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ARTICLE

Re Cheyne Finance plc and Commercial Insolvency

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I. Introduction

Section 123 of the Insolvency Act 1986 incorporates two tests for insolvency: the balance sheet test (whether liabilities exceed assets) and the commercial/cash-flow insolvency test (whether debts can be paid as they fall due).[1] Which of the two tests is relied upon frequently depends on the context in which the question of insolvency is raised, and the information available to the party seeking to establish insolvency. Most creditors' winding-up petitions are, for example, determined on the basis of commercial insolvency: that a company has failed to pay a debt currently due and owing, and in respect of which demand for repayment has been made. The failure to pay in circumstances where there is no genuine dispute as to whether the debt is owing in itself establishes a company's inability to pay its debts.[2]

Prior to the decision of the English High Court in *Re Cheyne Finance Plc* [2007] EWHC 2402 (Ch), the majority of commentators in this area had expressed the view that the wording of Section 123 was such that, in the context of the English legislation, the cash-flow test must be seen as focusing on a present inability to pay an accrued liability.[3] The language of Section 123(1)(e) is phrased in the current rather than future tense ('is unable', as opposed to 'will be unable'). The typical dictionary definition of fall due is 'become immediately payable'[4] and the notion of a debt being due is one which was thought to be such that 'debts payable in the future, prospective debts and contingent liabilities must all be ignored'.[5] In this regard, Section 123(2) of the Insolvency Act 1986 (which contains the balance sheet test of insolvency) makes specific reference to prospective and contingent liabilities whereas there is no equivalent reference in Section 123(1)(e). The conclusion reached by academics such as Professor Fletcher was therefore that:[6]

> 'What is of the essence, for the purposes of Section 123(1)(e), is the demonstration, by suitable and credible evidence, that the company is failing to pay its mature liabilities within a reasonable time of their becoming due ...'

Not all agreed that this should be the approach to assessing commercial insolvency,[7] Professor Goode argued that the Court could consider debts which fell due in the 'near future' or 'not too distant future'[8] (i.e. that although contingent and prospective liabilities were excluded, the date of assessment was capable of including an element of futurity). But the majority view appeared to be that, as a consequence of the language used in Section 123(1)(e), there was little scope for consideration to be given to debts other than those immediately due and payable.

This was to be contrasted with the approach adopted in Australia. In a series of Australian cases commencing with *Bank of Australia v Hall* (1907) 4 CLR 1514, and extending to the current day, a wider approach had been adopted to the concept of commercial insolvency. Notably, that approach had been adopted in the context of a statutory scheme which did not make express provision for a test of balance sheet insolvency.[9] It was therefore understandable from a practical perspective that an element of futurity had been injected into the

Notes

1 See, for example, *Re MDA Investment Management Ltd* [2004] 1 BCLC 217 at [121].
2 See *In re Bradford Tramways Company* (1876) 2 Ch D 373 per Malins VC and the reference to the inability or 'unreadiness' of a creditor to pay its debts. In many cases, non-payment of current debts will be (and has always been) the only and best available evidence of insolvency and that will suffice to prove insolvency: see *Lacey v Hill* (1870) 18 Eq 182 and the comments of Sir George Jessel MR therein.
3 See I. Fletcher, *The Law of Insolvency* (3rd edn, 2002) at para. 20-016, *McPherson's Law of Company Liquidation* (2001) at paras 11.20 to 11.23 and Sealy and Milman, *Annotated Guide to the Insolvency Legislation* (10th edn, 2007-2008).
4 See, for example, the Shorter Oxford English Dictionary, , Vol 1 (6th edn, 2007) p. 774.
5 See R. Goode, *Principles of Corporate Insolvency Law* (3rd edn, Thomson, Sweet & Maxwell, 2005) at para. 4-18.
6 Fletcher, *op. cit.*, at para. 20-016.
7 See McPherson, *op. cit.*, at para. 11.20.
8 See Goode, *op. cit.*, at para. 4-16.
9 See Sections 95A of the Corporations Act 2001, and the comments of Dodds-Streeton J in *Crema Pty Ltd v Land Mark Property Developments Pty Ltd* (2006) 58 ACSR 631 at 652.

Australian application of the commercial insolvency test. But this is now achieved by expressly requiring the Court to take into account contingent and prospective liabilities when assessing commercial insolvency.[10]

II. Cheyne Finance Plc – the issues

The difference in approach, and the first consideration by the English courts of the scope and extent of the commercial insolvency test, came to a head in the litigation arising from Cheyne Finance Plc entering receivership. Cheyne is an Irish company operating as a structured investment vehicle. A significant part of Cheyne's assets consisted of securities backed by assets including United States of America equity loans, some of which had suffered as a consequence of the USA sub-prime mortgage crisis.

In September 2007, receivers were appointed over the business and assets of Cheyne pursuant to the terms of a security trust deed. The appointment occurred upon the breach by Cheyne of a major capital loss test.

Soon after appointment, the receivers of Cheyne sought directions from the Court as to whether they should continue to pay debts as they fell due from monies coming into their hands during the period following an enforcement event, but prior to the declaration of an Insolvency Event. Competing arguments were raised on behalf of those creditors with early maturing senior debts (who wanted the receivers to continue on a pay as you go basis) and those creditors with later maturing debts who argued that full provision for payment of all senior debts should take precedence over payment on time and in full of debts as and when they fell due. The Court resolved this question of construction of the relevant documents in a judgment dated 13 September 2007 [2007] EWHC 2116 (Ch), holding that the receivers were required to manage Cheyne's assets with the express objective of achieving the timely payment in full of debts to senior creditors as and when they fell due for payment (i.e. pay as you go). It was assumed for the purpose of that decision, but without deciding the point (see §7), that an Insolvency Event (as defined) had not occurred in circumstances where Cheyne was able to pay its debts as they fell due and would be able to do so in the near future, but not in the more distant future because of a balance sheet deficit.

The receivers subsequently returned to Court, seeking clarification of whether an 'Insolvency Event' within the meaning of the relevant documentation had occurred. Arguments on this point turned on the construction of the relevant clause in the agreements, as well as the scope of the test for insolvency found within Section 123 of the Insolvency Act 1986. The key issue was whether Cheyne was insolvent for the purpose of the definition of Insolvency Event in circumstances where Cheyne could pay senior debts currently due, and those falling due in the very near future, but where it was regarded as inevitable in the middle or longer term future that default would occur.

III. The Insolvency Event

For the purpose of the Cheyne documentation, an Insolvency Event was defined as:

> 'a determination by the Manager or any Receiver that [Cheyne] is, or is about to become, unable to pay its debts as they fall due to Senior Creditors and any other person whose claims against [Cheyne] are required to be paid in priority thereto, as contemplated by Section 123(1) of the United Kingdom Insolvency Act 1986 (such subsection being applied for this purpose only as if [Cheyne's] only liabilities were those to Senior Creditors and any other persons whose claims against the Issuer are required under the Security Trust Deed to be paid in priority thereto.)'

It was common ground that the reference to Section 123(1) of the Insolvency Act necessarily excluded the balance sheet test. The only debts relevant in the context of the clause were those which were held by senior creditors, and it was those creditors (with short or long maturity notes) who argued the application. The debate focused on the degree of futurity incorporated within the notion of being unable to pay debts as they fall due within the meaning of Section 123(1), and the extent to which any degree of futurity could be said to be limited in the context of the documents in issue by the inclusion of the phrase 'is about to become' in the relevant clause.

IV. No, or limited, futurity

Certain of the creditors with short term debt argued that only those debts presently due were to be considered for the purpose of the cash flow test incorporated in Section 123(1), and that the language used to define Insolvency Event incorporated a limited degree of futurity by including the phrase 'is about to become' such that, even if there was an element of futurity in the cash-flow test incorporated in Section 123(1)(e), the extent of any futurity was governed and limited for the purpose of the clause by the wording adopted by the parties.

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10 See Section 459D of the Corporations Act 2001.

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It was noted that, where the draftsman of the 1986 legislation had intended to introduce an element of futurity and a focus on the ongoing and future ability of the company to meet debts as they fall due, clear language to that effect had been adopted.[11] The same could be said for other provisions in the companies legislation, all of which had adopted the words 'will be' when seeking to deal with the future ability of a company to meet its debts as they fall due.[12]

As a practical matter, those with short term debt submitted that there was no need for any wider construction to be given to Section 123(1)(e). The balance sheet test provided for by Section 123(2) of the Act ensures that, in any case where future and contingent liabilities exceed current assets, a company will be deemed to be unable to pay its debts. As commented on below, it is very difficult to conceive of any circumstances in which a Court could be satisfied that a company: (a) is able to pay its current liabilities; (b) is balance sheet solvent within the meaning of Section 123(2); but (c) will, at some stage in the future, be unable to pay liabilities then falling due.

That the question of prospective and contingent liabilities was only relevant to the balance sheet test appeared to have some support from the judgment of Nicholls LJ in *Byblos Bank SAL v Al-Khudhairy* [1987] BCLC 232 at 248G (i.e. they are relevant to an assessment of 'what were the assets and liabilities of the company on a particular day'), whilst the argument that commercial insolvency remained focused on whether a company could pay all of its presently owing debts in respect of which payment had been demanded, arguably found support in the decision of Slade J in *Re Capital Annuities Ltd* [1979] 1 WLR 170 at 187/188. The Australian approach was argued to be a result of differently worded legislation, and an extended approach which was both inconsistent with the wording of the English legislation and unnecessary.

It was therefore submitted that the effect of the clauses in issue was, on their proper construction, to create a priorities agreement in favour of short maturity notes, and that there was nothing commercially surprising or wrong with such a conclusion. Indeed, such a construction avoided the need to make difficult judgments about the value of Cheyne's assets.

V. Extended futurity

Despite this, Mr Justice Briggs rejected the arguments put forward by the holders of the short maturity notes. He held that, prior to the 1985/1986 reforms, English law posed the question of inability to pay debts without any rigid distinction between commercial cash flow insolvency on the one hand, and balance sheet insolvency on the other (paragraph 34 of judgment [2007] EWHC 2402 (Ch)). As such, a 'submission that commercial insolvency could not be established by reference to future debts could not have succeeded'. He cited in support of this conclusion a passage from *Byblos* at page 247 where Nicholls LJ said:

> 'Construing this section first without reference to authority, it seems to me plain that, in a case where none of the deeming paras (a), (b) or (c) is applicable, what is contemplated is evidence of (and, if necessary, an investigation into) the present capacity of a company to pay all its debts. If a debt presently payable is not paid because of lack of means, that will normally suffice to prove that the company is unable to pay its debts. That will be so even if, on an assessment of all the assets and liabilities of the company, there is a surplus of assets over liabilities. That is trite law.
>
> It is equally trite to observe that the fact that a company can meet all its presently payable debts is not necessarily the end of the matter, because para (d) requires account to be taken of contingent and prospective liabilities. Take the simple, if extreme, case of a company whose liabilities consist of an obligation to repay a loan of £100,000 one year hence, and whose only assets are worth £10,000. It is obvious that, taking into account its future liabilities, such a company does not have the present capacity to pay its debts and as such it 'is' unable to pay its debts. Even if all its assets were realised it would still be unable to pay its debts, viz, in this example, to meet its liabilities when they became due.'

Briggs J rejected the argument that this passage, insofar as it dealt with future liabilities, was focused on the balance sheet test and stated that 'Nicholls LJ is speaking about the ability of the company to meet its liabilities when they became due'. Hence what was said to be persuasive was the emphasis on the company's present capacity to pay its debts whenever they fell due.

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11 See, for example, section 8 of the Insolvency Act 1986 ('is or is likely to become unable to pay its debts (within the meaning given to that expression by section 123 of this Act)') as discussed in *Colt Telecom Group Plc* [2003] BPIR 324 and section 89 ('the company will be able to pay its debts in full').

12 See, for example, sections 156(2) and 173(3)(b) of the Companies Act 1985 and sections 643(1(b)(ii) and 714(3)(b)(ii) of the Companies Act 2006.

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It is undoubtedly correct that the focus of Nicholls LJ was on the position of the company at the present time, and not in the future. But it is to be noted that the above passage as cited by Briggs J halts part of the way through what might be said to be the relevant paragraph. It continues:

> 'It might be that, if the company continued to trade, during the year it would acquire the means to discharge its liabilities before they became presently payable at the end of the year. But in my view para (d) is focusing attention on the present position of a company. I can see no justification for importing into the paragraph, from the requirement to take into account prospective and future liabilities, any obligation or entitlement to treat the assets of the company as being, at the material date, other than they truly are.'

Even if the focus of the inquiry is on the company's present capacity to pay, that does not answer the question of whether any inquiry regarding current ability to pay future debts is to be assessed on anything other than a balance sheet basis. It is certainly arguable that, read in context, this passage suggests that Nicholls LJ only took contingent and prospective liabilities into account for the purpose of conducting a balance sheet inquiry.

The main thrust of Briggs J's analysis was, however, based on the approach in the Australian cases (see paragraphs 41 *et seq.*). Briggs J observed that the question before him had never been analysed in English authorities in detail, probably because of the presence of the balance sheet test in the relevant legislation. He went on to comment that (paragraphs 51 and 52):

> 'It is clear from that brief review of the Australian decisions that in an environment shorn of any balance sheet test for insolvency, cash flow or commercial insolvency is not to be ascertained by a slavish focus only on debts due as at the relevant date. Such a blinkered review will, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases fail to see that due to an endemic shortage of working capital a company is on any commercial view insolvent, even though it may continue to pay its debts for the next few days, weeks or even months before an inevitable failure.
>
> Furthermore, the common sense requirement not to ignore the relevant future was found to be implicit in the Australian case in the simple phrase "as they become due".'

Briggs J therefore reasoned that, first, although the English legislation had removed the reference to contingent and prospective liabilities when framing Section 123(1)(e), it had adopted 'what in Australia have always been regarded as the key words of futurity, namely the phrase "as they fall due". In that context, "fall due" is, in my judgment, synonymous with "become due"' (paragraph 53). The learned judge went on to conclude that 'the Australian approach makes commercial sense, whereas the blinkered approach of ignoring the future does not' (paragraph 54).

Secondly, Briggs J considered that there may be cases in which a company is not balance sheet insolvent but would satisfy an Australian style test for commercial insolvency. The example given was a company with GBP 1000 in cash and a very valuable but very illiquid asset worth GBP 250,000 which cannot be sold for two years. If that company has present debts of GBP 500, but a future debt of GBP 100,000 due in six months, it is, Briggs J suggested, unable to pay its debts as they fall due but would be balance sheet solvent.

The conclusion was therefore reached that the commercial insolvency test incorporated in Section 123(1)(e) of the Insolvency Act 1986 was the same as that in the Australian authorities, and did permit consideration of whether a company would be able to pay debts falling due at some point in the future and not merely immediately payable.

Whether this is the right conclusion may be subject to some debate. For example:

(1) A debt in existence but not due at the relevant date (see para. 51) is a contingent or prospective debt. It is in some regards strange as a matter of statutory construction if, having made express reference to such debts in Section 123(2), they are to be included in Section 123(1)(e) by reason only of the fact that the phrase 'as they become due' is used. The more natural reading, it might be argued, is that the absence of any such express reference actually makes it clear that the phrase 'as they fall due' cannot extend to debts which are not currently due.

(2) The need to adopt a common sense approach which does not ignore the relevant future is, in the context of the English legislation, met by the balance sheet test for insolvency. That test will ensure that prospective and contingent liabilities are taken into account when assessing insolvency for the purpose of the Insolvency Act 1986. Under that act, there is no lacuna which requires filling by adopting an extended interpretation of the commercial insolvency test.

(3) It is not clear that the example given by Briggs J works. The undefined illiquid asset would normally be capable of being used to raise finance, even if not sold. In fact, it is suggested that most hypothetical examples will, on analysis, indicate either a failure to value properly current assets or ignore the ability of a company to obtain alternative financing in order to provide liquidity. And, if an example of such a case were to occur where winding-up was thought to be appropriate, the proper basis might

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> well be under Section 122(1)(g) ('the court is of the opinion that it is just and equitable that the company should be wound up').[13]

In any event, as a matter of construction of the contract in issue, Briggs J went on to conclude that (regardless of the true position under Section 123(1)) it would be perverse to hold that the parties had intended to limit the scope of the Insolvency Event clause in the way suggested by the creditors with short maturing liabilities (see paragraph 59 *et seq.*). Briggs J stated that he could not 'envisage any reason why the parties to the Common Terms Agreement and Trust Deed should have intended to confer an absolute priority on the holders of early maturing Senior Debt' which would be the effect of limiting the scope of the clause in the way proposed by the holders of such debt. The consequence would be that the Receivers would be obliged to go on paying early maturing Senior Debts in full, knowing that a failure to pay anything in respect of later maturing debts of identical seniority was 'a racing certainty'.

Whilst Briggs J accepted that there was force in the argument that the phrase 'is about to become' in the Insolvency Event definition governed the extent of the futurity envisaged by the parties, he concluded in fairly brief terms that, in all the circumstances, the inclusion of that phrase must have been 'a piece of thoughtless drafting which adds little or nothing to "is"'. The learned judge was convinced that the consequences of the submissions made on behalf of the creditors with early maturing debts was so commercially unacceptable that the notion of Insolvency Event had to be construed so as to permit consideration of the fact that Cheyne would probably, on the assumed facts, be unable to pay its debts in full at some point in the future. Whilst it could be argued that the commercially unacceptable consequences were a result of the earlier decision relating to 'pay as you go', the fact that an Insolvency Event would only have occurred (on the basis of the submissions by the holders of early maturing debt) at a point shortly before the assets ran out (thus leaving little in the pot to be distributed *pari passu* upon the occurrence of the Insolvency Event) would suggest that the ultimate result achieved by Briggs J over the course of the two judgments is probably the right one. However, Briggs J's willingness to disregard the express wording of the contract in order to reach what he thought was the commercial result is a fairly remarkable illustration of the contemporary approach to construction adopted by the English courts.

VI. Conclusions

It is unlikely that many English cases will call for the application of Briggs J's extended commercial insolvency test. Normally, the balance sheet test will suffice.

If the test is to be applied, the facts of the particular case will be very important. In most cases, one will not be able to say with the certainty required that debts falling due in the future will not be capable of being paid. Indeed, this point was alluded to by Briggs J at paragraph 57 where he commented that 'in the case of a company which is still trading, and where there is therefore a high degree of uncertainty as to the profile of its future cash flow, an appreciation that s. 123(1)(e) permits a review of the future will often make little difference'. If one has to be 'satisfied (a state of mind which calls for careful and thorough enquiry), that inability to pay is more likely than not' (paragraph 74), there may be many cases in which a creditor will not be able to persuade the Court to reach the required conclusion.

In Australia, the cases have tended to focus on debts falling due 'in the immediate future'[14] or 'the reasonably near future'[15] such that there is 'pending insolvency'.[16] The extent of any projection into the future has been described as being a matter of commonsense – that the conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity: see *Sandell v Porter* [1966] 115 CLR 666 at 670 and *Quick v Stoland Pty Ltd* (1998) 29 ACSR 130. To this we can now add the comments of Briggs J at paragraph 50, where he noted that the question of how far into the future the enquiry as to present insolvency may go 'is a fact sensitive question depending upon the nature of the company's business and, if known, of its future liabilities.'

In the case of Cheyne, the Court's determination was based on certain assumed facts. It was plain that Cheyne would probably be unable to pay its senior debts in full as they fell due merely by letting its own investments run to maturity and collecting the resulting cash. Investments had to be sold and the sale process was likely to have a significant effect on the market itself.

Notably, Cheyne was in run-off rather than remaining a going concern. Where a company is still trading, the applicability of Briggs J's extended commercial insolvency test appears very difficult. Traditionally, the possibility of acquiring future assets has been ignored

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13 See *In re European Life Assurance Ste* (1869-1870) 9 LR Eq 122 and *Re a Company (No. 003028 of 1987)* [1988] BCLC 282 at 294c (per Scott J).

14 Per Needham J in *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820 at 838.

15 Per Griffith CJ in *Bank of Australia v Hall* (1907) 4 CLR 1514 at 1527 and 1528.

16 *Supra*, per O'Connor J at 1537.

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when assessing balance sheet solvency[17] precisely because any such exercise is inherently speculative and uncertain. Yet the future trading prospects of a company which will affect future cash flow, and the ability of the company to pay its debts as they fall due, is in most cases an exercise which is also inherently speculative and uncertain. Concluding with the required degree of certainty that a company will be commercially insolvent at some point beyond the immediate future is likely to be very difficult outside the context of companies in run-off. If that is the case, what appears at first glance to be a significant extension of the test for insolvency under the Insolvency Act 1986 may turn out to be nothing more than a hypothetical possibility which, due to evidential difficulties, has little relevance for most run of the mill cases that practitioners will encounter.

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17 See *Byblos, supra*, at 247 as set out above.

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