Dispute Resolution

June 2013

DISPUTE RESOLUTION BULLETIN

Eurosail: the balance-sheet insolvency test clarified

The question as to whether a company is insolvent or not is not only relevant to creditors who might wish to present winding up petitions against debtors. Many commercial agreements contain provisions in which events of default can be triggered by one party's insolvency. Such agreements often measure the insolvency of a party by reference to the "cash-flow" and "balance-sheet" tests contained in sections 123(1)(e) and 123(2) of the Insolvency Act 1986 (the "Act"). These tests were the subject of a recent Supreme Court decision, which offers helpful guidance on their interpretation and the interplay between them.

Under section 123 of the Act, creditors must be able to satisfy the Court that:

- The company is unable to pay its debts as they fall due (cash-flow insolvency).
- On the balance of probabilities, the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities (balance-sheet insolvency).

In *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL PLC* (9 May 2013), the Supreme Court had to decide whether or not Eurosail was insolvent under section 123 of the Act.

The facts of the case were complex. Eurosail was set up in 2007 as a single purpose entity to acquire a portfolio of mortgage backed securities, funded by the issue of floating rate loan notes. The final redemption date of the notes is in 2045. Eurosail hedged its position by entering into swap agreements with two Lehman Brothers entities. When Lehman Brothers became insolvent, the swap agreements were terminated and Eurosail was faced with a growing deficit. Although Eurosail was able to continue servicing the notes and was not cash-flow insolvent, several noteholders called an event of default under relevant agreements on the basis that Eurosail was balance-sheet insolvent.

A further issue involved a post enforcement call option (PECO) – which would enable an associated company of Eurosail to acquire all the

holman fenwick willan hfw

notes if Eurosail was unable to pay its debts – and how this affected the assessment of Eurosail's insolvency.

The Supreme Court concluded that the cash-flow and balance-sheet tests should be viewed together, confirming that the cash-flow test is concerned with presently-due debts as well as debts falling due from time to time in the reasonably near future. Once the Court was required to move away from the *"reasonably near future"*, the only sensible test to apply was the balance-sheet test. The definition of *"reasonably near future"* would depend on the nature of the company's business.

Bearing in mind that the final redemption date of the floating rate loan notes was not until 2045, which could not be considered as the reasonably near future, the Supreme Court applied the balance-sheet test to Eurosail. It concluded that on the balance of probabilities, it could not be satisfied that Eurosail was balance-sheet insolvent. The final redemption date of the loan notes was more than 30 years away and Eurosail's current financial position and future prospects depended on *"three imponderables"* outside its control: currency movements, interest rates and the UK economy and housing market. As a result, Eurosail's insolvency was a matter of *"speculation rather than calculation and prediction"* and could not be determined until much closer to 2045.

The Supreme Court's decision makes clear that the insolvency tests cannot be described as exact because they depend on an assessment of present assets and present and future liabilities. However, a number of the Supreme Court's comments are informative for those seeking to apply it:

- The burden of proof rests with the party asserting balance-sheet insolvency and depends on the available evidence. When incorporating section 123(2) of the Act into their contracts, commercial parties frequently specifically delete the requirement of proof 'to the satisfaction of the court'. The Supreme Court made clear that doing so will not affect where the burden of proof lies.
- Where a company's liabilities are deferred over a number of years and the company is paying debts when they fall due, the Court should proceed with great caution in deciding the company is balance-sheet insolvent.
- The expression *"balance-sheet insolvent"* must not be taken literally: a company's statutory balance sheet, properly prepared in accordance with the requirements of company law, may omit some contingent assets and/or liabilities.
- Importantly, the Court of Appeal's suggestion that a company would be deemed insolvent where it had reached *"the point of no return"* was rejected. This clarification is helpful and likely to be welcomed by creditors who may have otherwise found it difficult to meet such a high burden of proof.
- The PECO was not relevant to Eurosail's insolvency. A company's liabilities remain the same whether or not a PECO is in place and if there is a PECO, whether or not the call option has been exercised. These comments may have a significant effect on the use of PECOs in securitisation transactions, which is currently widespread.

For further information, please contact Rick Brown, Senior Associate, on +44 (0)207 264 8461, or richard.brown@hfw.com, or your usual contact at HFW. Research conducted by Marie-Anne Smith, Trainee.

Upholding the validity of arbitration clauses

The English High Court recently held that the arbitration clause in an agreement was still valid even if the subject matter of the agreement itself was unenforceable because of illegality. In doing so, the Court said that it had applied powerful commercial factors in support of upholding arbitration provisions, respecting the parties' choice and providing a one-stop process.

In *Beijing Jianlong Heavy Industry Group v. Golden Ocean Group Limited & Ors* (1 May 2013), five letters of guarantee were issued to the defendants (incorporated in Bermuda and Liberia) by the claimant, Beijing Jianlong (incorporated in the People's Republic of China). Each letter of guarantee contained an English law and London arbitration clause. Following a dispute, separate arbitrations were commenced in London under each letter of guarantee.

In the arbitrations, Beijing Jianlong argued that the parties knew that it is illegal under Chinese law for a Chinese legal person to give a guarantee to a foreign entity without having obtained prior authorisation from the Chinese State Administration for Foreign Exchange (SAFE) and, as a result, the transfer of any funds under the guarantees would be illegal as a matter of Chinese law. At the same time, Beijing Jianlong commenced parallel court proceedings in China for a declaration that the arbitration agreements were invalid.

Awards were made in the London arbitrations, holding that each tribunal had jurisdiction to hear the disputes and issuing an anti-suit injunction against Beijing Jianlong to restrain them from continuing the Chinese proceedings.

Beijing Jianlong argued that the arbitration agreements themselves fell foul of the principle in Foster v Driscoll because they were part of an overall scheme by which the unlawful guarantees were provided and concealed.

Beijing Jianlong applied to the English High Court under section 67 of the Arbitration Act 1996 (the Act). Section 67 provides that a party to arbitration proceedings may apply to Court challenging the substantive jurisdiction of a Tribunal or seeking an order that an award has no effect because the Tribunal does not have substantive jurisdiction.

For the purposes of the application, the parties agreed assumed facts: that any payments made under the guarantees would be illegal because SAFE authorisation had not been obtained and that the intention behind the choice of English law and London arbitration was deliberate, to circumvent the application of Chinese law under which the guarantees would be illegal. The parties also accepted that the "doctrine of separability" (which is given the force of law under section 7 of the Act) applied so that the arbitration agreements should be treated as distinct and separate from the guarantee agreements.

The issue before the Court was how the principle that an English law contract is not enforceable if the intention of the parties was to perform an act illegal in a foreign friendly country (established in *Foster v Driscoll* (1929)) applied to the arbitration agreements.

Beijing Jianlong argued that the arbitration agreements themselves fell foul of the principle in *Foster v Driscoll* because they were part of an overall scheme by which the unlawful guarantees were provided and concealed. Their sole purpose was to circumvent the application of Chinese law and they were an integral part of a scheme to procure the carrying out of illegal acts in China.

The Defendants argued that the policy underlying *Foster v Driscoll* is that the English courts should not assist the breach of the laws of other friendly countries within their territories. A London arbitration would not involve any act in China that would contravene any provision of Chinese law. In fact, if the arbitrators concluded that the guarantees fell foul of the *Foster v Driscoll* principle, they would refuse to enforce them.

The Court confirmed that an arbitration agreement is to be treated as a distinct and separable agreement from the contract of which it forms part. The unenforceability of a contract will not in itself result in the arbitration agreement within it being unenforceable. The policy and purpose of the rule which would invalidate the guarantees did not strike down the arbitration provisions. If the assumed facts were proved in the arbitrations, the guarantees would not be enforced. This would not give the Chinese government cause for complaint or breach the obligation of international comity identified by *Foster v Driscoll*. The position was not affected by any bad motives in choosing to arbitrate so as to conceal wrongdoing.

Further, the fact that Beijing Jianlong's position may be less favourable in arbitration under English law than it would be if the guarantee disputes were decided before the Chinese courts under Chinese law was irrelevant and no reason for the arbitration provisions to fail.

Despite the ingenuity of Beijing Jianlong's argument, this judgment is yet another example of the Court's willingness to uphold arbitration agreements in contracts that are otherwise unenforceable. The factual circumstances of the case also serve as a reminder that when obtaining guarantees from a Chinese company, it is important to ensure that any necessary SAFE authorisation has been obtained.

For further information, please contact David Chalcraft, Associate, on +(44) 0207 264 8228 or david.chalcraft@hfw.com, or your usual contact at HFW.

"And/or" – inaccurate, obscure, uncertain and/or just plain meaningless?

A Court of Appeal decision earlier this year, *Situ Ventures Limited v Bonham-Carter (7 February 2013)*, focused attention once again upon the use of the expression "and/or" in the drafting of commercial agreements. In 1944, Viscount Simon colourfully described this phrase as a *"bastard conjunction"*[1]. Despite repeated judicial criticism over the years, it remains in regular use. Is there a valid place for it in commercial agreements?

Situ Ventures concerned the construction of a clause in an agreement for the sale of shares in an estate agency business. The clause provided that the directors of the vendor would *"remain as Directors of the Company in a Non-Executive capacity unless otherwise agreed and/or requested by the Purchaser…"*. The question for the court was whether

1 Bonitto v Fuerst Brothers & Company Limited [1944] AC 75.

this gave the company the power to request that the directors not remain as directors and so put them under an obligation to resign.

In the judgment, both Mummery LJ and Lewison LJ had difficulty in construing the clause. Mummery LJ commented that the use of the expression *"and/or"* was unnecessary and confusing. He went on: *"…the use of the expression "and/or" in any legal document is in any case open to numerous more fundamental objections of inaccuracy, obscurity, uncertainty or even as being just plain meaningless"*.

Just in case anyone is not sufficiently discouraged from using the expression, it has been variously described elsewhere as a *"much condemned conjunctive-disjunctive crutch for sloppy thinkers"*[2], a *"linguistic abomination"*[3] and *"mischief caused by the inarticulate, if not illiterate drafting… [that] bespeaks negligence on the part of the drafter"*[4]. In the Florida Supreme Court it was said to be *"one of those inexcusable barbarisms ... sired by indolence"*[5]. In a recent Australian decision, it was described as an *"embarrassing expression which endangers accuracy"* and a *"common and deplorable affection inviting trouble"*[6] with the court suggesting that a careful drafter should avoid its use.

Case law suggests that there are two strands of analysis for the phrase, "selection" and "identification".

The "selection" approach involves the selection from one or more combinations available. For example, a standard use of the phrase "and/or" is to denote that items can be either taken together or as alternatives. The suggestion is that a better way of expressing the same idea would be to use the formula *"x or y or both"*.

The "identification" approach arises where the context requires some identification of a specific event and may offer guidance as to which choice is intended and which makes the best sense.

There are situations where "and/or" has a meaning and can properly be used. For example, where outcomes may be contingent or unknown or where it is used to anticipate alternative possibilities and unforeseen events. However, where there is a risk that, for the sake of brevity, it will create inaccuracy and where the drafter intends it to have a clear and identifiable meaning then, however awkward an alternative phrase may be, the use of "and/or" should be avoided.

Given Scrutton LJ's comment in Gurney v Grimmer 44 LLR 189 (1932) that: *"I am quite aware of the habit of some business people and some lawyers of sprinkling "and/or"s as if from a pepperpot all over the documents without any clear idea of what they mean by them, but simply because they think it looks businesslike"*, perhaps the best approach is to avoid the phrase altogether.

For further information, please contact Chris Lockwood, Partner, on +61 (0)3 8601 4508 or chris.lockwood@hfw.com, or your usual contact at HFW.

2 Raine v Drasin 621 SW 2nd 895 (1981).

3 The New Mexico Supreme Court in State v Smith 1947

4 Re Estate of Massey (Superior Court of New Jersey Chancery Division) 1998.

5 Cochrane v. Fla. E. Coast Rwy. Co., 145 So. 217 (1932).

6 Canberra Data Centres Pty Limited v Vibe Constructions (ACT) Pty Ltd [2010] ACTSC 20.

HOLMAN FENWICK WILLAN LLP
Friary Court, 65 Crutched Friars
London EC3N 2AE
T: +44 (0)20 7264 8000
F: +44 (0)20 7264 8888

Lawyers for international commerce hfw.com

© 2013 Holman Fenwick Willan LLP. All rights reserved

Whilst every care has been taken to ensure the accuracy of this information at the time of publication, the information is intended as guidance only. It should not be considered as legal advice.

Holman Fenwick Willan LLP is the Data Controller for any data that it holds about you. To correct your personal details or change your mailing preferences please contact Craig Martin on +44 (0)20 7264 8109 or email craig.martin@hfw.com