Briefing

BURGES SALMON

Corporate Turnaround and Insolvency

Can an entity whose debt obligations are limited in recourse be said to be balance sheet or cash flow insolvent?

Can a debtor be found to be balance sheet or cash flow insolvent even though its obligations are limited (in terms of creditor recourse) to the available assets? This was the question facing the High Court in *Re ARM Asset Backed Securities SA [2013] EWCH 3351*.

The background

ARM was an issuer of Luxembourg law governed bonds, backed by investments in US life insurance policies (through a Delaware based trust). The trust remitted proceeds to the company to allow it to meet bond obligations as and when they matured. The bonds themselves contained "limited recourse" provisions, meaning that bond holders could not receive more from the company than the assets it had in hand.

Day to day management of the company was carried out in London. A licence from the Luxembourg regulator was not initially sought. When its later application was refused, the company stopped taking on new business. Its directors, realising that the company could not service its bonds even though they were limited in recourse, sought a winding up order on the grounds that it was just and equitable to do so. They also sought the appointment of provisional liquidators.

The issues

The issues for the court were: (i) whether the company's COMI was located in England, (ii) whether the company could be said to be balance sheet or cash flow insolvent and (iii) whether it was appropriate to appoint provisional liquidators.

What did the court decide?

On the COMI issue, the court was satisfied that the fact the company's decision-making and administration was conducted from London (and that was apparent to third parties) was sufficient to rebut the presumption that the location of its registered office (Luxembourg) was the centre of main interests.

The court also decided that the company was balance sheet insolvent. Much reliance seemed to have been placed on the fact that bond holders would be entitled to submit proofs of debt for the full face value of their bonds, regardless of whether there would be assets available to meet them. It was clear that assets would be insufficient to meet the company's liabilities, and therefore the company was insolvent on both a balance sheet and a cash flow basis.

On the issue of the appointment of a provisional liquidator, the court decided that it was appropriate to do so, both on the basis that it was almost inevitable that a winding up order would be granted and - although assets would not be in immediate jeopardy - a liquidator would be better placed than the directors to propose a CVA or scheme of arrangement in order to realise the company's assets in an orderly manner.

What does this mean for practitioners?

It is unlikely that this will be the last we hear about this issue. The decision was made seemingly without reference to the Supreme Court decision in Eurosail (the subject of a previous bulletin by this firm), nor was the issue of whether a bond holder's proof for the full amount of their debt would actually be admitted to proof addressed. It is uncertain whether limited recourse provisions would entitle a full proof of debt to be admitted (particularly in light of Eurosail) and therefore whether balance sheet or cashflow insolvency are appropriate measures for an entity such as ARM (leaving aside issues of licensing by the Luxembourg authorities).

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