THE STATUTORY TEST FOR INSOLVENCY - S 123 IA 1986

BNY Corporate Trustees Services Limited & Ors v Eurosail- UK 2007 -3BL PLC [2013] UKSC 28

Christopher Brockman & Richard Ascroft, Guildhall Chambers

Introduction

1. Section 122(1) of the Insolvency Act 1986 (as amended[1]) specifies 7 circumstances in which a company may be wound up by the court, including where the company is unable to pay its debts. Section 123 of the same Act goes on to identify the circumstances in which such inability to pay debts is deemed to exist. This talk focuses on 2 of these:

   (1) s 123(1)(e): proof to the satisfaction of the court that the company is unable to pay its debts as they fall due (so-called cash-flow or commercial insolvency); and

   (2) s 123(2): proof 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 (so called balance sheet insolvency).

2. On 9 May 2013 the Supreme Court[2] delivered judgment in *BNY Corporate Trustee Services Ltd and ors v Eurosail-UK 2007-3BL PLC*[3] upholding the Court of Appeal's dismissal[4] from the judgment of Sir Andrew Morritt C[5], and provided clarification as to the proper meaning of s 123(2) and its interaction with s 123(1)(e). As will be seen, however, the decision leaves a number of questions unanswered.

3. Although the Supreme Court agreed that Eurosail had not been shown to be balance sheet insolvent in the sense required by s 123(2), it rejected the "point of no return" test applied by Lord Neuberger MR in the Court of Appeal and instead affirmed the approach favoured by Toulson LJ which held that s 123(2) required the court to reach a judgment as to whether it has been established that, looking at the company's assets and making proper allowance for its prospective and contingent liabilities, it cannot reasonably be expected to be able to meet those liabilities. What is now abundantly clear is that s 123(2) does not involve a mechanical balancing exercise.

4. The Supreme Court also decided a cross appeal in respect of the impact of a Post Enforcement Call Option, something widely used in securitisations but which is beyond the scope of this talk. Lord Hope's decision in respect of the PECO is summarised briefly below and is unsurprising in that it simply provides that the commercial and legal interpretations are one and the same.

5. As the facts of *Eurosail* demonstrate, the importance of the proper interpretation of s 123(2) is not confined contextually to a court's decision as to whether it is appropriate to wind up a company, but goes way beyond that. Obvious examples are:-

   5.1. Security and other documents which will frequently become enforceable upon the insolvency of a company (sometimes expressly incorporating s 123 or by use of the same or similar words), with the attendant consequences, for example the ability of a debenture holder to appoint an administrator;

   5.2. The transaction avoidance provisions in the 1986 Act where they are dependent upon the insolvency of the company (e.g. s 240(2)(a) (in the context of transactions at an undervalue and voidable preferences) and s 245(4)(a) (in the context of floating charges);

[1] Most recently (with effect from 12.05.11) by the removal of the ground based on the number of members of the relevant company (not being a private company limited by shares or by guarantee) falling below 2: see the Companies Act 2006 (Consequential Amendments and Transtitional Provisions) Order 2011 (SI 2011/1265), art 6(4).
[2] Lord Hope, Lord Walker, Lord Mance, Lord Sumption and Lord Carnwath.
[3] [2013] UKSC 28.
[4] [2011] EWCA Civ 227; [2011] 1 WLR 2524 (Lord Neuberger MR, Toulson and Wilson LJJ)
[5] [2010] EWHC 2005 (Ch); [2011] 1 WLR 1200.

5.3. director's disqualification proceedings where the allegation is that the relevant individual caused the company to trade whilst insolvent.

6. The facts of *Eurosail* demonstrate the level of complexity of the financial collaterisation of mortgages at the height of the property boom and are classic examples of the type of transaction that led to the failure of Lehman Brothers and the consequential collapse of banks worldwide, the repercussions of which continue to this day. Indeed Lord Walker in his judgment notes[6] that it has been suggested that the banking industry had a general inability to understand the risks inherent in its own creations.

Factual summary

7. Eurosail was a single purpose vehicle, one on many set up by the Lehman Brothers group shortly before the collapse of that group. The facts are succinctly set out in the judgement of Sir Andrew Morritt at first instance[7] and more fully in the judgment of Lord Neuberger in the Court of Appeal, from which much of the factual summary below has been taken.

8. In July 2007, in accordance with the purpose for which it was formed, Eurosail acquired, for just under £646m a portfolio of about £650m sterling denominated mortgage-backed loans ("the mortgages") all relating to UK residential properties. These mortgages were in the main so-called non-conforming residential mortgages, i.e. the borrowers did not satisfy the requirements of building societies and banks; sub prime mortgages.

9. The mortgages were at varying rates of interest, and had different final redemption dates (although most, possibly all, were redeemable early at the option of the mortgagor). In order to fund the acquisition, Eurosail sold investors various instruments. The total amount raised on the sale of different classes of interest bearing Notes was £659.75m. £9.75m of this amount was raised by way of different classes of interest bearing Notes. The balance of £9.75m was raised through the sale of so called ETc Notes which have been repaid.

10. The balance of £13.75m, being the difference between the cost of the mortgages and the amount raised, was devoted to the expenses of the issue.

11. The Notes were marketed in the usual way by means of a detailed Prospectus, and the arrangements governing the issue of the Notes were set out in a number of documents referred to as the "Transaction Documents". The most significant of these were the "Terms and Conditions of the Notes", a Trust Deed, a Deed of Charge, a "Securitisation Agreement" and a "Post Enforcement Call Option Agreement" (a "PECO").

12. Pursuant to the Trust Deed, the Claimant, BNY Corporate Trustee Services Ltd ("the Trustee"), was effectively constituted the trustee of the rights of the holders of the Notes against the Issuer, including the right to enforce the rights contained in the Trust Deed. Under the Deed of Charge, the Issuer granted to the Trustee, for the benefit of the Noteholders, security ("the Security") for the performance of its obligations, and a major aspect of the security was the grant of rights over the mortgages.

13. Some of the Notes were denominated in euros, some in US dollars, and some in sterling: the denomination of the Note determined the currency in which both the capital was repaid and interest was paid in the meantime. The Notes were in five Classes, Class A to Class E, with descending priority rights; the A Class had three subclasses 1, 2 and 3 (also with descending priority rights as to principal payments prior to enforcement), and Classes B to E only had a subclass 1. Many of the subclasses had more than one group, identified by a lower case letter identifying that group's currency denomination ("a" for euros, "b" for dollars, "c" for sterling), and every group within a subclass ranked pari passu.

14. The rate of interest payable on the Notes was linked to LIBOR, an inter-bank floating rate, and was lowest for the Class A1 Notes and highest for the Class E1 Notes. Each Class of Notes had a final maturity date (June 2045, except for the Class A1 Notes, for which the date was September 2027). The Class A Notes represented the majority in value of the Notes and were divided into three subclasses, A1b and A1c (a mixture of sterling and dollar Notes), A2b and

[6] Para 20
[7] [2011] 1 WLR 1200

A2c (also a mixture of sterling and dollar Notes), and A3a and A3c (mostly euro Notes, but some sterling Notes).

15. It was vital to the success of the issue that all the Class A Notes were accorded an AAA rating (or the equivalent) from the rating agencies. This was duly achieved, as was prominently recorded in the Prospectus, which also recorded that Notes in the Classes B1, C1, D1, and E1 ("the junior" Classes) were respectively accorded AA, A, BBB, and BB ratings (or their equivalents).

The Noteholders' Rights

16. The effect of the Terms and Conditions can be summarised as follows. The interest received under the mortgages is used to pay the interest due under the Notes. At least until a contractual "Enforcement Notice" (as explained below) is served, interest is paid quarterly to the Noteholders, and if the interest is insufficient, the junior Noteholders become at risk of having their rights to receive interest deferred to the date on which the relevant Notes are redeemed. There is no such provision for deferment in respect of the interest due on the Class A Notes. If the aggregate of the interest paid under the mortgages is greater than the interest which the Issuer has to pay out to holders of the Notes, this produces what is known as "excess spread".

17. As the mortgages are redeemed, the proceeds are to be used to pay off the Notes, on the quarterly dates on which interest is payable. The order in which principal amounts outstanding on the Notes are to be paid off, in the absence of enforcement, was A1, A2, A3, B1, C1, D1, E1, so A2 Noteholders received no repayment of principal until the A1 Noteholders had all been paid off, and so on down to the E1 Noteholders.

18. Some of the mortgages may result in a loss (typically where the mortgagor defaults and the proceeds of sale of the security are insufficient to repay the sum secured by the mortgage). In that event the "Principal Deficiency", i.e. the book loss created thereby, is, in effect, debited to the accounts of the junior Noteholders. However, the excess spread, as described above, may be used to extinguish this book loss.

19. In the event of the service of an Enforcement Notice, much of the above arrangements would change. First, the principal on the Notes would become repayable immediately, so the long stop dates of 2027 and 2045 would become irrelevant. Secondly, the priorities for repayment of principal and payment of interest would change: (i) the three sub-classes of Class A Notes would be collapsed into a single Class, so that they would rank pari passu for the repayment of capital, and (ii) until all the Class A Noteholders had been paid interest and capital in full, the junior Noteholders would not be entitled to receive anything. Thirdly, the Trustee would be entitled to enforce its "Security" over the mortgages – e.g. by selling them.

20. Condition 2(h) of the Terms and Conditions, after setting out the "Priority of Payments Post-Enforcement", stated that:

> *"The Noteholders have full recourse to the Issuer in respect of the payments described above, and are accordingly entitled to bring a claim under English law, subject to the Trust Deed, for the full amount of such payments in accordance with Condition 10."*

21. Condition 10 empowers the Trustee to "take such proceedings against the Issuer . . . as it may think fit to enforce the provisions of the Notes or the Trust Deed", but it is not bound to do so unless a specified proportion of the outstanding Noteholders request it.

22. By virtue of Condition 9 of the Terms and Conditions, an Enforcement Notice could only be served by the Trustee on the Issuer if, inter alia, two conditions are satisfied. The first is that one of the specified "Events of Default" has occurred; the second is that the Trustee certified that the event in question is *"materially prejudicial to the interests of the Noteholders"*. The only relevant Event of Default was Condition 9(a)(iii) ("Condition 9(a)(iii)"):

> *"The Issuer . . . ceasing . . . to carry on business . . . or being unable to pay its debts as and when they fall due or, within the meaning of Section 123(1) or (2) (as if the words 'it is proved to the satisfaction of the court' did not appear in Section 123(2)) of*

the Insolvency Act 1986 (as that Section may be amended from time to time), being unable to pay its debts."

23. Thus the provisions of the Insolvency Act are incorporated into the terms and conditions of the Notes.

The problem

24. Because Eurosail's assets (i.e., the mortgages) were all sterling-denominated but most of its liabilities (under the "a" and "b" groups of Notes) were denominated in Euros or dollars, Eurosail entered into a currency hedge in order to protect its position against adverse movements in sterling. Similarly, because Eurosail could become exposed to fluctuations in interest rates, it entered into an interest rate hedge. The hedge in each case was effected by a so-called swap contract, and the counterparty under each contract was a Lehman Brothers company. Lehman Brothers entered bankruptcy proceedings in the autumn of 2008 and the swap contracts were terminated. Eurosail has lodged claims for the loss of the hedges in the Lehman insolvency, but these claims have not been admitted. The cancellation of the swaps and fluctuations interest rates left Eurosail in a substantial net liability position which was reflected in its latest audited balance sheet. Nonetheless Eurosail continued to perform all of its obligations when they fell due.

25. The principal question for the Court was whether Eurosail should be "deemed unable to pay its debts" within the meaning of s 123(1) or (2) IA 1986 (as if the words "it is proved to the satisfaction of the court" did not appear in s 123(2)), under Condition 9(a)(iii).

First Instance

26. The Chancellor held that Eurosail was not balance sheet insolvent. In particular he held that a Court when asked to carry out the exercise under s.123(2) IA 1986 does not take a snapshot at any given time. Just because a company's audited accounts show a net liability position, that is not conclusive evidence that the company is insolvent for the purposes of s.123 IA 1986. The Chancellor set out the following guidance on how balance sheet insolvency was to be assessed:

26.1. Only the present assets, and not any contingent or prospective assets, should be included in any valuation of the assets of a company for the purposes of s 123(2). The value of such assets was their value to the company, but whether the value should be assessed on a going concern or break-up basis was unclear.

26.2. The requirement under s 123(2) to take into account contingent and prospective liabilities did not require that unascertained liabilities of the company be added at their face value to the debts presently owing by the company. This would be commercially illogical; an obligation to pay £100 today has a higher present value than an obligation to pay £100 in five years. Moreover, had such an approach been intended the statutory wording would have been different; s 123(2) would have provided that the amount of the company's liabilities "include its contingent and prospective liabilities";

26.3. Section 123(2) is silent on what "taking into account" involves but its content must be recognized in the context of the overall question posed by the subsection, namely whether the company is deemed to be insolvent because the amount of its liabilities exceeds the value of its assets. That involves a consideration of the overall context and facts applicable to the company in question. Such an exercise includes "taking into account" when any prospective liabilities fall due, whether such liabilities are denominated in a foreign currency, what assets are available or will become available to meet any future liabilities and if any provisions have been made for the allocation of losses.

27. Applying that guidance, the Chancellor concluded that the value of the assets of the Issuer exceeded the amount of its present liabilities, taking account of its contingent and prospective liabilities "to such extent as appears necessary at this stage".

The Court of Appeal

28. Lord Neuberger MR, who gave the leading judgment, upheld the High Court's decision (albeit for slightly different reasons) and found that the company was not balance sheet insolvent for the purposes of s.123(2) or the event of default in condition 9(a)(iii) of the notes. It was held that because of the wording of the Eurosail event of default (which cross-referred to s.123 of the Act), it was necessary to give the statutory provisions the meaning and effect which they have in the statute, and so Lord Neuberger MR and Toulson LJ spent some time explaining and examining the history and purpose of the statutory "balance sheet test". Lord Neuberger MR noted that although the audited accounts of the company had showed a net asset deficit for the last three years (Eurosail's latest financial statements and management accounts revealed net liabilities of £75 million and £130 million respectively), and whilst this was probably the correct starting point, this should only be considered as the beginning of the enquiry rather than being definitive. He stated that it would be impractical and undesirable for s.123(2) IA 1986 to be satisfied every time a company's liabilities exceeded the value of its assets on the basis of the face value as it would result in many solvent and successful companies falling within s.123(2) and at risk of the presentation of a winding-up petition. In carrying out the "balance sheet test" under s.123(2), the assets and liabilities need to be valued sensibly taking into account when the debts are due, the value of the debts and with "*a firm eye on commercial reality and commercial fairness*". It was also held that it is correct to value future and contingent liabilities in a foreign currency at the present exchange rate.

29. Specifically, Lord Neuberger considered that in order to satisfy the "balance sheet" test of insolvency, it would be necessary for the company to have reached the "*point of no return*". This expression is not defined or mentioned in the legislation, but Lord Neuberger MR refers to this arising when directors should have "*put the shutters up*". For this reason and various other factors (particularly the extent of assets, the uncertainty of the currency liability, the relatively long periods over which the notes were due to be repaid and the fact that the company always had a very small margin of net asset surplus), the court found that the company was not within the ambit of s.123(2) IA 1986.

The Supreme Court

30. The Supreme Court also held that Eurosail was balance sheet solvent, with Lord Walker giving the leading judgment. As in the Court of Appeal the Supreme Court carried out a detailed analysis of the history of the legislation, starting with sections 78 and 80 of the Companies Act 1862 where the test was simply stated as *"Whenever it is proved to the satisfaction of the court that the company is unable to pay its debts"*. Although a contingent or prospective creditor could not present a winding up petition, if another creditor did and secured a winding up order, contingent and prospective creditors were admitted to proof.

31. In *Re European Life Assurance Society* (1869) LR 9 Eq 122 the court dismissed a winding up petition against a company which had issued a large number of life policies and annuity contracts and appeared to be in financial difficulties on the basis that *"inability to pay debts must refer to debts absolutely due"* so a contingent or prospective creditor could not petition. Whilst the Life Assurance Companies Act 1870 changed the law in respect of insurance companies by directing that account be taken of contingent and prospective liabilities; the general change came in relation to companies in the Companies Act 1907 which was then repeated in the Companies (Consolidation) Act 1908 where s. 130 (iv) provided that a company was 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, and, in determining whether a company is unable to pay its debts the Court shall take into account the contingent and prospective liabilities of the company."*

32. In *Re Capital Annuities Ltd* [1979] 1 WLR 170 Slade J observed (at 185):-

> *"From 1907 onwards, therefore, one species of 'inability to pay its debts' specifically recognised by the legislature as a ground for the making of a winding up order in respect of any company incorporated under the Companies Acts was the possession of assets insufficient to meet its existing, contingent and prospective liabilities."*

33. The Supreme Court also found that Briggs J in *Re Cheyne Finance Plc (No 2)* [2008] Bus LR 1562 in interpreting a security trust deed was right in saying (at ¶ 56) that what section 123(1)(e) required was as follows:

> *"In my judgment, the effect of the alterations to the insolvency test made in 1985 and now found in section 123 of the 1986 Act was to replace in the commercial solvency test now in section 123(1)(e), one futurity requirement, namely to include contingent and prospective liabilities, with another more flexible and fact sensitive requirement encapsulated in the new phrase 'as they fall due."*

34. The Supreme Court recognised that whether or not the test of balance sheet insolvency is satisfied must depend on the available evidence as to the circumstances of the particular case and that the burden of establishing balance sheet insolvency rests on the party asserting it.

35. It also noted that whilst the Cork Commission had been commissioned in 1976 and the final Cork Report published in October 1979 the process of implementing the proposals was not commenced until 1984 following a spate of financial scandals. It was then rushed through with very little consultation before the drafting of the Bill itself. This led to the passage of the Bill becoming contentious and confused in both Houses of Parliament and amendments were made at the Committee stage, with a total of approaching 1,200 amendments being made by the time the Bill received the Royal Assent. [8] Nonetheless Lord Walker found that the changes in the legislative form were not intended to make significant changes to the law saying that:

> *"The changes in form served, in my view, to underline that the "cash-flow" test is concerned, not simply with the petitioner's own presently-due debt, nor only with other presently-due debt owed by the company, but also with debts falling due from time to time in the reasonably near future. What is the reasonably near future, for this purpose, will depend on all the circumstances, but especially on the nature of the company's business... The express reference to assets and liabilities is in my view a practical recognition that once the court has to move beyond the reasonably near future (the length of which depends, again, on all the circumstances) any attempt to apply a cash-flow test will become completely speculative, and a comparison of present assets with present and future liabilities (discounted for contingencies and deferment) becomes the only sensible test. But it is still very far from an exact test, and the burden of proof must be on the party which asserts balance-sheet insolvency."*

36. The Supreme Court also recognised that the business of Eurosail could not be compared with that of an ordinary trading business. It had no suppliers, no stock and had to make no decisions about pricing, purchasing or raising new capital. The only important management decision that could possibly be made would be an attempt to arrange new hedging cover in place of that which was lost when Lehman Brothers collapsed. To that extent, said Lord Walker, Eurosail's present assets should be a better guide to its ability to meet long term liabilities than would be the case of a company actively engaged in trading. The value of the long term liabilities was, however, a matter of speculation, dependent upon the vagaries of currency movements, interest rates and the UK economy and housing market and over a period of more than 30 years (to the final redemption date of some of the Notes in 2045)

37. Lord Walker also considered that the *"point of no return"* test proposed by Lord Neuberger MR in the Court of Appeal should not pass into common parlance. Further in the case of companies where liabilities are deferred over 30 years and where it is paying its debts as they fall due, the court should proceed with extreme caution in deciding whether a company is balance sheet insolvent.

38. Lord Walker held that given that Eurosail's ability to pay all its debts, present or future, may not be finally determined until much closer to 2045. The Conditions contain several mechanisms to ensure that liabilities in respect of principal can be deferred until that date. That being so, the Supreme Court could not be satisfied that there would eventually be an inability on the part of the Issuer to pay its debts. It further found that whilst the Court of Appeal had based its decision on the point of no return test it would have reached the same conclusion had it applied the correct test.

[8] *See Law of Insolvency* 4th Ed; Ian Fletcher, at para 1-034

Remaining uncertainty

39. Notwithstanding the Supreme Court's:

(1) confirmation of the inclusion in the cash flow test of an element of futurity; and

(2) rejection in the context of balance sheet insolvency of the "point of no return" test (thought by many to represent an unnecessarily high hurdle to surmount),

A degree of uncertainty remains in respect of each basis. Just what is the reasonably near future for the purposes of cash flow insolvency is arguably ripe for argument. In the context of balance sheet insolvency the Supreme Court gave no real guidance on what factors will be relevant beyond the period over which long term liabilities are payable.

40. It is clear from the Supreme Court's decision that making an assessment of balance sheet insolvency pursuant to section 123(2) IA 1986 will very much depend on the circumstances of the case. While an excess of liabilities over assets in a company's audited financial statements will likely remain the starting point in making an assessment pursuant to section 123(2) IA 1986, in order to satisfy the balance sheet insolvency test, directors and creditors must also arrive at an independent expectation that the company will not be able to meet its liabilities. This makes the balance sheet test appear much like a longer term cash flow insolvency test.

Impact beyond winding-up

41. Clearly the implications of the Eurosail decision go beyond the mere practice of the court on the hearing of a winding up petition and set out below are some of the circumstances to which it is relevant, in particular where it is necessary to establish insolvency at any given point in time within the context of transaction avoidance to recover assets into an insolvent estate.

42. **Contractual insolvency events of default**: s.123 IA 1986 is frequently incorporated into contractual documentation whether by express reference or by use of the same language, as was the case in *Eurosail*. In many cases it will now be more difficult to establish balance sheet insolvency where there are long term liabilities. In light of the potential difficulty of such an analysis, parties in future commercial transactions may wish to include an insolvency event of default provision which is triggered upon crossing a specific threshold for impaired net worth, based on an audited balance sheet (or other empirical measure), rather than relying on a cross-reference to section 123(2) IA 1986.

43. **Transactions at an undervalue and Preferences:** s.240(2) IA 1986 provides that the relevant time for a transaction at an undervalue or a preference shall not be a relevant time unless the company was at the time unable to pay its debts within the meaning of s.123 IA 1986.

44. **Avoidance of floating charges:** s.245 IA 1986 provides a similar qualification in relation to floating charges created by an unconnected party within 12 months of the onset of insolvency and again makes reference to s.123 IA 1986. Similar considerations apply and again it make be more difficult to pursue claw back provisions.

45. **Wrongful trading:** there should not be much of an impact on wrongful trading claims because s.214 IA 1986 concentrates on the foreseeability of that there is no reasonable prospect of avoiding insolvent liquidation rather than the timing of actual insolvency.

The Post Enforcement Call Option (“the PECO”)

46. The "forbiddingly voluminous" documentation in respect of the Notes included a PECO, which provided, upon exercise of the option, for the acquisition by the option-holder of the remaining Notes for a nominal sum following realization and distribution of Eurosail's assets if such assets are insufficient to pay all amounts due in respect of the Notes.

47. The Supreme Court (Lord Hope giving the leading judgment on the PECO issue) agreed that the purpose of a PECO is to achieve bankruptcy remoteness for Eurosail. Its aim is to prevent Eurosail from being susceptible to insolvent winding up proceedings by ensuring, so far as

possible, that if its assets prove to be insufficient to meet its liabilities, the directors of Eurosail will not instigate bankruptcy proceedings in respect of the company.

48. Eurosail argued that while, as a matter of contract, its liabilities were unlimited in recourse, as a matter of commercial substance and in practice, they were the equivalent of a limited recourse provision. The A3 Note holders submitted that the terms of the PECO clearly did not have the effect of limiting the liability of Eurosail in respect of the Notes to the value of Eurosail's assets and the PECO was of no effect prior to enforcement. Accordingly, at all times prior to exercise of the PECO, the Noteholders remained entitled to payment in accordance with the Conditions.

49. In Lord Hope's judgment, the legal and commercial effect of the PECO were the same and did not impact on the amount of Eurosail's liabilities:

> *"To limit those liabilities as [Eurosail] contends would contradict the parties' clearly expressed commercial intention as found in the contractual documents. The fact that the economic result of the PECO may be the same as if the Noteholders' right of recourse had been limited to [Eurosail's] assets is beside the point. It can be expected to achieve bankruptcy remoteness as effectively. But it would not be in accordance with the true meaning of the documents to treat the two methods as if they had the same effect in law."*

Christopher Brockman
Richard Ascroft
Guildhall Chambers
June 2013