Institution: UNIVERSITY OF WOLVERHAMPTON

Unit of Assessment: LAW

Title of case study:

Overruling the "point of no return" test in the statutory meaning of "inability to pay debts"

1. Summary of the impact (indicative maximum 100 words)

The statutory definition of "insolvency" involves proving a debtor's "inability to pay debts." In corporate insolvency, this definition is found in s123 Insolvency Act 1986. Although s123 has existed for over a hundred years (in various forms), its meaning has not been fully understood. The historical explanation of this definition, found in the underpinning research, as to the true meaning of the definition, has been adopted by the Supreme Court (in May 2013) in *BNY Corporate Trustee Services Limited v Eurosail* [2013] UKSC 28 in overruling the Court of Appeal's "point of no return" interpretation of s123.

2. Underpinning research (indicative maximum 500 words)

The research was carried out by Professor Peter Walton. Walton has been an academic at the University of Wolverhampton for 25 years. The research in question took place during the REF census period, specifically during the Summer and Autumn of 2011. Walton carried out an in-depth doctrinal and historical analysis of the statutory meaning of "inability to pay debts". The research activity involved two research trips to the Bodleian Library (to locate and consider mostly nineteenth century texts), searching Hansard online and reading cases and legislation. The research issue had been suggested to Walton by Stephen Davies QC at the Insolvency Lawyers' Association Academic Colloquium in Spring 2011 as an important practical matter which would benefit from full academic analysis.

Prior to the research, no academic or court had fully considered the judicial and Parliamentary development of this important statutory definition. The Court of Appeal's 2011 decision in *Eurosail* ([2011] EWCA Civ 227) was based upon a number of misconceptions as to how and why the law had developed in the way it did. The Court of Appeal's decision on the meaning of "balance sheet" insolvency (defined in s123(2)), that a company was only unable to pay its debts once it had reached the "point of no return" was shown by the research to be erroneous.

Until recent times it was widely assumed that where a company's liabilities outweighed its assets, it was balance sheet insolvent. The problem faced by the courts in the period following the Insolvency Act 1986, and specifically in *Eurosail*, arose when the courts were asked to take account of "contingent and prospective liabilities" in assessing balance sheet insolvency under section 123(2). The Court of Appeal's understanding of the history and effect of this phrase led it into error.

The explanation provided by the underpinning research showed how contingent and prospective liabilities are to be taken into account when assessing balance sheet insolvency (and indeed "cash flow" insolvency under section 123(1)(e)). For example, the historical background to the statutory definition was explored and explained, beginning with the law up to and including the critical case of *Re European Life Assurance Society* (1869-70) LR 9 Eq 122, the effect of which was to lead to a new definition of insolvency for insurance companies only in the Life Assurance Companies Act 1870. The link between the 1870 definition, through the Loreburn Committee Report (1906 Cd 3052) to the wording of the Companies Acts 1907 was identified by the research (and referred to by the Supreme Court at para 29 of Lord Walker's judgment). The research explained that the1907 wording remained essentially unchanged up to, and including, section 518 Companies Act 1985. Its wording then underwent some changes in becoming section 123 Insolvency Act 1986.

It was this change in wording that permitted some courts of first instance and the Court of Appeal in *Eurosail*, to decide that the new wording must mean something different to the old wording. The underpinning research showed clearly that Parliament's intention had been to clarify the previous wording's

meaning and not to change it. The crucial Parliamentary statement relevant to this point had not been identified by the Court of Appeal but the Supreme Court repeated the quotation uncovered by the underpinning research and relied upon it in reaching its conclusions.

The research is published in a high quality law journal. The research was relied upon by counsel (Gabriel Moss QC and Richard Fisher) for the appellants in the *Eurosail* hearing before the Supreme Court. Counsel included the article in the Supreme Court trial bundle. Lord Walker, in giving the leading judgment of the Supreme Court "derived great assistance" (at para 26 of the judgment) from the research.

3. References to the research (indicative maximum of six references)

Peter Walton '"Inability to pay debts": Beyond the Point of No Return?' [2013] *Journal of Business Law* 212-236

(listed in REF 2)

4. Details of the impact (indicative maximum 750 words)

The contribution, impact or benefit (Maximum 750 words)

The Supreme Court used the underpinning research in order to explain the meaning of s123 in reaching its decision in *Eurosail*. Lord Hope, who presided over the Supreme Court decision, has recently described the significance of the meaning of s123. His Lordship stated extra-judicially in August 2013 (to the Banking and Financial Services Law Association, Gold Coast, Australia, in a speech entitled *A light at the end of the tunnel? – BNY in the UK Supreme Court*) that a: "clear definition of the expression "unable to pay its debts" is, of course, fundamental to any system of corporate insolvency law."

The explanation of what is arguably the most important definition in insolvency law is impactful in the immediate context of s123. This provides the test for whether or not a company is insolvent which, if satisfied, permits the court to make a winding up order. A possible finding of balance sheet insolvency is a particular concern for large pension funds which may technically fall within s123(2) due to large contingent liabilities and consequently be wound up insolvent even though they are able to pay their debts as they fall due. If the meaning of s123 remained uncertain (as it was after the Court of Appeal decision in *Eurosail*), such pension funds would remain concerned as to their potential for being wound up insolvent on the basis of large future and contingent debts (that is, the liability to pay pensions in the future). The potential in this context for widespread economic and social disaster cannot be understated.

The s123 definition is also incorporated by reference into a number of other important Insolvency Act 1986 provisions (e.g. ss 214A, 238, 239 and Schedule B1, para 11). In particular, it is used daily by liquidators and administrators in proving the requirements to attack transactions at an undervalue under s238 and voidable preferences under s239. These are the most commonly used office holder transaction avoidance provisions and bring in millions of pounds per annum into insolvent estates. Without a clear understanding of the meaning of s123, such actions would be made less common and more uncertain.

Section 123 is also widely adopted in drafting commercial agreements where it is used as the trigger for default permitting one party to terminate the agreement or to take enforcement action. It was in the context of incorporation into a commercial agreement, governing a complex securitisation transaction entered into by the collapsed Lehman Bros group, that the *Eurosail* case was fought. The consequence of the *Eurosail* decision cost the claimant in the case millions of pounds but did have the significant effect of confirming that many other such securitisations (involving many hundreds of millions of pounds) are unlikely to be attacked as being balance sheet insolvent based upon future and contingent liabilities. The Supreme Court interpretation of s123 brings certainty to the solvency status of such widespread and significant investment vehicles.

It is highly unusual for the most senior court in the United Kingdom to adopt the work of an academic as setting the scene for its judicial debate and decision making. The impact of the research can be seen from the

fact that their Lordships recognised the specialist nature of the research and the practical consequences of it (please see the next section for Lord Hope's description of this process in this specific case).

The beneficiaries of the research are lawyers, insolvency practitioners and their respective clients including major pension funds and banks. It is critical to understand the meaning of insolvency in order to advise both businesses which find themselves in difficult financial positions and office holders representing businesses which have already entered a formal insolvency procedure. It is equally critical that parties to commercial agreements (including but not limited to loan agreements) can fully understand the terms being used in those agreements. Certainty in law is important to society generally especially when the law involves such a fundamental concept as the meaning of "inability to pay debts".

5. Sources to corroborate the impact (indicative maximum of 10 references)

1. *BNY Corporate Trustee Services Limited v Eurosail* [2013] UKSC 28 (specifically at para 26)

2. Lord Hope speaking extra-judicially to the Banking and Financial Services Law Association, Gold Coast, Australia in a speech entitled *A light at the end of the tunnel? – BNY in the UK Supreme Court* 29 August 2013 which may be found at: http://www.supremecourt.gov.uk/docs/speech-130829.pdf made a number of comments explaining the relevance of the underpinning research and its central nature to their Lordships' deliberations in *Eurosail*. His Lordship explained:

"*In an article from which Lord Walker was later to say that he had derived great assistance, 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 1869, 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 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."

3. Lord Hope continued in explaining the specialist and practical nature of the underpinning research:

"[*T]he references … 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 … 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 … 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*."

4. In addition to the *Eurosail* case itself and the extra-judicial comments of Lord Hope, it is possible to see the relevance of the case (and therefore the research informing it) from considering the number of commentaries made by practitioners about the case, both in law journals and on the websites of large commercial solicitors' firms. For a selection of such writings please consider the following:

Lowe "A pragmatic approach from the appeal courts" (2013) 26 Insolvency Intelligence 80

Bailey "Supreme Court retreats from the point of no return on inability to pay debts" (2013) *Company Law Newsletter* 1

http://www.mycorporateresource.com/index.php?option=com_content&view=category&layout=blog&id=1850&Itemid=205910