Client Alert

September 2021

Australia: The Arrium Series (#6) - Lender reliance and loss causation

In brief

The Arrium Series

Welcome to issue #6 of our **Arrium Series**, where senior members of the Baker McKenzie team involved in the successful defence of proceedings against the former CFO, former Treasurer and other former employees of the Arrium Group, consider key issues arising in those and related insolvent trading proceedings and from the judgment handed down on 17 August 2021.[1]

A summary of the relevant background to the Arrium proceedings, some key terms and the key issues to be considered in this **Arrium Series** can be found in issue #1 here, issue #2 (which considers solvency in the context of large debts due in the relatively distant future) can be found here, issue #3 (which considers when and how duties of care may be owed to lenders) can be found here, issue #4 (when may company officers and employees be personally responsible for representations) can be found here and issue #5 (which considers the interpretation and application of Material Adverse Change clauses) can be found here.

In this issue

Today's issue - Lender reliance and loss causation

Loss or damage is an essential element in a claim for negligence or misleading or deceptive conduct and it is for the plaintiff to prove that the alleged wrongful conduct caused that loss or damage ("causation").

Reliance, whilst not a necessary condition to prove causation in all cases, is usually important in establishing the necessary causal nexus between a misrepresentation and loss[2].

Ultimately, the plaintiffs in both Arrium Lender Proceedings failed to establish the necessary causal link between the alleged wrongful conduct and any loss suffered.

The Arrium judgment:

- **illustrates the difficulties a lender may have in establishing reliance and causation in respect of alleged misleading representation.**
- **highlights the importance of lenders having proper processes to verify, and consider, representations and warranties.**
- **demonstrates the critical role evidence (or the lack of it) can play in establishing causation.**

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

[2] Reliance was also relevant in the Anchorage Proceedings to the question of whether a duty of care existed in the first place (as discussed in Issue #3 - "Do you owe a lender a duty of care?")

Relevant legal principles

Negligence

Under section 5D of the Civil Liability Act 2002 (NSW) and its statutory equivalents in all Australian states and territories bar the Northern Territory[3] (the **Uniform CLA**):

- a plaintiff alleging that negligence caused a particular harm must prove that:
  - the negligence was a "necessary condition" of the occurrence of the harm (known as "factual causation");[4] and
  - it is appropriate for the scope of the negligent person's liability to extend to that harm (known as "scope of liability" and sometimes also referred to as "normative causation");[5] and
- for the purposes of establishing "scope of liability", the court must consider whether or not, and why, responsibility for the harm ought be imposed upon the negligent party.[6]

Misleading and deceptive conduct

Where a claim for damages is made under section 236 of the *Australian Consumer Law* (**ACL**) for contravention of the statutory prohibition, found in section 18 of the ACL, against misleading or deceptive conduct in trade and commerce, a plaintiff must establish that loss or damage was suffered "because of" such conduct.

"But for" causation test

The "necessary condition" test in the Uniform CLA has been described by the High Court as a "statutory statement of the 'but for' test of causation".[7]

In the Arrium judgment, the Court noted that, when looking to answer the question of whether a loss sought to be recovered under section 236 of the ACL was suffered "**because of"** the misleading or deceptive conduct, it is also "usual" to ask "whether the loss would have occurred **but for** the contravening conduct".

In *Lewis v Australian Capital Territory*[8], Edelman J explained how that "but for" test is to be applied, in the following terms:

> *[T]he test for causation of loss asks whether the wrongful act was necessary for the loss. The "but for" or counterfactual approach "directs us to change one thing at a time and see if the outcome changes". The change is the removal of the wrongful act. If the loss would lawfully have occurred but for the wrongful act then the wrongful act was not necessary for the loss. The counterfactual approach thus involves a hypothetical question where no other fact or circumstance is changed other than those which constituted the wrongful act.*

Court's findings

In relation to the negligence claims made against the signatories to the Impugned Notices by the plaintiffs in the Anchorage Proceedings, the Court found that **factual causation** could not be made out, and the plaintiffs' case on causation failed, for at least **three** reasons:

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[3] *see s 51 Wrongs Act 1958* (Vic), *s 5C Civil Liability Act 2002* (WA), *s 11 Civil Liability Act 2003* (Qld), *s 3 4 Civil Liability Act 1936* (SA), *s 13 Civil Liability Act 2002* (Tas) *and s 45 Civil Law (Wrongs Act) 2002* (ACT) which variously refers to "negligence", "harm" or "breach of duty"
[4] ss (1)(a) in each case
[5] ss (1)(b) in each case
[6] ss (4) in each case
[7] *Strong v Woolworths Ltd* (2012) 226 CLR 182
[8] (2020) 381 ALR 375; [2020] HCA 26 at [178]

- first, if any of the signatories had made enquiries of the CFO (who the Court said seemed to be the "obvious candidate" of whom enquiries would be made), they would have been told on each occasion that the representation could be made.
- secondly, at least until 11 February 2016 (when the Arrium Board agreed to the conclusion of the Going Concern Note[9]), the "no MAE" Representation was true on each occasion on which it was made.
- thirdly, the plaintiffs had failed to establish reliance.

In finding that **reliance** had **not** been established, the Court:

- noted that it was the plaintiffs' case that the relevant lenders suffered harm because they relied on the "no MAE" Representation in advancing or rolling over the relevant loans;
- found that those plaintiffs led **no evidence** of that reliance, in circumstances where, amongst other things, the plaintiffs elected **not** to call any lender witnesses (having only served an outline of evidence from one lender employee who was not ultimately called);
- concluded that reliance could **not** be inferred from the fact that the giving of the notices "was an essential step in the process by which loans were made or rolled over", because to do so would be to focus on the "wrong issue";
- held that:
    - the **correct question** to be answered was whether the lenders **relied on the representations said to have been made by the particular signatories personally** or, instead, relied "solely on the fact that the notices were given in accordance with the relevant facility agreement and the warranties were given by the entity seeking to make the drawdown"; and
    - this raised the question of "whether the Lenders paid **any** attention to the representations contained in the … Notices …. and …what it was about **representations made in a personal capacity** by the… [signatories] … that caused the Lenders to advance or rollover funds – in the sense that **but for** those personal representations they would not have done so" (emphasis added);
- found that there was **no** evidence that the lenders relied on **any** representation made by the signatories personally, with **no explanation** having been given for what it was about the signatories personally, and what they personally did and said, that caused the lenders to advance or rollover funds **because** the representations were made by the individuals, rather than the corporate entity alone;
- also found that:
    - there was "substantial evidence" that the lenders were **aware** of Arrium's deteriorating financial position and that the sale of Mining Consumables for an acceptable price was essential if lenders were to be repaid in accordance with the terms of their respective facility agreements;
    - lenders knew that, if that did not occur, it would be "necessary" to reach some agreement to vary the terms of the facilities;
    - lenders were aware of the change in Arrium's financial position between FY14 and FY15;
    - most, if not all, lenders "must have appreciated", throughout the relevant period, that there was a **risk** that they would not be repaid in full; and

[9] discussed in Issue #5 - Interpretation and application of Material Adverse Change clauses

- lenders were making their **own assessment** of Arrium's financial position and what was in **their best interests** in the circumstances and were **not** relying on the truth of the "no MAE" Representation in making that assessment.

In relation to the claims made by certain of the plaintiffs in the Anchorage Proceedings alleging breaches of statutory prohibitions on **misleading and deceptive conduct** by the signatories, the Court:

- found similar issues with reliance and causation; and
- concluded, for the same reasons, that the relevant plaintiffs had **failed** to establish that their alleged loss would not have been incurred but for the signatories signing the Impugned Notices.

In relation to the claims by the Anchorage plaintiffs that the CFO had **breached a duty of care** allegedly owed to lenders by directing that all available monies under the various facilities be drawn down, or by (allegedly) failing to ensure the "no MAE" Representation and No Event of Default Representation were accurate, the Court held that:

- the plaintiffs had failed to give "any convincing explanation of why it would be appropriate to hold the CFO liable for the consequences of the directions he gave"; and
- it was "not clear" why the scope of the CFO's liability should extend to harm suffered from the fact that lenders advanced the funds they did.

In relation to the **accessorial liability claims** against the CFO and Treasurer, the fact that the plaintiffs in the Anchorage Proceedings failed to establish reliance on the representations contained in the Impugned Notices was again a reason why those claims failed.

In relation to the claim that the Treasurer had separately made **negligent and misleading misstatements** in the course of a discussion with one lender concerning the accuracy of representations made in a particular drawdown notice and the progress of the sale of Arrium's

Mining Consumables business, the Court, on the question of reliance and causation, held that:

- the "real question" was whether that lender was inclined **not** to honour the drawdown notice before the conversation and whether the Treasurer said something during the conversation which, either alone or together with other matters, caused the lender to **change** its mind; and
- the plaintiffs in the Anchorage Proceedings had **not** proved that to be the case, where:
  - the evidence suggested the lender "had and thought that it had learned very little as a result of the conversation";
  - the lender's most senior executive present in the discussion "must have had" his own "considerable knowledge" of Arrium's financial circumstances as a result of his acting for a potential bidder for Arrium assets;
  - it was also "apparent" that the lender's research arm prepared regular updates on Arrium's business; and
  - the Court was not prepared to conclude that the lender relied on anything the Treasurer said because the lender "made its own assessment of Arrium's financial circumstances and the risks of honouring and not honouring the Drawdown Notice and, having received nothing of much assistance from … [the Treasurer], decided to honour it".

Finally, in relation to the claims made by the plaintiffs in the BoC Proceedings, the Court found that, even if the plaintiffs had established that the CFO or Treasurer had engaged in misleading and deceptive conduct (which they had not), the plaintiffs had not established that any conduct caused them any loss, including because:

- the plaintiffs' reliance evidence:

- was "generic in nature and stated at a level of generality that makes it impossible to understand the reasoning process that forms the basis of the reliance"; and
- did not specifically address what the Court described as a "disconnect" between the plaintiffs' case on causation and its case that the Impugned Notices were misleading insofar as they made the "no MAE" Representation;

- with one exception (where there was no evidence that the contents of the representations were "important" to that witness):
  - there was no evidence that any plaintiff checked to see whether any Impugned Notices contained the relevant representations; and
  - the plaintiffs instead relied upon the syndicate agent to undertake those checks but the agent was not required to do that and there was no evidence that this was ever done;
- the evidence instead indicated that "the opinions that the lenders formed on the financial circumstances of Arrium and what was in their best interests given Arrium's financial position were formed as a consequence of their own analysis rather than the statements in the Drawdown Notices";
- there was also a "difficulty" in applying a "but for" test because it was "difficult to separate the contractual requirements in relation to the Drawdown Notices from the representations the Drawdown Notices contain", where:
  - the "but for" test of causation required that the only change that can be made in the hypothetical world is a change to the facts that constitute the wrongful act;
  - normally, that would involve an assumption that the misleading statements were not made but, in this case, "the statements said to be misleading are required by the agreements so that the hypothetical assumption requires an assumption that a notice is given that does not comply with the relevant agreement;
  - while it might "readily be concluded that a drawdown would not occur in those circumstances" it was also "not possible to say whether that is because the notice does not comply with the terms of the agreement or because the lender is no longer being misled about Arrium's financial position"; and
  - the lenders "cannot elevate their refusal in the hypothetical world to comply with the Drawdown Notice because the notice did not comply with the agreement as proof that they were misled by statements contained in the Drawdown Notice";
- while the alternative counterfactual of qualified representations sought to avoid that problem, there were "a large number of ways in which the representations can be qualified, which makes the formulation of an appropriate counterfactual difficult if not impossible"; and
- the "formulation of appropriate qualifications will necessarily introduce additional representations which involves a departure from the requirement that the only change that should be made in the counterfactual world is one that removes the misleading conduct".

Ten key takeaways

In summation, the 10 key takeaways from the Arrium judgment on the issues of reliance and loss causation are as follows:

1. The plaintiff in civil proceedings usually bears the onus of establishing reliance, and always bears the onus of proving causation, on the balance of probabilities.

2. A plaintiff alleging negligence caused a particular harm must prove both the negligence was a "necessary condition" (cause) of the alleged harm and that it is appropriate that the scope of the defendant's liability extends to that harm.

3. A plaintiff alleging contravention of statutory prohibitions against misleading or deceptive conduct (such as section 18 of the ACL) must prove that it suffered loss "because of" that conduct.

4. The question of whether negligence was a "necessary condition" of the harm or whether harm was suffered "because of" misleading conduct (as the case may be) may usually be answered by asking whether the loss would have occurred "but for" the wrongful conduct.

5. That test is to be applied using a counterfactual approach, which involves a hypothetical question where no other fact or circumstance is changed other than those which constituted the wrongful act (i.e. only the wrongful act is removed).

6. If the answer to that hypothetical question is that the loss would have lawfully occurred anyway then the wrongful act was not necessary for (causative of) the loss.

7. Where the question is whether a plaintiff relied on representations made by a particular individual, it will be important that the plaintiff lead specific (rather than general and generic) evidence of actual reliance wherever possible and it is dangerous for a plaintiff to only rely on inferences that may (or may not) be able to be drawn from what occurred.

8. In cases where there is a question of whether a defendant was "only" acting as an "organ" of a company or was also acting in a personal capacity, it will be imperative to identify, and prove, what it was about the defendant personally, and what they did and said, that caused the plaintiffs to act to their detriment.

9. It is essential to have effective systems to monitor what representations and warranties are, or are not, being made or given and, if mandated to be made or given in a particular form, whether they have been qualified.

10. Plaintiffs need to be in a position to rebut any evidence that they made and relied upon their own assessments, and formed their own views, as to what action to take or not take, uninfluenced by the wrongful conduct and, even if that wrongful conduct was partly causative for the plaintiff's loss, the plaintiff's knowledge and actions or inactions may still open up questions of contributory negligence (or equivalents).

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