

Friday 30th August, 2013

Opening Plenary

9.00am – 10.00am

Paper by

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A light at the end of the tunnel? BNY in the UK Supreme Court

Banking and Financial Services Law Association

Gold Coast – 29 August 2013

A light at the end of the tunnel? – BNY in the UK Supreme Court

1. *Introduction*

“There is no branch of the law of England that exhibits such extraordinary specimens of contrariety of opinions and irreconcilable decisions as the Bankrupt Law”¹. So said Edward Christian in the introduction to his work on the subject in 1812. That may have been a fair comment about the state of the law in England at that time. Indeed when it was proposed that a similar system of bankruptcy law should be introduced in Scotland it met with determined opposition by the Scots lawyers. A quarter of a century later, in the preface to his edition of the leading 19th century textbook on Scots mercantile law², the editor noted that even when the English system had made great progress toward what might be described as perfection there was still resistance to the idea that the laws of the two jurisdictions should be made the same. As he put it, it might naturally be imagined that that would have been the most obvious and best course by that stage, as there was so much trade between Scotland and England:

“But there is some soul of good in things evil: national jealousy, and the repugnance which still prevailed [in Scotland] to an acknowledgment of superiority on the part of England, prevented any premature attempt to assimilate the jurisprudence of the two countries.”

As a result there are still some differences between the two countries in their laws relating to personal bankruptcy. Scots law still regards personal insolvency as a status, which is not necessarily accompanied by any active proceedings for sequestration. The great principle on

¹ Edward Christian, *Introduction to Christian's Bankrupt Laws, Vol 1* (London: Clarke & Sons, 1812).

² Professor George Joseph Bell's *Commentaries on the Law of Scotland*, 7th edition (Edinburgh: T & T Clark, 1870), vol 1, p x.

which it proceeds is that from the moment of his insolvency the debtor is bound in the conduct of his affairs to act as a mere trustee for his creditors³. But for all practical purposes, for obvious reasons of practical convenience, the laws for dealing with corporate insolvency have been assimilated. I hope that the system which we now have is good enough to withstand Edward Christian's withering criticism.

A clear definition of the expression "unable to pay its debts" is, of course, fundamental to any system of corporate insolvency law. In the United Kingdom the definition has for over 150 years been prescribed by statute, currently the Insolvency Act 1986. The most basic test, whether a company is unable to pay its debts as they fall due⁴ – the "cash flow" test, appears to be clear enough. And in the vast majority of cases, where that test can be applied, it causes no difficulty. The distress that it gives rise to is, of course, another matter.

That is something that the unsuspecting players and supporters of Rangers Football Club, the traditional rivals of Celtic in the Scottish Premier League, found out last year when their club had to go into administration. It owed over £9m to the Revenue for the payment of which the Revenue were not prepared to wait any longer, and it had run out of money. It was, and was likely to continue be, unable to pay its debts as they fell due. To the disbelief and dismay of the fans – and it, is fair to say, some supporters of Celtic and other rival clubs too – Rangers was ultimately relegated to the Third Division, and is now in the process of slowly climbing back up the ladder to the Premier League where it really belongs. Another club in the Premier League, Heart of Midlothian, found itself earlier this year in the same predicament. When a company cannot pay its debts as they fall due there is really no escape from action which is taken to protect their position by its creditors. But what if the creditors are still

³ Ibid, vol 2, p 171.

⁴ Insolvency Act 1986, section 123(1)(e).

being paid as their debts become due and payable but concern is being expressed about the state of the company's balance sheet⁵?

There is no doubt that for a long time there has been some uncertainty about the extent to which contingent and prospective, or future, liabilities can be considered in assessing a company's present inability to pay debts. The answer to that question may not matter all that much if the context in which the question is asked is an application for the winding up of the company. The statute uses the word "may". It indicates that, even if the insolvency court is satisfied that the company is currently unable to pay its debts, it has a discretion as to whether or not to grant the order⁶. This enables it to take account of the commercial realities of the situation and to be persuaded to look to the future and, perhaps, to take a long view. But it does matter very much indeed if the test is used for a different purpose altogether – to establish whether or not there has been a default in the area of structured finance and securitisation, and if for that purpose the court's discretion is written out of the test altogether.

That was the context for the discussion of the issue in the UK Supreme Court in *BNY Ltd v Eurosail plc*⁷. The directions of the court were sought as to whether an event of default had arisen under the terms and conditions which governed the issue of loan notes in the course of a securitisation transaction which comprised a portfolio of mortgage loans secured on residential property in the United Kingdom. Although the same answer to the question whether there was a default was given in the Chancery Division by the Chancellor, Sir Andrew Morritt⁸, by the Court of Appeal⁹ and, in its turn, by the Supreme Court, the

⁵ Ibid, section 123(2).

⁶ Ibid, section 122(1): "A company *may* be wound up by the court if...".

⁷ [2013] UKSC 28, [2013] 1 WLR 1408.

⁸ [2010] EWHC 2005, [2011] 1 WLR 1200.

reasoning differed in some respects at each level and the discussion revealed that there were inconsistencies in the approach taken by the lower courts to the earlier case law. The UK Supreme Court had to do what it could to resolve these differences. The question which everyone will no doubt now be asking is whether it was successful in doing that.

I must at once declare an interest, as I presided over the panel which heard the appeal in the Supreme Court. The other Justices were Lord Mance, Lord Walker, Lord Sumption and Lord Carnwath. All of us had some experience of insolvency law. In my case this was mainly when I was in practice at the Bar in Scotland. The routine cases which came my way were enlivened by challenges that payments should be struck down as gratuitous alienations or unfair preferences. This was a fertile area of practice for the young advocate. The financial crisis which led to the collapse of Lehman Brothers has, of course, generated a lot of work for the Supreme Court. Earlier this year, in a case from Scotland, the question was whether a claim by a Scottish subsidiary of an Icelandic Bank which had been hit by the crisis could be set off against the Icelandic Bank's claims in the Scottish Bank's insolvency, under a Directive which regulates cross-border matters in the European Economic Area of which both Iceland and the UK are part¹⁰. More recently still, the court has had to consider how to protect employees in the Lehman and Nortel group of companies from the consequences of an underfunded occupational pension scheme¹¹. The list goes on and on.

Of the five of us on the panel in *BNY*, Lord Walker was the undoubted specialist. Corporate insolvency is a field with which he was very familiar because of his many years in practice as a chancery specialist in Lincoln's Inn. So he was invited to write the judgment after we had

⁹ [2011] EWCA Civ 227, [2011] 1 WLR 2524.

¹⁰ *Joint Administrators of Heritable Bank plc v Winding up Board of Landsbanki Islands hf* [2013] UKSC 13, [2013] 1 WLR 725.

¹¹ *In re Nortel GmbH* [2013] UKSC 52. [2013] 3 WLR 504.

discussed the case among ourselves after the hearing. It was one of the last judgments that he wrote before he retired at the end of March this year. My task of explaining, and defending, that judgment is made much easier than it otherwise might have been had he not been with us on the hearing of that case.

2. What the case was about

I need to remind you first of how the statutory definition of inability to pay debts is currently worded in the UK's 1986 Insolvency Act. I am aware that the wording of the statutes which regulate these matters in New Zealand and Australia respectively is different. So it is worth recalling the UK wording, to set the context for this lecture.

Section 122(1)(f) of the 1986 Act provides that a company may be wound up by the court if it is unable to pay its debts. Section 123(1) sets out four situations in which a company will be deemed to be unable to pay its debts because of a failure to comply with a statutory demand, three of them depending on which of the various jurisdictions in the United Kingdom the issue arises. Section 123(1)(e) adds to this list a fifth, which requires the exercise of judgment by the court. It occurs "if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due." That situation, as we know, is commonly referred to as cash-flow insolvency. Section 123(2) then provides:

"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."

This situation, which also requires the exercise of judgment by the court, is commonly referred to as balance sheet insolvency.

What then of the facts? Eurosail was incorporated in England and Wales in 2007. It was a special purpose vehicle, designed for use in one transaction only. In 2007 it issued five classes of floating rate notes with maturity dates of 2027 and 2045. They were backed by a portfolio of mortgage loans which were secured on residential property in various parts of the United Kingdom. Most of the mortgages were non-conforming, in that they did not meet the lending requirements of banks and building societies. The margin between the amounts raised by the note issue and the price paid for the mortgages was also from the outset quite small – about 0.62%. The plan was that the interest and principal received by the issuer from the mortgages should cascade down a metaphorical waterfall, after claims for remuneration, charges and expenses, according to a series of priorities among the note-holders. The structure was designed for the long term, as the maturity dates of the notes indicate.

The issue, although simple in its conception, was accompanied by a series of agreements and other documents designed, among other things, to accommodate the risks due to the very small margin of assets over liabilities. This resulted in a huge volume of paper comprising many tens of thousands of words. Judges like myself who are not in the trade are astonished by the industry of those who put such things together. We wonder at the ability of those who have to apply and understand them. Indeed, the thought does pass our minds as to whether they really do understand them at all – can one mind really grasp what is going on? Fortunately for us, the point which we had to decide could be stated quite simply.

Under the conditions of issue of the loan notes the trustee, BNY, was entitled on the occurrence of certain specified events of default to serve on the issuer an enforcement notice declaring the notes to be due and payable. One of those events was that the issuer was unable to pay its debts as and when they fell 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 deemed unable to pay its debts...”¹²

The exclusion of the reference to proof to the satisfaction of the court is important. The discretionary part of the statutory formula for balance sheet insolvency – that the court “may” make the order – is omitted. Everything depends on a proper understanding the remaining part of the statutory formula – the jurisdictional part, as it was called during the argument. What do the words “the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities” really mean?

The basic scheme was that the note-holders’ returns on their investment was to be recovered when the mortgages were paid. In the meantime the issuer was paying interest as it fell due on all of the notes together with all its other accruing obligations. These payments were funded by the cash generated by the mortgages. So there was no question of the issuer being deemed to be unable to pay its debts as they fell due under section 123(1)(e). It was not cash flow insolvent. But five holders of a class of notes designated as A3, whose rights had not yet been fully redeemed unlike those in A1, and who were postponed to the A2 note-holders in the receipt of principal out of the funds received on the redemption of the mortgages but who would rank *pari passu* with them in the event of the service of an enforcement notice, had become concerned as to whether there would be a sufficiency of assets for them to be able to recover the cost of their investment. So they decided to contend that the state of the issuer’s balance sheet was such that it should be deemed to be unable to pay its debts under section 123(2).

¹² Condition 9(a)(iii); see the quotation in [2013] UKSC 28, [2013] 1 WLR 1408, para 5.

The situation which led to these proceedings arose in this way. The issuer's funding arrangements were accompanied by a series of currency swap agreements which were guaranteed by a subsidiary of Lehman Brothers. You can imagine what that led to. In September 2008 the guarantor filed for Chapter 11 bankruptcy, and two months later in November 2008 the swaps were terminated. Matters were made worse by the depreciation of sterling against the euro and the US dollar in which many of the notes had been denominated. The swap agreements were designed to make up for any losses arising from the depreciation of any of the three currencies. Their termination meant that actual losses were now being incurred whenever sterling was being converted to pay interest and to meet the issuer's liabilities arising on early redemption.

The prevailing low level of interest rates had resulted in a surplus of interest receipts. They had enabled the issuer to continue to pay interest in full on the notes of each class. But there was now a significant deficiency in its net asset position. So the A3 note-holders decided to take action to protect their position. The effect of the bankruptcy of the swap counterparty was to leave the notes unhedged against movements in the currency. The note-holders argued that an event of default had occurred. The lack of an effective currency hedge meant that the value of the company's assets was less than the amount of its liabilities, taking into account all of its prospective and contingent liabilities. Their case in essence was that, simply because the issuer's own balance sheet showed that this was so, an event of default had occurred.

The issuer and the A2 note-holders denied that the statutory wording had that effect. Their case was that, if the A3's approach was right, the issuer would be subject to an event of default at any time when the value of the loans was less than the value of the outstanding

principal. If that was correct, it would have a fundamental impact, not only on the Eurosail transaction which would have to be changed radically if it was to survive, but on many other similar securitisations as well. The structure had been intended to provide a robust and predictable means of allocating cash flows derived from loans over the long term under a carefully developed and elaborate contractual mechanism. Instead it would from the outset be inherently fragile and unstable, and liable to collapse into early enforcement at any moment. There was a lot at stake. That is why the trustee BNY decided to take the case to court for a direction.

3. The decisions below

At the heart of the A3 note-holders' case were the propositions that the statutory tests contained questions of jurisdiction and of discretion, and that they should be kept strictly separate from each other. The question of discretion extended not only to whether the company should be wound up because it was unable to pay its debts when they fell due under section 123(1)(e). It extended also to the question whether it should be wound up because it had a negative balance sheet for the purposes of section 123(2). In both cases, it would be open to the court to do what seemed to it to be right in its unfettered discretion. That would depend on the whole circumstances of each case. The jurisdiction question, on the other hand, did not require the exercise of any discretion at all. It was an arithmetical exercise. All it required was the striking of a balance between liabilities and assets. This was the only question by reference to which the issue as to whether a specified event of default had occurred was to be tested. This was because the question of discretion had been eliminated for the determination of that issue. It was also said that, looking at the matter more broadly in the interests of insolvency law generally, this analysis would provide the high degree of certainty which this area of the law required.

The Chancellor was asked to regard himself as bound by a passage in the judgment of Nicholls LJ in *Byblos Bank*¹³. The question in that case was whether, under section 223(d) of the Companies Act 1948, now repealed, the company was unable to pay its debts. The definition in section 223(d) required the court, in determining that matter, to take account of the contingent and prospective liabilities of the company. Nicholls LJ said it seemed to him that what was contemplated was evidence of the present capacity of the company to pay all its debts. The section, he said, was focussing attention on the present position of the company¹⁴. There was no justification for treating the assets of the company as being, at the material date, other than they truly were. There is an echo here of the well-known remark by Sir William James V-C in 1869 in *Re European Life Assurance Society*¹⁵ that the court has nothing to do with any question of future liabilities, or with the question whether any business that the company might carry on tomorrow or hereafter will be profitable or unprofitable.

The Chancellor rejected this submission. He said that the legislation with which he was now dealing was in materially different terms. His was the first time that the statutory requirement to take into account the company's contingent and prospective liabilities had required such close consideration. He had regard to the wording of section 123(2) of the 1986 Act which introduced that requirement, and to the judgment of Briggs J in *Re Cheyne Finance plc*. In that case the judge said¹⁶ that the effect of the alteration to the statutory test from that in the earlier legislation was to introduce a more flexible and fact-sensitive requirement. This was encapsulated by adding the phrase "as they fall due" to the cash flow test in section 123(1)(e).

¹³ *Byblos Bank SAL v Al-Khudairy* [1987] BCLC 232.

¹⁴ *Ibid*, p 247.

¹⁵ *In re European Life Assurance Society* (1869) LR 9 Eq 122, at 128.

¹⁶ *Ibid*, para 56.

In the Chancellor's view, therefore, the exercise that the balance sheet test in section 123(2) called for was not to arrive at a snap shot of the affairs of the company at a particular point of time. He was not suggesting that section 123(2) could not apply to a company whose assets and liabilities were such that it had obviously reached the point of no return. But he regarded himself as entitled to infer in this case that the value of the issuer's assets did exceed the amount of its present liabilities, having taken account of its contingent and prospective liabilities to such extent only as appeared necessary at that stage.

In the Court of Appeal the leading judgment was given by the then Master of the Rolls, Lord Neuberger. He recognised that the A3 note-holders' argument had the virtue of conceptual and practical simplicity. But he did not accept it¹⁷. He said that it would be rather extraordinary if the effect of section 123(2) was satisfied every time a company's liabilities exceeded the value of its assets. He did not think that it was satisfactory to have to rely always on the court's discretion to refuse to make a winding-up order. The commercial undesirability of the company being at risk of insolvency proceedings, even if they were likely to be dismissed, was self-evident. Such a mechanistic approach would only be justified if the words of section 123(2) compelled that conclusion. In his opinion they did not. In his view the purpose of section 123(2) had been accurately characterised by Professor Roy Goode, when he said¹⁸:

“If the cash flow test were the only relevant test [for insolvency] then current and short-term creditors would in effect be paid at the expense of creditors to whom liabilities were incurred after the company had reached the point of no return because of an incurable deficiency in its assets.”

¹⁷ [2011] 1 WLR 2524, paras 43-46.

¹⁸ *Principles of Insolvency Law* (3rd ed), para 4-06.

Developing this point in a passage part of which was to prove controversial¹⁹, Lord Neuberger then said that subsection (2) was included in section 123 to cover a case where, although it could not be said that a company was currently unable to pay its debts as they fall due (either because it has no debts which are currently payable or because it has, or can achieve, the cash flow to pay such debts), it was in practical terms clear that it would not be able to meet its future or contingent liabilities. A future or contingent creditor could often claim to be prejudiced by the company using its cash or other assets to pay current creditors. But, within bounds, that was an inherent risk in the futurity or contingency of the liability. It was only when it could be said that the company's use of its cash or other assets for current purposes amounted to what might be characterised as a fraud on the future or contingent creditors that it could be said that it had reached "the point of no return". In his opinion section 123(2) applied to a company whose assets and liabilities (including contingent and future liabilities) were such that it had reached the point of no return. It could only be relied on by a future or contingent creditor of a company which has reached the end of the road or in respect of which the shutters should be put up – imprecise, judgment-based and fact-specific as such a test might be.

Toulson LJ said that he agreed with the Master of the Rolls²⁰. Like him, he believed that Professor Sir Roy Goode had rightly discerned the underlying policy of section 123(2). But he appeared to put just a little bit of distance between himself and the Master of the Rolls as to the use to be made of the Professor's pronouncement. He said that while Professor Goode's reference to a company having reached the point of no return because of an incurable deficiency in its assets illuminated its purpose, it did not purport to be a paraphrase of it. Essentially what section 123(2) required the court to do was to make a judgment as to

¹⁹ [2011] 1 WLR 2524, para 49.

²⁰ *Ibid*, para 106.

whether it had been established that, looking at the company's assets and making a proper allowance for its prospective and contingent liabilities, it cannot reasonably be expected to be able to meet those liabilities. If so, it will be deemed insolvent although it is currently able to pay its debts as they fall due. But the more distant the liabilities, the harder this will be to establish.

It does not seem to have occurred to either judge that this difference in emphasis was all that important. Indeed Wilson LJ said that he agreed with both judgments²¹. But both approaches soon attracted critical attention. In an article from which Lord Walker was later to say that he had derived great assistance²², Dr Peter Walton said that Lord Neuberger's points about reaching the end of the road and putting the shutters up might be seen as rather stretching the wording of section 123(2), and he questioned whether they were sound. He noted that Toulson LJ had chosen rather different language to describe the test. But he said that Toulson LJ had brought uncertainty into his judgment by referring to the making of proper allowance for future and contingent liabilities and pointing out that it was reasonable to expect that, if the liabilities are far in the distance, the task of proving balance sheet insolvency will be that much more difficult.

This, said Dr Walton, seemed somewhat vague, and it paid no attention to what was intended by the predecessors of section 123(2). There was a strong argument, he said, that the Insolvency Act 1986 did not change the meaning of "inability to pay debts" from that which was given to the phrase by Sir William James VC in 1869²³, that the court has nothing to do with any question of future liabilities or with the question whether any business that the company might carry on tomorrow or hereafter will be profitable or unprofitable. There was

²¹ Ibid, para 212.

²² '*Inability to pay debts*': *Beyond the Point of No Return* [2013] JBL 212. See [2013] 1 WLR 1408, para 26.

²³ *In re European Life Assurance Society* (1869) LR 9 Eq 122, at 128.

also a strong argument that in assessing future and contingent liabilities for the purposes of balance sheet insolvency the court should consider only the current balance sheet of the company. A present day value can be given to assets and to future and contingent liabilities. After all, if on this approach a company is balance sheet insolvent even though still able to pay its debts as they fall due, the court retains a discretion not to make the order if it thinks that the company should not be wound up.

That, then, was the setting for the discussion of this issue in the Supreme Court.

4. The Supreme Court's judgment

Lord Walker began by examining the legislative history of sections 122 and 123 of the 1986 Act. Concentrating first on section 123(1)(e), which contains the phrase “if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due”, he observed that, unlike the other deeming provisions set out in that subsection, it does not treat proof of a single specific default by a company as conclusive of its inability to pay its debts. Instead its range was much wider because it focussed not on a single debt but on all the company's debts “as they fall due” – words which looked to the future as well as the present. Those words did not appear in the earlier legislation, nor did the express reference in section 123(2) to the test of whether the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. The courts below had treated those provisions as materially different from those previously in force. Yet a government spokesman had said when the 1986 legislation was going through Parliament that it was not seeking to amend the law.

This led him to undertake a careful review of the legislative history since the Companies Act 1862, whose general structure was similar to that which we have now. He concluded, in the light of the authorities including *Byblos Bank* that neither the notion of paying debts as they fell due or of balance sheet insolvency was unfamiliar before the enactment of the 1986 Act. But he was impressed by the judgment of Briggs J in *Re Cheyne Finance plc*²⁴ which drew on Australian authority as to the question of whether, under the pre-1992 test based on inability to pay debts as they become due, references to debts which will fall due in the future was permitted as well as to prospective or contingent liabilities.

Among the decisions noted by Briggs J was the observation by Griffith J in *Bank of Australasia v Hall*²⁵, where he said that the words “as they become due” required that some consideration should be given to the immediate future. More recently, in *Sandell v Porter*²⁶ Barwick CJ said that the conclusion of insolvency ought to be clear from a consideration of the debtors’ financial position in its entirety and, generally speaking, not drawn simply from evidence of a temporary lack of liquidity. The Chief Justice added this comment:

“It is the debtor’s inability, utilising such cash resources as he has or can command through the use of his assets to meet his debts as they fall due, which indicates insolvency.”

Briggs J noted that the cases since the introduction in 1992 of the formula now to be found in section 95A of the Corporations Act 2001, which has supplemented the familiar phrase “as and when they become due” by adding the words “and payable”, have continued this theme. But in *Southern Cross Interiors Pty Ltd v Deputy Commissioner for Taxation*²⁷ Palmer J held that those words added nothing to the formula based on the word “due”. Briggs J concluded that these Australian decisions showed that in an environment shorn of any balance sheet test

²⁴[2007] EWHC 2402 (Ch), [2008] 2 All ER 987.

²⁵(1907) 4 CLR 1514, at 1527.

²⁶(1966) 115 CLR 666, at 670.

²⁷(2001) ACSR 305.

for insolvency such as yours, cash flow or commercial insolvency is not to be ascertained by a slavish focus only on debts due at the relevant date. They showed that the common sense requirement not to ignore the relevant future was implicit in the simple phrase “as they become due.”

Lord Walker carried these thoughts forward into his analysis of section 123(2). The government’s position in Parliament had been that the changes which it introduced made little significant change in the law. But they did serve to underline the point that the cash flow test was not concerned 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 in the reasonably near future. And once the court has to move beyond the reasonably near future, any attempt to apply a cash flow test will become completely speculative. A comparison of present assets with present and future liabilities – the section 123(2) balance sheet test – becomes the only sensible test, although it is still far from exact. The onus must be on the party who asserts balance-sheet insolvency to show that it is satisfied.

He then turned to the judgment of the Court of Appeal. He said that the “point of no return test” was not the right test, if and in so far as it went beyond the need for the petitioner to show on balance of probabilities that the company had sufficient assets to meet all its liabilities. But he said that the Court of Appeal would have reached the same conclusion without any reference to it, and that he agreed with their conclusion. For him it was enough that the issuer’s ability or inability to pay all its debts, present or future, may not be finally determined until much closer to 2045 – more than 30 years from now. Two factors in particular led him to this conclusion. The first was the fact that the loan notes contained various mechanisms for ensuring that liabilities in respect of principal are, if necessary,

deferred until the final redemption date. The second was the fact that movements of currencies in the meantime, on which so much depends, were incapable of being predicted with any confidence. He said that the court could not be satisfied that there will eventually be a deficiency.

5. *Some reflections*

What is one to make of this remarkable case? There are, I suggest, five points that can be made.

First, I must acknowledge the part that the Australian cases have played in the development of thinking as to the meaning of the words “as they fall due”. It was perhaps unfortunate, as Lord Walker observed, that the judgment of Sir William James V-C in *Re European Life Assurance Society*²⁸ had come to be regarded as a leading case in England. His comment in 1869 that the court has nothing to do with the question of any future liabilities or with the question whether the question of the probability whether any business which the company may carry on tomorrow or hereafter will be profitable or unprofitable was still being referred to with approval in the Court of Appeal as recently as 1987, when Nicholls LJ said in the *Byblos Bank* case²⁹ that the exercise described by James V-C was the exercise that required to be done under section 223 of the 1948 Act, which had been re-enacted as section 518 of the Companies Act 1985. There is no doubt that the Australian approach to the interpretation of section 95A(1) of the 2001 Act, which was so helpfully set out by Briggs J in his judgment in *Re Cheyne Finance plc*³⁰, made it much easier for the Supreme Court to reach the decision that it did. The UK legislation is, of course, different because it includes the balance sheet test set out in section 123(2) which, because it was seen not to answer the question whether

²⁸ *In re European Life Assurance Society* (1869) LR 9 Eq 122, at 128.

²⁹ *Byblos Bank SAL v Al-Khudairy* [1987] BCLC 232, 248.

³⁰ [2007] EWHC 2402 (Ch), [2008] 2 All ER 987.

the company's business was viable³¹, Australian law has rejected. But the words "as they fall due" in section 123(1)(e) form an essential part of the background to a proper understanding of what the following subsection, section 123(2), means. If, as the Australian jurisprudence tells us, the question whether there is an inability to pay debts as they fall "due" is not to be ascertained by a slavish focus only on debts due at the relevant date, and that it is common sense not to ignore the relevant future, the same approach, surely, is appropriate when one comes to consider how to apply the balance sheet test under our law. The development of that understanding was, for us, a significant step forward.

Secondly, the putting to bed of the "point of no return test" was helpful. Lord Neuberger was, of course, right to see that test as imprecise and judgment-based, as was his analogy of putting the shutters up. If so, the question which has to be answered will always depend on the circumstances. But the use of these words did appear to raise the bar for a successful application under section 123(2) rather high. Nor was there any very good reason for doing so, other than Professor Goode's comment about the purpose of the subsection. But that comment was meant simply to illustrate, not to paraphrase. It has to be admitted too, as Dr Peter Walton pointed out in his article³², that the use of the phrase "point of no return" was stretching the meaning of the statutory language. It does not say anything about the standard to be applied. It is right to notice, however, that Dr Walton's approach was rather reactionary. His point was that the answer to the way future and contingent liabilities were to be assessed for the purposes of the balance sheet test was to be found in James V-C's judgment in the *European Life* case³³, which Lord Walker has rejected. That was why he was unhappy too with Toulson LJ's way of describing the balance sheet test which, despite what Dr Walton said, was endorsed by Lord Walker in the Supreme Court.

³¹ Ford's *Principles of Corporation Law* (13th edition), para 20.100, p 979.

³² See fn 18, above.

³³ See fn 24, above.

Third, the references by Lord Neuberger to Professor Goode and by Lord Walker to the assistance that he had derived from Dr Walton's article are themselves of some interest. When I was starting life at the Bar over 40 years ago we were firmly told that no reference was to be made to any textbook or article unless the author was dead. This was because it was not until he (or she – but on those days the idea that reference could possibly be made to an article by a woman was not in contemplation) had died that one could be certain this was their last word. Also judges in those days did not like being told what to think by those who were not judges. How things have changed, and how much better we are for it. Of course judges may be tempted, as Lord Neuberger perhaps was and I very probably would have been too, to go perhaps a little further than they might otherwise have done by a remark by an academic of such distinction as Professor Goode. But I can say from my own experience that the debt that we owe to the specialist commentators in an area of the law which is so complex, and yet so much in need of being practicable, is very great.

Fourth, it is worth reminding ourselves of a point made by Toulson LJ in the Court of Appeal³⁴ that another temptation, to decide the case in the way that would seem to make the best commercial sense in the particular context of a securitisation agreement, had to be resisted. As he said, he saw much force in the argument that it would cause considerable concern in the securitisation market if section 123(2) were to be interpreted in the way for which the A3 note-holders contended – in other words, that the questions of jurisdiction and discretion had to be kept separate from each other. As far as the jurisdiction question was concerned, it was argued that the approach should be that indicated by James V-C and Nicholls LJ, which excluded any contemplation of what the future might hold. The effect of

³⁴ [2011] 1 WLR 2524, para 108.

this approach on the agreement was plain for all to see. But, as Toulson LJ said, to construe the section by reference to the particular interests of players in the securitisation market would be to allow the tail to wag the dog. The task was to construe the agreement by reference to the statute, not the statute by reference to the agreement. The Supreme Court was, of course, very much conscious of this point too. I do not think that there could be said to be any indication in Lord Walker's painstaking judgment, in which he took so much trouble to search for the true meaning of the words of the statute, that he was deflected from that task in the slightest by concern as its effect on the meaning and effect of the agreement.

This leads on, however, to the fifth point, which I hinted at earlier. The legal documents that seem to be thought necessary to support a securitisation issue of this kind are, as Lord Walker observed³⁵, forbiddingly voluminous. One has to ask how much thought those who were responsible for the definition of the event of default that was in issue in this case gave to the effect of the formula that they adopted. By adopting the wording of section 123(2) stripped of the reference to the function that the subsection gives to the court in its application, they were removing the element of discretion which in practice will always have a part to play in the decision whether a winding up order should be made. They were exposing themselves to what the A3 note-holders referred to as the jurisdiction test only. The convenience of doing so is obvious, of course. The occurrence of the default event was intended to be capable of being identified according to its own terms. The delay and uncertainty of having to rely on the court to provide the answer is eliminated. So far so good. But did they ask themselves what this test really meant?

³⁵ [2013] 1 WLR 1408, para 10.

The documentation of the issue was prepared in 2007, a year before the collapse of Lehman Brothers which created so much damage to all sectors of the market around the world – and has created so much work for us lawyers in its turn. It was period when everything seemed to be going so well. The Chancellor of the Exchequer in the UK, Gordon Brown, was proclaiming that the days of boom and bust were over. Perhaps the idea that a strict approach might be taken to the application of the balance sheet test was not thought to be likely to cause any difficulty in that atmosphere of unbridled optimism. The swaps counterparty was in place and there was a margin, albeit rather small, between the amounts raised by the note issue and the price paid for the mortgages. But it should surely have been obvious to anyone who had studied the case law, including the judgment of Nicholls LJ in *Byblos Bank*, that it would not require much of a change of fortune to expose the issuer to the risk of being held to be in default. The postponed note-holders such as those who brought these proceedings would not have been concerned about that. But those who were being given priority, and the issuer itself, certainly ought to have been. Any document drafted in optimistic times using the standard balance sheet insolvency test, especially in a transaction with such narrow margins, will be vulnerable. There is perhaps a warning here that in the mass of documentation that surrounds transactions of this kind, much of it no doubt the product of the word processor, there may be lurking a time-bomb, a trap for the unwary, which in a less complicated set of documents would attract more attention.

6. *Looking ahead*

Finally, what about the future? I am not sure what you who practise in New Zealand and Australia will derive from this decision, except the glow of satisfaction that we all feel when we see that judges who are engaged in comparative legal analysis recognise that the judges in another jurisdiction have shown them the way forward. Perhaps our decision will lead

Australian law to look more kindly on the balance sheet test. It was rejected because, as the editors of Ford's *Principles* explain³⁶, the legislation is concerned with the failure of a unit in a trading environment – with the viability of the company's business by reference to ability to trade. The decision in the *BNY* case shows that, on our approach, the balance sheet test too meets that requirement.

We have yet to see what effect Lord Walker's analysis of section 123 will have in the UK outside the specialised field of securitisation. In practice, I would suggest, not very much. The court retains a discretion as to whether or not there should be a winding up order, and the government made it clear that it was not the purpose of the new statutory formula to change the law. But the analysis may in practice, as Lord Neuberger suggested when he was advocating the "point of no return" test³⁷, do something to protect a company which is still able to pay its debts as they fall due from the commercial undesirability of being at risk of being wound up simply because the aggregate value of its assets is less than its liabilities on any given day. I do not think that anyone is likely to complain about that. The distinction between the questions of jurisdiction and of discretion on which the A3 note-holders relied is being collapsed somewhat, but the statute itself does not say that they must be dealt with separately. What the academics will make of the analysis has yet to be seen. But I believe that Professor Goode's description of the purpose of section 123(2), read in its context, should still carry some weight.

I have included in my title for this lecture the question – is there a light at the end of the tunnel? I am not going to be so bold as to suggest that this is a way of expressing the test which should now be applied to section 123(2). But it is meant to indicate that the chances of

³⁶ See fn 31, above.

³⁷ [2011] 1 WLR 2524, para 45.

a company which can still pay its debts as they fall due, but whose current balance sheet does not look all that good, being wound up under section 123(2) are a bit less than they were before. That, I think, is in sympathy with the Australian approach, which looks for liquidity in a trading environment. As we all live and practise in an increasingly globalised economic community, that must be good thing.

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22 August 2013

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