its exposure to currency-rate fluctuations. These swap arrangements ceased in 2008 with the collapse of Lehman Brothers. Without the protection of the hedging arrangements, Eurosail's net-asset position weakened substantially, but it was still able to pay its debts as they arose.

The security trustee was entitled to declare an event of default under the notes and enforce the security if, among other conditions, Eurosail could be deemed unable to pay its debts under the

balance-sheet test of section 123(2) of the Act. A notification of an event of default would also alter the priorities between noteholders such that subordinated "A3" noteholders would then rank equally with, rather than behind, "A2" noteholders. Naturally, this would also reduce the distribution for A2 noteholders. Additionally, a post-enforcement call option ("PECO") had been granted under the securitisation. The PECO provided that in the event the security for the notes was enforced and found to be insufficient to pay all amounts due in respect of them, an affiliate of Eurosail had a call option for the notes for nominal consideration. PECO provisions are a common feature of securitisations with a UK-incorporated issuer as a means of satisfying rating-agency requirements for insolvency remoteness. The expectation is that an affiliate would release the issuer from further liabilities rather than allow the issuer to enter into an insolvent liquidation.

The court was asked to decide whether Eurosail was unable to pay its debts under the section 123(2) balance-sheet test and whether the PECO would have any effect on that decision.

**First-Instance Decision: Assets v Liabilities**

The first-instance court decided that Eurosail was able to pay its debts within the meaning of section 123(2); the key point was the interpretation of "taking into account contingent and prospective liabilities." It decided that the assets to be valued were the present assets of the company. According to the court, the nature of Eurosail's business meant that it was not necessary to consider whether valuation was on a going-concern or breakup basis, but the court did explicitly include the as-yet unallowed claims against the Lehman Brothers estate as an asset of Eurosail.

In contrast, the court narrowed which liabilities needed to be counted and how much weight to give them. The court rejected the idea of comparing liabilities on their face value to assets on their face value, deeming it "commercially illogical" not to give weight to the maturity date of the obligations. The judge also noted that section 123(2) refers to "taking into account" liabilities, not "includ[ing]" liabilities. Thus, the court reasoned, a straight aggregation of present and prospective liabilities was not what Parliament intended when it enacted the provision.

The court also rejected the company's financial statements as a means of establishing insolvency, concluding that such records considered elements which were deemed to go "beyond what [section] 123(2) requires," while also excluding assets which the court held ought to be counted.

The court also took into account the fact that: (i) the notes in question were not due to mature until 2045; (ii) any valuation of liabilities relating to currency fluctuations was "entirely speculative"; and (iii) the notes were actually fully funded, as any losses in the underlying asset pool would also reduce the liabilities due to the noteholders through the operation of the "principal deficiency ledger" governing the notes (a mechanism for distributing the risk of principal losses among noteholders in reverse order of seniority).

Since the court concluded that Eurosail was solvent, there was no need to consider the PECO, although the judge made side comments that in his opinion the PECO had no effect on the liabilities because, until the option holder should decide to release the issuer from liability, the issuer's liabilities would remain.

## Court of Appeal: "The Point of No Return"

The court of appeal agreed with the lower court that Eurosail was solvent and able to meet its debts. In its reasoning, the court agreed with the lower court that examining only a balance sheet or a company's financial statements was not the test. Many solvent and successful companies, the court noted, had greater liabilities than assets, especially early in their history, yet it would be "mechanistic, even artificial" to deem such a company insolvent. However, the court of appeal went on to state that a company would be found balance-sheet insolvent only if the company "had reached the point of no return." It stated that future or contingent creditors face an inherent risk that the company's assets might be used to pay current creditors or for other purposes, but they are not prejudiced by that risk until those payments, in the judge's colourful phrase, "may be vernacularly characterised as a fraud on the future or contingent creditors." According to the court, only at that point may a company be deemed to have reached the point of no return. Even so, the court acknowledged that that test would be "imprecise, judgement-based and fact-specific."

A supporting judgment drew back from endorsing the "point of no return" idea, suggesting that it illuminated rather than paraphrased the legislation. Instead, the concurring judge focused on the idea that a court would make proper allowance for contingent and prospective liabilities but that the more distant the liabilities, the harder it would be to establish that such liabilities would not be satisfied.

**The Supreme Court: The Imponderable Factors**

The Supreme Court backed the view that insolvency may occur before the point of no return and that this phrase should not "pass into common usage." According to the court, the true test should be whether on a balance of probabilities the debtor has insufficient assets to be able to

meet all of its liabilities, applying a discount for contingencies and future liabilities. This test would come into play once any attempt to apply a cash-flow test became too speculative as the time frame lengthened beyond the reasonably near future. That said, the court acknowledged that it was "still very far from an exact test" and that the burden of proof would be on the party trying to prove balance-sheet insolvency.

Given that it is an inexact test, the Supreme Court concluded that the available evidence in the circumstances was the critical factor. Eurosail's business, the court explained, was quite unlike a normal trading business. In fact, the only important management decision to be made in this context would have been to attempt to find alternative hedging cover in light of Lehman Brothers' demise. Although it might then be quite easy to list Eurosail's assets against its liabilities, the court held that there were three "imponderable factors" which prevented it from finding Eurosail insolvent. Those factors were: (i) fluctuation of the US dollar against the pound sterling for hedging arrangements; (ii) movement in the London interbank offered rate (LIBOR) affecting the interest rates of the loans; and (iii) changes in the UK real estate market, which affected the value of the underlying pool of assets.

Because maturities on some obligations could be deferred for more than 30 years and Eurosail was paying its debts as they fell due, the Supreme Court expressed the greatest reluctance to make a finding of insolvency. Generally, the Court wrote, any court should proceed with "the greatest caution in deciding that a company is in a state of balance-sheet insolvency under [section] 123(2)."

Like the first-instance court, the Supreme Court concluded that it was not necessary to make a finding on the status of the PECO, but given the frequency with which PECOs are used, the court

did consider it useful to make some passing comments. It held that PECOs were irrelevant in the exercise of balancing assets and liabilities to establish balance-sheet insolvency. According to the court, it is not possible to distinguish the intended commercial effect of these provisions from their legal effect, so PECOs have no role to play when assessing a company's liabilities.

## Where to Next?

In some ways, the Supreme Court judgment in *Eurosail* does not tell us anything new. Crucially, it pushed back on the court of appeal's "point of no return" concept, keeping to a fairly common-sense view of proving insolvency via a balancing of potential assets and liabilities based on evidence and allowing for judicial discretion. The court also allowed market practice to prevail regarding securitisations and PECOs, while noting that it had not been persuaded purely on that basis.

Nonetheless, the series of *Eurosail* rulings has brought some judicial interpretation to a previously unconsidered section of legislation. The judgment has also helped clarify some points that were previously open or unclear. This is especially important as the statutory language has been utilised, sometimes with modifications, in a range of contracts and market-standard documents. Thus, securitisations and PECOs can continue to operate as they did before *Eurosail*.

Points of clarification provided by the *Eurosail* rulings include the following:

- The cash-flow test should look only to what is the reasonably near future in the relevant circumstances. How far ahead the test should look will vary depending on the facts, but some forward-looking analysis should be included.
- Although a court should be wary of finding a company's balance sheet insolvent, it need not establish that the company has reached the point of no return to conclude that it is balance-sheet insolvent. The party trying to claim insolvency bears the burden of proof.

- A company’s financial statements are only a starting point for an analysis of balance-sheet insolvency. Full consideration of all evidence of assets and liabilities should be taken into account.

- There can be different weighting and discounting of liabilities. For example, the longer the maturity of the obligation, the lower the value that may be attributed to it (since it is more likely that the company will be able to satisfy it, resulting in a relative decline in the value of the liability). In the same way, an assessment should be made as to the likelihood that a contingent liability will become an actual one; the more likely the event, the greater the value that should be attributed to the claim.