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Client Update

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NSW Supreme Court provides guidance on the insolvency test

***Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025**

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AT A GLANCE

- The NSW Supreme Court recently dismissed two cases brought by various lenders against officers and employees of the failed steel giant Arrium, because it was not satisfied that the defendants' representations on loan drawdown notices were false or that Arrium was insolvent at the time that the drawdowns were made.
- The decision also addresses issues in proving insolvency in circumstances where debts are not technically due for a significant period.
- This article examines a key argument in the *Bank of Communications Co Ltd* (BOC) Proceedings, which was that the alleged representations were false because the relevant Arrium entities were insolvent at the time they were made.
- For insurers and their insureds, this decision provides useful guidance on the application of the insolvency test in section 95A of the *Corporations Act 2001* (Cth), particularly regarding the permissibility of hindsight evidence and the relevance of an entity's business to the court's assessment.

OVERVIEW

Arrium was an Australian-listed company operating three large businesses in the mining, mining consumables and steel manufacturing sectors.

In 2015, following a downturn in commodity prices (particularly iron ore), management commenced a strategic review designed to address its debt position of approximately AUD2.8 billion (maturing between July 2017 and June 2023).

In February 2016, following that review, Arrium made a recapitalisation proposal that involved the lenders agreeing to a significant debt write-off. In April 2016, the lenders rejected that proposal and the directors subsequently resolved to place the company into voluntary administration.

Proceedings were brought by two groups of lenders (the "Anchorage Plaintiffs" and the "BOC Plaintiffs") in connection with drawdown and rollover notices issued by Arrium between December 2015 and February 2016.

These were issued under various bilateral and syndicated facility agreements, which led to the lenders advancing additional funds to Arrium and/or rolling over funds already advanced.[1]

The proceedings alleged that representations, said to have been made by Arrium employees in the drawdown and rollover notices issued to the lenders, were misleading or deceptive and negligent.

THE ISSUE

The BOC Plaintiffs alleged that each of the drawdown/rollover notices contained, and by virtue of the terms of the relevant facility agreements made, a representation to the effect that Arrium and each of its subsidiaries were solvent at the date of the agreement and at the time that each drawdown/rollover notice was issued.[2]

Ball J considered that:

> *"In substance, that raises the question of whether any of the relevant Arrium Entities was insolvent between 7 January 2016 (when the first impugned Drawdown Notice was issued) and 16 February 2016 (when the last drawdown was advanced)."*[3]

It was common ground that:

- The BOC Plaintiffs bore the onus of proof on the issue of solvency.
- The question of solvency should be determined at a group level.
- The relevant test is set out in section 95A of the *Corporations Act 2001* (Cth) (the Act), which provides that that a person is solvent if, and only if, the person can pay all the person's debts, as and when they become due and payable.

Ball J described the BOC Plaintiffs' case on insolvency as "narrow and atypical".[4] In essence, their case was that Arrium was insolvent from 7 January 2016 because, from at least that date, it could not pay its banking facilities that were maturing in July 2017.

THE DECISION

Relevant principles

In determining the question of Arrium's solvency, Bell J set out these relevant (and uncontroversial) principles:[5]

- The question of whether a company can pay its debts as and when they become due is a question of fact that involves a realistic commercial assessment of the company's financial position as a whole.[6]
- The fact of insolvency must be proved on the ordinary civil standard (ie. on the balance of probabilities).[7]
- A debt is taken to be owing at the time stipulated for payment in the contract unless there is evidence proving to the court's satisfaction that there has been an express or implied agreement between the company and the creditor for an extension of time, or that some estoppel applies or that there is evidence of an imminent compromise between the creditor and the debtor.[8]
- It is for the party asserting that a company's contractual debts are not payable at the times contractually stipulated to make good that assertion by satisfactory evidence.[9]
- The test of insolvency is future looking, such that the question is not simply whether the company can pay debts falling due at or around the date the question arises but whether, as at that date, it can pay debts falling due in the future.[10] How far into the future depends on the particular facts of the case.[11]
- The question of solvency is to be determined by reference to the circumstances as they were known or ought to be known, at the date at which the question of solvency is assessed and not in hindsight. However, the Court can have regard to what actually happened, to the extent that it sheds light on what was likely at the time when the question of solvency is to be assessed.[12]

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[1] NSW Supreme Court Proceeding Nos. 2018/104383 (**Anchorage Proceedings**) and 2019/316305 (**BOC Proceedings**).
[2] *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025 (***Arrium***), at [244].
[3] *Arrium*, at [244].
[4] *Arrium*, at [254].
[5] *Arrium*, at [255] to [262].
[6] *Sandell v Porter* (1966) 115 CLR 666; *Southern Cross Interiors Pty Ltd v Deputy Commission of Taxation* (2001) 53 NSWLR 213; [2001] NSWSC 621 (***Southern Cross***) at [54]; *Australian Securities and Investments Commission v Plymin* (2003) 175 FLR 124; *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* (2008) 39 WAR 1; [2008] WASC 239 (***Bell***) at [1090] per Owen J.
[7] *Bell* at [1097]; *Octaviar Public Trustee (Qld) v Octaviar Ltd* (2009) 73 ACSR 139; [2009] QSC 202 (***Octaviar***) at [134] per McMurdo J.
[8] *Octaviar* at [134].
[9] *Southern Cross* at [51].
[10] Octaviar at [134].
[11] *Re Cube Footware Pty Ltd* [2013] 2 Qd R 501; *Bell* at [1128].
[12] *Lewis v Doran* (2009) 219 ALR 555; *Bell* at [1117].

The BOC Plaintiffs' case

The BOC Plaintiffs' insolvency case argued:

1. Because of Arrium's deteriorating liquidity position, it had limited time in which to realise sufficient cash to repay, or to refinance, the facilities falling due in July 2017.
2. By 7 January 2016, it was apparent that Arrium's ability to repay those facilities was entirely dependent on the sale of its mining consumables business for a sufficient price, which it would not be able to achieve.
3. The defendants bore the onus of establishing (by evidence not assertion) that, from 7 January 2016, Arrium was not in fact required to repay the facilities falling due in July 2017 in full at that time, which they had not done.
4. The fact that Arrium was placed into voluntary administration on 7 April 2016, seven weeks after the last drawdown was made, was evidence that Arrium was insolvent at that time and insolvent at the time that the drawdowns were made.[13]

Decision

Ball J rejected the BOC Plaintiffs' arguments. In particular, Ball J found that the BOC Plaintiffs' reliance on the voluntary administration as evidence of Arrium's insolvency at the time of the drawdowns/rollovers was misconceived for two reasons:

1. All that the appointment of voluntary administrators proved was that the directors considered that Arrium was, or was likely to become, insolvent. The opinion of the directors does not establish the position objectively and the resolution is consistent with the directors holding the opinion that Arrium was likely to become insolvent, not that it was insolvent, on 7 April 2016.[14]
2. More importantly, the BOC Plaintiffs' argument involved an "impermissible use of hindsight", and that hindsight cannot be used to establish a fact at some point of time. At most it provides evidence of what was likely or possible at that time. Ball J stated that the fact that Arrium was insolvent on 7 April 2016 was at best evidence that Arrium, in January or February 2016, was likely to become insolvent at some later time.[15]

Ball J found that the relevant debts were not due for approximately 18 months (or longer). In the ordinary course, the debts would not be repaid in full before they were due but, rather, would be refinanced (with the same or different lenders). In outlining this expectation of the ordinary course, Ball J drew a distinction between cases involving publicly listed companies (such as Arrium) and cases involving trade creditors (such as *Southern Cross* – which was relied upon by the BOC Plaintiffs).[16]

Ball J expressed the view that, while trade creditors "might well expect to be paid when their debts are due", it is common for publicly listed companies to rely on borrowings for part of their working capital.[17] Accordingly, the BOC Plaintiffs bore the onus of proving that, from 7 January 2016, it was unlikely that the relevant lenders would be prepared to extend their loans on some basis. To do otherwise would "wrongly shift the burden of proof on the question of solvency to the defendants".[18]

Ball J found that the possibility of refinancing and other possibilities available to Arrium at that time, including the potential sale of its mining consumables business, were relevant factors in saying whether Arrium would be unable to pay its debts 18 months later.

On that basis, Ball J held that there were still sufficient possibilities for Arrium to deal with its debt in January or February 2016, such that it could not be said that Arrium was insolvent at that time.

Because the BOC Plaintiffs failed to prove that Arrium was insolvent at any relevant time, they consequently failed to prove that the drawdown/rollover notices were misleading and deceptive by representing that Arrium was solvent when it was not.[19]

> **While hindsight evidence may indicate what was likely or possible at the time, that alone will not be sufficient to discharge the onus of proof.**

[13] *Arrium*, at [270] and [287].
[14] *Arrium*, at [289].
[15] *Arrium*, at [290].
[16] *Arrium*, at [268] and [269].
[17] *Arrium*, at [268] and [269].
[18] *Arrium*, at [269].
[19] *Arrium*, at [492].

IMPLICATIONS

The BOC decision provides useful guidance on the application of the insolvency test in section 95A of the *Corporations Act 2001* (Cth), particularly regarding the permissibility of hindsight evidence and the relevance of an entity's business to the court's assessment.

While hindsight evidence may indicate what was likely or possible at the time, that alone will not be sufficient to discharge the onus of proof – evidence will still be required to prove what the position actually was at the relevant time.

The decision also highlights the difficulties in proving insolvency where the relevant debts are not due and payable for a significant period. In this case, the BOC Plaintiffs unsuccessfully argued that the sheer size of Arrium's debts to its lenders, coupled with its alleged failure to have a proper plan to address repayment, meant it was insolvent much earlier than the date those loan facilities matured.

Although the test for insolvency is future looking, the decision recognises the reality that the further into the future a debt is due, the more options a company will have available to it to address eventual repayment (and in turn, avoid a finding that it was insolvent at an early date).

Insurers and insureds should also note that Ball J's application of the insolvency test in the BOC Plaintiffs' insolvency case is likely to apply to other claims brought by liquidators against the former directors of insolvent entities.

Need to know more?

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