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**Introduction**

The company’s **inability to pay debts** is the most common ground for the winding up of companies and, by definition, all-encompassing in the case of insolvent companies.

Under Maltese law section 214 (a) (ii) of Company Act 1995 states that the company may be dissolved and wound up by the court in case of the company is unable to pay its debts. The definition of this ground is to be found in sec. 214 (5) of Company Act. Based on it the inability to pay debts of the company can be proved by the way of **two alternative tests**: cash flow test and balance sheet test. These tests have different purposes. In simple words, cash flow test is in general about the debts which have already become due; balance sheet test is about the liabilities, e.g. contingent and prospective debts.

Before the consideration of these tests I would like to mention that even though Maltese Insolvency law is mainly based on UK Insolvency law, there are some **differences between Maltese law and UK law** in this question. The first difference is that under UK law the ground inability to pay debts can be applied in four scenarios, while in Maltese law there are only two of them. UK law describes the inability to pay debts in Insolvency Act 1986[[1]](#footnote-1). Also there is a difference between UK and Maltese cash flow test, it will be considered later on in this paper.

**Cash flow test and balance sheet test**

**Cash flow test** is more for the lawyers because you do not have to work with accounting documents of the company. All you need is the state of a fact that there is a debt unpaid for the period of 24 weeks after the issue of executive warrant on the basis of executive title.

The scheme of cash flow test can be represented as followed. There are two companies A and B. A owns B some money and does not pay it when it is due. B starts the case in a court against A and wins it, e.g. court issues a judgment in favour of B. A judgment is an executive title[[2]](#footnote-2). In perfect situation A must pay its debts to B on the basis of this judgment. But usually companies do not do it. Then a judgment creditor is appointed. The judgment creditor has a power to issue an executive warrant[[3]](#footnote-3). Usually it can be in three copies to the different banks where A has its accounts. The banks, in their turn, freeze the accounts of A and send the debt money on the accounts of B. If this scenario does not work, then B has to wait 24 weeks from the moment of issue the executive warrant and after can start the winding up proceedings against A.

Under UK law the cash flow test is different[[4]](#footnote-4). The company is deemed to be unable to pay its debts if a creditor to whom the company owes more then £750 immediately payable has delivered to it at its registered office a notice and the company has for three weeks thereafter neglected to pay the debt. Moreover, these twenty-one days should be clear. If the creditor presents the petition for winding up before the expiration of the time, he will not be able to rely on the company’s failure to comply with his demand for payment in the notice as proof of its inability to pay debts[[5]](#footnote-5). Above all, it must be shown that the company has neglected to pay the debt demanded. If the company, in good faith, disputes its liabilities, it can not be said to have neglected to pay the sum demanded[[6]](#footnote-6).

Observing the authors, we find Sealy stating that cash flow test is the most common reason for making the winding up petition. Another author, Pennington, makes the definition of cash flow test very simple. Everything reduces to the presence of current cash. If a company does not have a cash to pay to a creditor, it is deemed to be insolvent.

**Balance sheet test** is more for the accountants. The balance sheet test for insolvency was first introduced in UK law in Insolvency Act 1985[[7]](#footnote-7). Balance sheet test will is to be satisfied if the company is unable to pay its debts on prospective and contingent liabilities. Maltese legislation endorsed balance sheet test. It is described under Maltese law in section 214 (5) (b) of Company Act 1995, and under UK law in section 123 (2) of Insolvency Act 1986.

Balance sheet test is a “red light” for the potential creditors. This solvency is very important for the creditors who are in a position to invest their money in a company. Usually, balance sheet test is more preferable than cash flow test because the creditors are more protected with it by giving them an opportunity to take into consideration future liabilities of the company and not only its present financial position. In other words, this test is much fair both to the company and the creditors. So, this test is all about the future possible liabilities, and the circumstances are varied depending on the particular case.

**The reasons of not having a single test**

These two tests are alternative. The test is to be chosen by a person who brings the application to the court. **The reasons of having not a single test** are following:

* 1. The company may fail cash flow test but satisfies balance sheet test (e.g. be balance sheet insolvent), and it still may be liquidated. And reverse situation: Prof. Prentice shows that the company may be balance sheet solvent but cash flow insolvent. As an example we can consider the *Cornhill Insurance* case[[8]](#footnote-8). The insurance company owned some amount of money to a certain person. For some reason it decided not to pay it. According to contingent and prospective liabilities it was solvent, but according to the fact of not paying the debt it was insolvent. In conclusion court stated the inability to pay debts.
  2. It is much easier to state the fact of satisfaction of cash flow test than balance sheet test because the latter one needs the access to information (which not everybody will be glad to give on request) and special expert knowledge to read and understand that information. Besides, it is not so easy for a person to construct a true and fair value of the company. On the other hand, there can be some problems of accuracy connected with cash flow test.
  3. The minus of having cash flow test on its own can be illustrated with the following situation. There can be a sole creditor having a small claim against the company. That creditor because of some reason decided to request the winding up of the company. Therefore the remedy is excessive and not proportional to the claim. The main interest and purpose of the Insolvency law is the protection of the creditors. The creditors can not be sufficiently protected with cash flow test on its own. Prof. Goode states that balance sheet test adds more protection to the companies, while cash flow test makes individuals more protected.

**The treatment of the debts and liabilities under the both tests**

The definitions of debts and liabilities are to be found in UK Insolvency Act 1986. According to it,

“**’debt’** is to be construed in accordance with following: the bankrupt is deemed to become a subject to that liability [a bankruptcy debt] by reason of an obligation incurred at the time when the cause of action accrued”[[9]](#footnote-9).

“**’liability’** means a liability to pay money or money’s worth, including any liability to under an enactment, any liability for breach of trust, any liability in contract, tort or bailment and any liability arising out of an obligation to make restitution”[[10]](#footnote-10).

In the Insolvency Rules 1986 we can find following:

“’debt’ means any of the following –

1. any debt or liability to which the company is subject at the date on which it goes into liquidation;
2. any debts or liability to which the company may become subject after that date by reason of any obligation incurred before that date”[[11]](#footnote-11).

The very important provision is the rule 13.12 (3). It states that –

“ for the purposes of references in any provision of the Act [Insolvency Act 1986] or the Rules, it is immaterial whether the debt or liability is present or future, whether it is certain or contingent, or whether its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion”.

The term “liability” is wider than term “debt”. Under the alternative tests debts and liabilities are treated differently.

Under cash flow test, the company is unable to pay its debts if it can not pay them as they fall due out of cash or very liquid assets, and it can not pay all its debts over a lengthy period of time by a steady realization of all its assets. But on the other hand, cash flow test does not deal at all with the debts and other liabilities of the company which have not been accrued due, or which are liabilities for not liquidated damages.

In *Re Capital Annuities Ltd[[12]](#footnote-12)*, it was held that inability to pay debts occurs where company’s present, contingent and prospective liabilities exceed the present value of its assets. So, under balance sheet test, the company is unable to pay its debts if the value of its assets is less that the amount of its liabilities. Before 1871 the court could not take account of prospective and contingent liabilities in making this assessment. Since those liabilities are very important for the insurance companies, in that year it was provided that account should be taken of such liabilities of determining the solvency of those companies[[13]](#footnote-13). Later on, in 1907 these liabilities were made applicable to assessing the solvency of all other companies[[14]](#footnote-14) Maltese law fails to define what contingent and prospective liabilities are. That is why we have to refer to UK case law. One of the most important cases in insolvency is *Byblos Bank SAL v Al-Khudhairy* [1987]. Here the court outlines certain guidelines which will be considered when assuming whether or not balance sheet has been satisfied. Firstly, the court will take into consideration the fact that the company has ceased to carry out its business. If it definitely happens, than court can apply balance sheet test as possible technique. Secondly, the court has to draw the distinction between accrued liabilities and those which may accrue in future connected to transactions already entered to. It should be done because accrued liabilities are definite debts. The liabilities which may accrue are dispute debts: if it takes very long period of time to repay these liabilities that they can be taken into consideration when applying balance sheet test. Also court held that no assets should be taken into consideration in balance sheet test if they may accrue in future. As to contingent and prospective liabilities, in the *Byblos Bank* case express provision were maid to include those liabilities in determining the company’s solvency.

In the other case, *Taylor’s* *Industrial Flooring Ltd v Malta & H Plant Hire (Manchester) Ltd*[[15]](#footnote-15) court held that the proof by a creditor that his debts has not being paid is the prima facie evidence that the company is insolvent if the company gives no reason for not paying it.

In Malta the judgment concerning balance sheet test is *Axel* *Johnson International AB vs. Aluminum Extrusions Ltd* (28/05/2003). In this case the court:

1. held considerable discretion and determined the dissolution and winding up of the company;
2. summed up its role within this context as debts inquiring to the general situation of the company: either determines that the winding order should be issued, or that the company will be able to operate in the future and will be in position to pay its debts;
3. took into consideration contingent and prospective liabilities when applying balance sheet test;
4. declared the defendant company to be insolvent as its liabilities are far exceed its assets, and ordered the dissolution and winding up of the company on the basis of Article 214 (2) (a) (ii) – inability to pay debts.

In conclusion, I would like to make it clear one more time. Cash flow tests deals only with debts that have already become due. Balance sheet test deals with future liabilities and future payments as well as available now assets. Balance sheet test take into consideration prospective and contingent liabilities.

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4. Michael Forde “*The Law of Company Insolvency*”, The Round Hall Press, Dublin, 1993.
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6. Pennington, Robert R. “*Pennington’s Corporate Insolvency Law*”, Butterworth, 1991.
7. UK law on line – www.opsi.gov.uk
8. UK legislation – www.infolaw.co.uk/lawfinder

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*Axel* *Johnson International AB vs. Aluminum Extrusions Ltd* (28/05/2003).

1. Section 123 (1) (e) is about cash flow test; section 123 (2) describes balance sheet test. [↑](#footnote-ref-1)
2. Executive title also can be public deed and judicial bills of L.L.D. [↑](#footnote-ref-2)
3. An executive warrant may be a judicial sale, a warrant of seizure, a judicial warrant, a warrant in factum or a warrant of ejection. [↑](#footnote-ref-3)
4. Section 123 (1) (a) of Insolvency Act 1986. [↑](#footnote-ref-4)
5. *Re Catholic Publishing and Bookselling Co Ltd* (1864) 2 De GJ & Sm 116. [↑](#footnote-ref-5)
6. *Re Fitness Centre (South East) Ltd* [1986] BCLC 518. [↑](#footnote-ref-6)
7. Schedule 6, para 27 (1) (u). [↑](#footnote-ref-7)
8. *Cornhill Insurance plc v Improvement Services Ltd* [1986] 1 WLR 114. [↑](#footnote-ref-8)
9. Sections 385 (1), 382 (2) of Insolvency Act 1986. [↑](#footnote-ref-9)
10. Section 382 (4) of Insolvency Act 1986. [↑](#footnote-ref-10)
11. Rule 13.12 (1) of the Insolvency Rules 1986. [↑](#footnote-ref-11)
12. [1979] 1 WLR 170. [↑](#footnote-ref-12)
13. Section 21 of the Life Assurance Companies Act 1871. [↑](#footnote-ref-13)
14. Section 28 of the Companies Act 1907. [↑](#footnote-ref-14)
15. [1990] BCLC 216, [1990] BCC 44. [↑](#footnote-ref-15)