The Supreme Court clarifies that the ‘balance sheet insolvency’ test is fact specific, focussing on whether there will eventually be a deficiency.

A company can be wound-up under the Insolvency Act 1986 (“IA”) if it is “unable to pay its debts”. A company is deemed to be in this position if it is either cash flow insolvent (s123(1) IA) or if it satisfies the so-called “balance sheet insolvency” test (s123(2) IA).

While creditors have generally relied on the cash flow insolvency test when seeking to put a company into liquidation, the s123(2) “balance sheet insolvency test” is often referred to in commercial contracts and finance documents. It is also relevant when assessing whether a transaction may be vulnerable to challenge under insolvency claw-back legislation.

While the balance sheet insolvency test has been on the statute book for over a century, its exact meaning has remained the subject of some debate. While ultimately a question of emphasis, some argued that the test should be broadly based on the company’s statutory balance sheet, while others took the view that s123(2) was looking more at the company’s medium and long term liquidity, and that it would therefore be wrong to focus unduly on the company’s current balance sheet position. Indeed, it was suggested by Lord Neuberger in the Court of Appeal that the s123(2) insolvency test was linked to the company having reached a “point of no return”, at which its eventual insolvency had become inevitable.

The Supreme Court’s recent decision in BNY Corporate Trustee Services Ltd v Eurosail [2013] UKSC 28, has helped to clarify the meaning of s123(2). The Supreme Court rejected the “point of no return” formulation, holding instead that the balance sheet insolvency test requires the court to be satisfied, on the balance of probabilities, that a company will have insufficient assets to be able to meet all of its liabilities, including prospective and contingent liabilities, as and when they eventually fall due.

Background

The case concerned an issue by Eurosail, a special purpose vehicle, of five classes of loan notes, as part of a securitisation transaction relating to a portfolio of mortgage loans. The events of default under the loan notes included a direct reference to s123(2) IA, which was potentially relevant as...
Eurosail’s latest audited balance sheet showed a net deficit of over £74m. While Eurosail continued to pay interest and principal under the loan notes when due, a group of its noteholders commenced litigation, arguing that Eurosail was insolvent under the s123(2) balance sheet insolvency test.

**Supreme Court’s decision**

The Supreme Court upheld the Court of Appeal’s decision that Eurosail was not “balance sheet insolvent” under the s123(2) test, holding that:

- the fact that a company’s latest audited balance sheet showed a net deficit did not necessarily mean that the company was “balance sheet insolvent” for the purposes of s123(2) IA;
- instead, the court must be satisfied that, on the balance of probabilities:
  - (i) a company has insufficient assets to be able to meet all of its liabilities, including prospective and contingent liabilities, if and when they eventually fall due; and that
  - (ii) there will therefore “eventually be a deficiency”.
- Lord Neuberger’s description in the Court of Appeal of s123(2) being a “point of no return” test “should not pass into common usage as a paraphrase of the effect of section 123(2)".

To illustrate the need to consider the specific circumstances of each case, the Supreme Court indicated that it would be easier to demonstrate that a SPV such as Eurosail was insolvent under the s123(2) test than an actively trading company which was making on-going commercial decisions about its business, suppliers, pricing policy and even raising new capital. The current net asset position of such a company would be a less reliable guide to its ability to meet its long-term liabilities, than that of a SPV such as Eurosail which was in a “closed system” and did not really have a business.

In the leading judgment, Lord Walker emphasised that Eurosail’s liabilities (some of which would accrue in 30 years time) were subject to three “imponderable” factors which could not be predicted with any confidence: currency movements, interest rates and the health of both the UK housing market and the wider UK economy. In those circumstances, 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)".

**Practical Implications of this judgment**

**Insolvency related Events of Default**: This decision confirms that the s123(2) test is very fact specific. If, therefore, a party wishes to have a contractual termination right if their counterparty’s statutory balance sheet shows net liabilities, they should, rather than simply referring to s123(2) IA, either have an event of default referable to their counterparty’s audited balance sheet or include a financial covenant, requiring the counterparty to have net assets which, if breached, would constitute an event of default.

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Implications for insolvency based actions: A liquidator or administrator may only challenge the validity of a transaction under s238 IA (transaction at an undervalue), s239 IA (preference) or s245 IA (avoidance of certain floating charges) if it took place at a time when the company was unable to pay its debts. Had the “point of no return” formulation of the s123(2) insolvency test been adopted, it is probable that only transactions which took place when insolvency had become inevitable would have been caught. The Supreme Court’s formulation of the s123(2) test could potentially result in more transactions being challenged, although doing so will remain difficult, not least because of the imprecise nature of the s123(2) test.

Cash flow and balance sheet insolvency: a clear dividing line?

The Supreme Court approved Briggs J’s decision in Re Cheyne Finance Plc (No.2) [2008] Bus LR 1562, confirming that the cash-flow insolvency test is concerned with presently due debts and those falling due from time to time in the “reasonably near future”. The s123(2) test, on the other hand, is concerned with liabilities accruing beyond that time. As Lord Walker pointed out, using a cash-flow test in this context would be “completely speculative”, the “only sensible test” for such a period being “a comparison of present assets with present and future liabilities (discounted for contingencies and deferment)”. It is clear, however, that the Supreme Court did not view the two tests as being entirely separate. For the s123(2) test to be met, there must be an expectation that a debtor will not be able to meet its future and contingent liabilities when they fall due. As such, what is commonly described as a balance sheet insolvency test is, in effect, more of a medium to long term liquidity test, to be judged on a case by case basis taking into account the company’s wider circumstances.