HAIR-TRIGGER – RESPONDING TO THE SLIGHTEST PROVOCATION OR STIMULATION

WHEN IS A COMPANY CASH-FLOW INSOLVENT

Cheyne Finance
[2007] EWHC 2402 (Ch)

1. Insolvency clauses – clauses in contractual documents which stipulate serious consequences in the event that a party should become insolvent in some way – have a long pedigree and can be very effective (see, e.g., the review of deprivation clauses by Neuberger J. in *Money Markets International v London Stock Exchange* [2002] 1 WLR 1150). The insolvency trigger varies – compare *Wake-Walker v AKG Group Limited* [2003] EWCA Civ 375 and *MHMH Ltd v Carwood Barker Holdings PLC* [2004] EWHC 3174 (Ch); *[2006] 1 BCLC 27.* If the fact of insolvency (rather than formal insolvency) is chosen as the trigger, more often than not section 123 IA 1986 will be a reference point. That section contains both the statutory test for "cash flow" / "commercial" insolvency and also the "balance sheet" test.

"Cash flow" / "commercial insolvency" test

2. The "cash flow" / "commercial insolvency" test requires that it be proved to the court that the company : "is unable to pay its debts as they fall due" (IA 1986, s.123(1)(e)). The difference between this and the "balance sheet test"[1] was always considered to be plain sailing. In 1962 the court in *Re Tweeds Garages Ltd* [1962] Ch 406 (at 410) approved the following passage which appeared in the 13th edition (1957) of Buckley on the Companies Act :

   > "Commercial insolvency means the company being unable to meet current demands upon it. In such a case it is useless to say that if its assets are realised there will be ample to pay 20 shillings in the pound: this is not the test. A company may be at the same time insolvent and wealthy. It may have wealth locked up in investments not presently realisable; but although this be so, yet if it have not assets available to meet its current liabilities it is commercially insolvent and may be wound up."

3. In this way, it was always thought that the "cash flow" or "commercial insolvency" test had regard only to debts which are currently due and not to contingent or future liabilities (*Re European Life assurance Society* (1869) LR 9 Eq. 122 and *Re a Debtor (No 17 of 1966)* [1967 1 All ER 668).

4. The wording of what is now s.123(1)(e) has changed from time to time. The Companies Act 1862, s.80(4) provided that a registered company was deemed unable to pay its debts : "Whenever it is proved to the Satisfaction of the Court that the Company is unable to pay its Debts." It is easy to see how this provision might be construed as referring only to debts absolutely due for payment and not to debts due to be paid in the future. It involves an instantaneous view of what is presently due (this is re-inforced by the present tense "is").

5. Does the addition of the words : "as they fall due" in the modern formulation add anything ? It would now appear that they might. As appears below, the judgment of Briggs J in *Cheyne Finance* would suggest that the test now invites the court to take instead a progressive view, so that the court must assess whether the company can now pay its debts presently due and whether it can in the future pay its debts as they fall due. Before looking at his reasoning, it is appropriate to recall the relevance of such a debate.

Relevance of the "cash flow" or "commercial insolvency" test

[1] See ss.123(2) (registered companies) and 224(2) (unregistered companies) : "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 or prospective liabilities."

6. Apart from the small matter of constituting a statutory threshold for commencing formal insolvency proceedings against individuals, companies, partnerships and a host of special bodies, the "cash flow" or "commercial insolvency" test is also conventionally used as a trigger for adverse consequences in a wide variety of legal settings, e.g. :

   a. Loan/security agreements
   b. Guarantees
   c. Construction project documentation
   d. Romalpa clauses
   e. Termination provisions in leases/licences
   f. Deprivation clauses
   g. Contractual automatic termination clauses
   h. Franchise/Sponsorship agreements
   i. Joint venture/shareholder agreements
   j. Supply/Service agreements
   k. Protective trusts
   l. Insurance/re-insurance contracts

7. It is fair to say that such insolvency trigger clauses conventionally incorporate the whole of s.123 (cash flow and balance sheet insolvency) but this is not invariably the case. In the same way, the "cash flow" or "commercial insolvency" test is an internal trigger within the insolvency legislation itself determining the nature and extent of various rights and liabilities. The more obvious of these include s.240(2) IA 1986 (relevant time for the purpose of transactions at an undervalue and preferences) and s.245(4) IA 1986 (period of susceptibility of certain floating charges).

8. In *Fraser v Oystertec* [2004] BCC 233, the court observed in relation to the operation of an insolvency "divestment" clause that it would be undesirable for a company to be in a "hair trigger position" of potentially losing an asset by reference to the vicissitudes of cash flow. In the commercial context, certainty as to the meaning of s.123(1)(e) is highly desirable. Regrettably, the decision in *Cheyne* would appear to have created some uncertainty.

Cheyne – the disputed definition of "Insolvency Event"

9. Receivers appointed under a trust deed sought directions as to the true construction of a definition of "Insolvency Event" appearing in the security documentation. The essential question was whether they should take into account contingent or future debts when applying the cash flow test. There was a strong commercial imperative to obtain such a broad interpretation in that :

   a. Cheyne could pay its early maturing senior debt on a "pay as you go" basis, but this would have meant a forced sale of the asset portfolio.

   b. Such a sale could only have been achieved at a substantial discount with the result that the senior debt would not be paid in full.

   c. Therefore a finding that an Insolvency Event had occurred would provide the receivers with the best chance of realising the asset portfolio for the benefit of all those holding the senior debt.

10. The definition of Insolvency Event in *Cheyne* was as follows:

"**Insolvency Event** means a determination by the Manager or any Receiver that the Issuer [*Cheyne*] is, or is about to become, unable to pay its debts as they fall due to Senior Creditors and any other persons whose claims against the Issuer 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 the Issuer'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)."

11. The following points are immediately apparent :

    a. The parties omitted reference to s.123(2) – the balance sheet test.

    b. However, they had introduced into the statutory wording the following new words :"or is about to become".

    c. The new words plainly import some element of futurity.

    d. The new words resonate with the formulation in paragraph 11 of Schedule B1 to the Act : "or is likely to become unable to pay its debts" (compare the analysis of Jacob J. in *Re Colt Telecom* [2002] EWHC 2815 (Ch)).

12. It is surprising therefore that the court did not rely upon the new words ("or is about to become") as grounds for providing the receivers with the commercial answer which they desired. On the contrary, the judge found that the new words were irrelevant ("a piece of thoughtless drafting"). It was this finding which opened the door to a more expansive interpretation of s.123(1)(e).

Cheyne - Interpretation of s.123(1)(e)

13. Having referred to the decision in *European Life Assurance* (above), the judge noted that there was little authority on the meaning of the modern form of the cash flow test in s.123(1)(e). He did not refer to *JSF Finance and Currency Exchange Co Ltd v Akma Solutions Inc* [2001] 2 BCLC 307 in which Park J refused to take into account a contingent debt under s.123(1)(e) on the grounds that : "A contingent debt where the contingency has not happened has not fallen due".

14. The judge referred to a divergence of views expressed in academics works. In fact, of the writers referred to by the judge (Sealy & Milman, McPherson, Goode and Fletcher), it appears that only the 3rd edition of Professor Goode's celebrated work : Principles of Corporate Insolvency, favoured the incorporation of an element of futurity when applying the cash flow test (Professor Goode had expressed a different view in the 2nd edition).

15. Against this background of apparent uncertainty in this country, the judge then turned his attention to Australian jurisprudence. In Australia there is an express provision in the Corporations Act 2001, ss.95A and 459D that the court may take into account a contingent or prospective liability of a company when determining whether it is insolvent on the liquidity test – this has been so for some time (see e.g. *Brooks v Heritage Hotel Adelaide Pty Ltd* (1996) 20 ACSR 61). Nevertheless, the judge's conclusions based on the Australian jurisprudence formed the central plank of his reasoning that an element of futurity is admissible when applying the cash flow test in England.

16. In the event, Briggs J found that the words : "as they fall due" as they appear in s.123(e) are synonymous with the words "become due" as they appear in the Australian legislation. The Australian judges have decided that "become due" in their statutory test permits consideration of future debts. Therefore, he found that both formulations involved an element of futurity such that future debts are relevant to an inquiry as to whether the cash flow test has been satisfied under s.123(1)(e).

17. In paragraph 55 of his judgment, Briggs J reasoned as follows :

> "..a company may not always be balance sheet insolvent where an Australian style test for commercial insolvency is satisfied, as in this example: The company has £1,000 ready cash and a very valuable but very illiquid asset worth £250,000 which cannot be sold for two years. It has present debts of £500, but a future debt of £100,000 due in six months. On any commercial view the company clearly cannot pay its debts as they fall due, but it is, or would be, balance sheet solvent."

18. But such an analysis is abstracted and unreal. In this respect, context is everything. The company in question might be able to raise the necessary funds on the security of its illiquid assets, it might have a bountiful parent or shareholder or be able to raise funds aliunde. Six months can be a long time in the life of a trading company in a fluctuating market (as Jacob J. concluded in paragraph 87 of *Colt Telecom* (above) when dismissing suggestions that *Colt* was cash flow insolvent : "Such a shaky, tentative, and speculative peering into the middle-distance is no basis for forcing a company into administration"). As the playwright said : "what might happen is what keeps us alive."

19. In a sense, this level of abstraction is at the heart of Cheyne and it is essential to understand its closed universe. Cheyne was in run-off with no prospect of future business. As an entity, a Special Investment Vehicle, it was what the Americans describe as "bankruptcy remote". There were no external creditors and the only internal creditors had agreed (subject to the interpretation issues) the order and priority of payments between them. Even future cash flow projections were as concrete as office-holders are entitled to expect. In this sense, at least, in common with much of the problems which caused the credit crunch, Cheyne's was an unreal world.

20. In the end, it can be said that the judge was not persuaded by a literal interpretation of a provision (section 123(1)(e)) which does not in terms refer to prospective or future debts. He favoured a more "flexible" and "fact sensitive" interpretation of the phrase "as they fall due". On the facts, this appears to have been considered necessary in order to avoid an artificial result of conferring payment priority on the senior creditors who just happened to have shorter priority than other senior creditors of the same class. However, as noted above, both by reference to the bespoke clause which the judge was required to construe and also by reference to the special nature of Cheyne's structure, it would and should have been open to the judge to determine the construction point without the need for wider consideration of s.123(1)(e).

Cheyne – the implications

21. On a narrow, credit-crunch perspective, this new approach might well feature in an increasing number of solvency analyses. What (if any) are the broader implications ? It remains to be seen where the flexible approach to s.123(a) will lead us. In paragraph 57 of his judgment, Briggs J noted

> "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. In many, if not most, cases the alternative balance sheet test will afford a petitioner for winding up a convenient alternative means of proof of a deemed insolvency."

22. It has been suggested that, apart from tightening up future drafting, conventional wisdom might need to be revisited in various familiar situations which require an assessment of insolvency. Auditors might be more demanding of directors before agreeing to sign off on the accounts. Above all it has been suggested that existing drafting must be reviewed. But the objective intentions of the parties at the time should take into account the prevailing understanding when the contract in issue was signed. In his respect, one might be mindful of paragraph 97 of the judgement of the Court of Appeal in *National Westminster Bank v Spectrum Plus* [2004] Ch 337:

> "For twenty five years parties have used the form of debenture used in *Siebe Gorman* under the understanding that its meaning and effect were those held by Slade J. Not only will banks have relied upon this understanding, individuals will have guaranteed the liabilities of companies to banks on the understanding that the banks would first be entitled to look to their charges on book debts, unaffected by the claims of preferred creditors. In these circumstances, even if Slade J's construction of the debenture had appeared erroneous, I would have been inclined to hold that the form of debenture in question had, by customary usage, acquired the meaning and effect that he had attributed to it."

23. That said, trigger-happy cowboys may well find grounds in *Cheyne* to apply commercial pressure on and otherwise cause trouble for counter-parties who are subject to insolvency clauses incorporating the cash flow test. The decision in *Cheyne* might also cause a rise in fees in return for a waiver of default and/or provide increased leverage in restructuring or workouts. Remember Vince (Travolta) in Pulp Fiction: he had his finger on the trigger when Jules (Samuel L Jackson) went over the bump in the road.

Stephen Davies QC, Guildhall Chambers
Justin Bickle, Oaktree Capital Management

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