Balance Sheet Insolvency: The Point of No Return

The decision of the Court of Appeal in *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL plc and others [2010] EWCA Civ 2007,* is good news for distressed companies in need of some breathing space. In this case, the Court of Appeal held that the balance sheet test for insolvency is only intended to apply where a company has reached a *"point of no return"* rather than being used as a *"mechanistic, even artificial, reason for permitting a creditor to present a petition to wind up a company".* The Court upheld the High Court's earlier decision that Eurosail was not insolvent under s123(2) and provided a useful summary of how future and contingent liabilities should be evaluated for the purposes of assessing balance sheet insolvency.

Background to the insolvency test

The test for insolvency under English law is whether the debtor has an *'inability to pay debts'.* The tests for this are set out in the Insolvency Act 1986 ("IA"). Under section 123(2) a company is deemed unable to pay its debts if the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. This is the test for 'balance sheet insolvency'. Under section 123(1)(e) of the IA a company is regarded as unable to pay its debts if it is unable to pay its debts as they fall due. This is the test for 'cash flow insolvency'.

The essential difference between the balance sheet test and the cash flow test is that the focus of the former is on 'liabilities' (including contingent and prospective liabilities) which is a much broader concept than just straight "debts". Even if a company could meet its debts as they fall due it would be technically insolvent if its total liabilities exceeded its total assets.

There has, however, been very little judicial consideration of how the balance sheet test is to be applied in practice as the majority of court decisions have focused on the cash flow test which normally forms the basis for winding up/administration applications.

The requirement under section 123(2) to evaluate a company's contingent and prospective liabilities in assessing its solvency was considered in *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL plc and others.*

The Decision

The Court held that a company is not balance sheet insolvent solely because its liabilities exceed the value of its assets. The Court noted that, were this interpretation to be adopted, many companies would find themselves deemed unable to pay its debts and consequently unable to access investment or credit.

Rather, the Court decided that a company becomes balance sheet insolvent only when the size of liabilities (including contingent and future liabilities) as opposed to the value of its assets are such that it has reached the *"point of no return".* In other words where it becomes clear that a company, although able to pay its debts at the present time, will not be able to meet its future or contingent liabilities.

Valuation and the importance of audited accounts

As to how such future and contingent liabilities should be valued, the Court rejected the argument that section 123(2) requires one to take future and contingent liabilities into account at face value, and decided that a commercial valuation exercise was needed: *"The idea that one has to carry out a valuation exercise in relation to future and contingent debts is supported by commercial common sense".*

The Court concluded that, whilst audited accounts portraying a true and fair view of the company's financial position have *'real force',* these should simply form the start of the valuation exercise as audited accounts will inevitably be historic and often conservative. The valuation exercise should be carried out *'with a firm eye both on commercial reality and on commercial fairness. Clearly, the closer in time a future liability is to mature, or the more likely the contingency which would activate a contingent liability, the more probable it would be that section 123(2) would apply'.*

So was the company insolvent?

On analysis, the Court of Appeal found that the current value of the company's liabilities was in the region of £70 million in excess of the value of its assets. However, several factors needed to be balanced.

- The company had substantial assets, the current asset deficit being only 17%;
- The deficit was largely based on the assumption that exchange rates would remain as they are. The reality was that there was great potential for change in the difference between Eurosail's assets and liabilities due to currency fluctuations; and
- There was a long forward looking period – many of the notes issued by the company, which formed the basis of the claim, had a final redemption date in 2045, and the values of assets and liabilities would inevitably fluctuate over this period.

Comment

Eurosail demonstrates how audited accounts are the starting point, but by no means the end point, when undertaking the valuation exercise required for 123(2): accounting principles are no longer determinative.

A key point is that the balance sheet insolvency test under section 123(2) is not an entirely independent ground for the winding up of a company detached from a company's ability to pay its debts. Instead, it is supplemental to the cash flow test in section 123(1)(e) and is intended to cover situations where a company has reached the point of no return of an incurable deficiency in its assets. In this sense, the cash flow insolvency test appears to have been merged into the balance sheet insolvency test. It remains uncertain how far the balance sheet test for insolvency can now be distinguished from the cash flow test.

Colt Telecom

It should also be noted that the judge's comments in Eurosail echo comments made in *Colt Telecom [2002] EWHC 2815.* Whilst the judge in Colt Telecom was considering the cash flow test, he gave short shrift to speculation over the future health of a company. As the judge put it *"shaky, tentative and speculative peering into the middle-distance is no basis for forcing a company into administration".* It was made clear that any allegation of insolvency is a serious matter and one that requires solid foundation.

In Colt Telecom, the judge noted that factors such as the company's ability to refinance and the volatility of the telecoms market meant that the noteholders claim that the company's cash would run out was speculative and unprovable. The parallel is clear, and there is an obvious judicial reluctance to engage in 'crystal ball gazing' when carrying out a valuation exercise of a company's liabilities. Look into the future, yes, but don't try to look too far ahead.

Whilst the Eurosail decision provides welcome (and long needed) guidance from the Court, the difficulty with the flexible approach taken is that it does not provide much certainty for future cases. Given that a net liability position of £70 million was deemed insufficient to render Eurosail's balance sheet insolvent, what disparity is required before a company can be considered unable to pay its debts under section 123(2) of the IA? The judgment clearly allows room to manoeuvre when the company is able to meet its debts but has a liability of uncertain value to meet some 35 years down the future, but what happens if the liability matured in say 15, 10, or 2 years? In light of this uncertainty, it may be that lenders and/or noteholders in future transactions consider including a bespoke insolvency event of default provision which clearly sets out in what circumstances the relevant company will be deemed to have negative net worth and thereby trigger an event of default, instead of relying on a cross-reference to section 123(2) of the IA as did the Applicants in this case.

It remains uncertain whether this case will proceed to the Supreme Court. Until then, the judgment will dissuade many creditors from relying upon an event of default based on section 123(2) of the IA in the absence of other more clear cut events of default.