Briefing Note

High Court Ruling on the Balance Sheet Test

BNY Corporate Trustee Services Ltd v. Eurosail-UK 2007-3BL plc and others [2010] EWHC 2005 (Ch)

Executive Summary

The High Court recently considered the exact scope of the test for whether a company is unable to pay its debts, as set out in section 123(2) of the Insolvency Act 1986 (IA 1986), referred to as the “balance sheet test.” The court held that the test does not simply track the balance sheet in a company's accounts. Instead, assets should be valued at their present value, without taking into account contingent or prospective assets. On the other hand, the value of liabilities must “take into account” contingent and prospective liabilities. Some of the difficulties involved in applying the balance sheet test in structured finance investments revolve around what exactly is meant by the phrase “take into account”. It is clear that it does not mean that all contingent and prospective liabilities are simply aggregated and deducted from the value of the company’s assets. However, the difficulty for the trustee, the Court and creditors is ascertaining the degree to which contingent liabilities—which might not fall in for many years—are to be taken into account.

Background

The inability of a company to pay its debts is determinative evidence of its insolvency. The definition of "inability to pay debts" is found at section 123(1)(e) IA 1986, which states that:

> "A company is deemed unable to pay its debts if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due."

This is often referred to as the "cash flow test".

The "balance sheet test" is contained in section 123(2) IA 1986 which states that:

> "A company is also 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."

In this case, the issuing company, E, an SPV had entered into a securitisation of "sub-prime" residential mortgage loans. E had purchased the mortgage loans with the proceeds of notes it had issued to investors and its obligations under the notes were secured by the mortgage loans. The security was held by a trustee, B, on behalf of the noteholders. B was entitled to declare an event of default under the notes and enforce the security if, among other things, E could be deemed unable to pay its debts under the terms of section 123(2) IA 1986 and B certified that it was its opinion that this was materially prejudicial to the interests of the noteholders.

As a result of the termination of “swap” transactions which had been put in place to eliminate E’s exposure to exchange rate and interest rate fluctuations, E recorded a significant loss in its financial statements. However, it had continued to make all payments due on the notes and expected to have sufficient funds to redeem the top three classes of its notes before their stated maturity.

The holders of one of the classes of notes were concerned that their notes would not be redeemed as early as initially projected and argued that B should declare an event of default on the grounds that E should be deemed unable to pay its debts under section 123(2) IA 1986. The noteholders argued that, as the balance sheet test had to take into account E’s prospective and contingent liabilities, E should be treated as liable for the full amount of those liabilities if converted into sterling at present exchange rates.

The Court’s Decision

The Court ruled that E was not to be deemed unable to pay its debts under section 123(2). The Court also offered the following clarifying points in relation to the balance sheet test:

- Assets should be valued at their present value. Contingent or prospective assets are not to be taken into account.

- Liabilities have to take into account contingent and prospective liabilities. However, this does not mean that contingent or future liabilities should be valued as if they are due immediately.

- The taking into account of a prospective liability involves considering the relevant facts of the case, including when the liability falls due, whether it is payable in sterling or another currency, and the extent to which the size of the liability depends on the value of particular assets that have been set aside to meet it.

- For the purposes of audited accounts, a company's balance sheet is prepared on accounting principles that are different from the factors the court has to consider, as referred to above. Therefore, a deficit on a company's balance sheet will not automatically mean that it is deemed unable to pay its debts under section 123(2).

Comment

The precise effect of the balance sheet test will remain uncertain until it is clarified exactly what the court meant by "taking account of prospective and contingent liabilities". However, it is likely that insolvency-related events of default provisions will need to be drafted more precisely and be matter-specific. Agreements should also not seek to rely solely on section 123(2) events of default.

In practice, it may be difficult for creditors to assess whether a borrower is insolvent on a balance sheet basis as the accounting principles used in the preparation of its balance sheet for audit purposes do not result in the borrower's assets and liabilities being stated in a way which is easily interpreted for the purposes of section 123(2). It is likely that more loan documents will include a basic balance sheet solvency test within financial covenants in addition to relying upon section 123(2), to try to get round this problem. Of course, in practice, in the vast majority of cases involving ordinary trading companies, creditors rely on the cash flow test in order to present a winding-up petition and this case will not affect those situations.

The balance sheet test is crucial in many “structured finance” investments where creditors with contingent claims not falling due for some time in the future become concerned that the available assets will be used up paying the current creditors.

The trustees are expected to appeal against the court’s decision. It is hoped that more detailed guidance will be given as to how to assess the balance sheet test and so interested parties should monitor the position.

Richard Baines, Principal & Robin Hastings, Trainee Solicitor

September 2010

If you would like further information on this or any other related matter please e-mail us at ccd@druces.com or contact Richard Baines on +44(0)20 7216 5518 or email: r.baines@druces.com.