Australia: The Arrium Series (#2) - Determining solvency where current debts are being paid but large debts are due in the relatively distant future

Mark Chapple
Partner
Sydney

Jayme-Lyn Hendriks
Senior Associate
Sydney

Kathleen Jeremy
Senior Associate
Sydney

Charlotte Hendriks
Senior Associate
Sydney

The *Arrium Series*

Welcome to issue #2 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.

Today's issue - determining solvency where large debts due in distant future

As discussed in issue #1, it was alleged, in both the BoC Proceedings and in related insolvent trading proceedings[2], that the Arrium Group as a whole was **insolvent** in January/February 2016 when various drawdown notices to the total value of approximately AUD 370 million were submitted and those loans advanced.

Knowing how to properly determine solvency is critical to debtors, creditors, company directors and insolvency practitioners alike.

Typically, a plaintiff seeking to establish insolvency (often a liquidator in an unfair preference or insolvent trading claim) will be trying to prove that a company is unable to pay all of its debts which are *currently* due and payable and/or which will become due and payable in the *near* term.

By contrast, and as with the insolvent trading proceedings, the BoC plaintiffs' case on insolvency (described by the Court as "narrow and atypical") was that the Arrium Group was insolvent in **January and February 2016** only because it was unable to repay approximately $871 million in debt maturing in **July 2017** (i.e. 18 or more months later)[3], on the basis that:

- the "only way" the Arrium Group would be able to repay that debt was through a sale of its Mining Consumables business (the "jewel in its crown") and it was "apparent", by 7 January 2016, that the group could not obtain a price for that business which would be sufficient to enable it to both repay that debt *and* continue as a viable remainder.

- these conclusions were "supported" by the fact that the Arrium Group entered administration in early April 2016, which was only seven weeks after the last drawdown was made.

---

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

[2] which conditionally settled on day 34 of the trial

[3] the plaintiffs in the insolvent trading proceedings expressly denied that it was any part of their case that some other debt was going to arise prior to July 2017 which the Arrium group could not pay when due while the BoC plaintiffs having stated, by their Senior Counsel, that they were not seeking to advance a different case, were not permitted to subsequently advance a contention that the Arrium Group would "run out of cash in the next few months" so as to exclude the possibility of a later sale of Mining Consumables, which was described as "the very case" that had been disavowed.

Baker McKenzie.

Relevant legal principles

The following (well-established) legal principles were identified by the Court as "uncontroversial":

- solvency is a question of fact that involves "a realistic commercial assessment of the company's financial position as a whole" and, in a civil case (as these were), insolvency must be proved on the balance of probabilities.

- at least normally, a debt is taken to be owing at the time stipulated for payment unless there is evidence proving otherwise (such as a contractual rescheduling or *via* an estoppel).

- the test of insolvency is a "forward looking" exercise in prediction which necessarily involves some uncertainty and speculation[4], how far the Court should look into the future depends upon the particular facts of the case but, "normally", it will not be too far into the future "because there are so many unknowns or contingences" in predicting the future.

- although 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 is assessed", rather than with hindsight, the Court can look backwards to what actually happened if, and where, that "sheds light" on what was likely at the time when the question of solvency is to be assessed.

Court's findings

The Court held that:

- at the time of the drawdowns, the Arrium Group had at least 16 months to "deal with" the debts maturing in July 2017 and net assets of $2,328.4 million based on its 31 December 2015 accounts which were not suggested to be defective.

- given those matters, it was "to be expected that in the normal course of events Arrium would, if necessary, either be able to sell assets or raise finance on security of those assets in order to repay the facilities due in July 2017".

- it was no answer to say that it was "apparent", in January 2016, that Arrium could not obtain an acceptable price for its Mining Consumables business *at that time* because "the question is whether Arrium was able to …[do so] …before those facilities became due."

- there was "no reason" why Arrium could not have resumed the sale process later but still within time so as to achieve a successful sale, which is precisely what the administrators ultimately did when they sold the Mining Consumables business for USD 1.23 billion on 4 November 2016 after a forecast improvement in commodity prices had actually occurred.

- given that, and that a program of cost-cutting was "likely to lead to costs savings which themselves would affect the price that Arrium needed to obtain from a sale of Mining Consumables", it was "too uncertain" to say, in January/February 2016, that "it was more likely than not" that the Arrium Group would be unable to raise sufficient cash over the following 16 months to repay the July 2017 facilities.

- it was not satisfied, in any event, that Arrium would have run out of cash at any time before July 2017 so as to prevent a later sale of Mining Consumables, including where:

    - the Arrium liquidator who gave evidence accepted that the best available business records for assessing Arrium's short-term cash flows were its 8, 13 and 17 week liquidity forecasts and that the best available business records for assessing longer term cash flow were the prevailing budgets, forecasts and business plans, none of which indicated that the Arrium Group would run out of cash before July 2017.[5]

---

[4] *Octaviar Public Trustee (Qld) v Octaviar Ltd* (2009) 73 ACSR 139; [2009] QSC 202

[5] while some forecasts indicated that Arrium would "breach" a self-imposed liquidity "buffer", it was held that even such a breach would not demonstrate the Arrium group would run out of cash

- "down-side" stress-testing of business plans and forecasts, which applied (cyclically low) "spot" commodity prices for an extended period were only modelled possibilities not expected outcomes in circumstances where both Arrium and independent forecasters expected the low "spot" price would improve.

- while the fact that subsequent iron ore prices were mostly above both the budgeted and "spot" iron ore prices could not be used for the purposes of determining whether the Arrium Group was solvent in January/February 2016, it was admissible evidence on the question of whether the business plans were prepared on a reasonable basis and supported the view that "the business plans were an appropriate basis by reference to which Arrium's solvency should be judged".

- although the timing of the eventual improvement in the iron ore price was delayed against expectations, "it was still reasonable to expect it would happen soon, since that is what independent reputable third-party forecasters were predicting".

- even in February 2016, Arrium had actual total liquidity of $368 million.

- while there was "considerable uncertainty" regarding Arrium's future, which meant that it was preferable to deal with the maturing debts sooner rather than later (which Arrium's board recognised and was attempting to do), those uncertainties did *not* demonstrate there was "no realistic prospect" that Arrium would be able to sell Mining Consumables for an acceptable sum before July 2017, rather than only a risk that it might not have been able to do so.

- it also could *not* be said that the Arrium Group was insolvent in circumstances where the evidence demonstrated that:

  - a large corporate group with debts of this size ($871 million) would normally "refinance debts with the same or different Lenders, quite possibly on different terms and in different amounts", rather than expecting to be able to repay all of its borrowings in cash out of operating profits.

  - those debts were not repayable for an extended period (at least 16 months).

  - Arrium was also receiving advice from UBS and Lazard that banks may be prepared to accept less than full payment if that was the best way to maximise their return.

- the fact that Arrium did go into administration on 7 April 2016 was *not* evidence that Arrium was insolvent at 7 April 2016, let alone at the time of the earlier drawdowns in January and up to 16 February 2016, because:

  - all the appointment of administrators proved was that it was the opinion of the Arrium board, by 7 April 2016, that Arrium had become insolvent or was likely to become insolvent in the future and the resolution passed on 7 April 2016 was consistent with the latter conclusion.

  - in any event, the contention required an "impermissible use of hindsight" where the fact that Arrium was insolvent on 7 April 2016 (if it was a fact) was, at best, evidence that, as at January/February 2016, Arrium was likely to *become* insolvent rather than evidence that it *was* insolvent in January/February 2016.

  - Arrium's circumstances also "changed very substantially" between 16 February 2016 (when it was found to be apparent that Arrium could not achieve an acceptable sale of Mining Consumables at that time) and the appointment of administrators on 7 April 2016 as remaining "realistic" options to address the July 2017 maturities with the co-operation of existing lenders[6] each fell away until it was suddenly announced, in early April 2016, that most lenders had "lost confidence"; a "dramatic" change in circumstances which "ruled out" any possibility of a consensual recapitalisation at a discount or an "amend or extend" and "explained" why the board appointed administrators when they did.

[6] refinancing at an agreed discount, reaching an "amend and extend" agreement with or without a discount with its existing lenders or doing nothing and addressing the situation later in the year when market conditions were expected to improve

Ten key takeaways

In summation, the 10 key takeaways from the judgment on the issue of determining solvency where current debts are being paid but large debts are due in the relatively distant future are as follows:

1. Assessing solvency requires a realistic commercial assessment of the company's financial position as a whole.

2. The test of insolvency is "forward looking".

3. How far the Court should look into the future depends upon the particular facts of the case, rather than there being any set or particular period of time.

4. It will often be more difficult to reach a factual conclusion as to whether a company is solvent if it is necessary to have regard to a future period measured in years rather than months.

5. "Common sense" dictates that a court should avoid speculation so that "normally" a court ought not look too far into the future given the serious consequences of a (premature) determination of insolvency and because there are so many unknowns or contingences in predicting the future.

6. It is impermissible to use hindsight to determine whether a company was, in fact, insolvent but hindsight *can* be used where it sheds light on what was likely at the relevant time, including as to the availability of other sources of funding as a matter of commercial reality[7] and the reasonableness of budgets and forecasts which existed at that relevant time.

7. The requirement that a plaintiff must prove insolvency on the balance of probabilities is *not* to be equated, or confused, with a company being insolvent simply because it may be able to be said, on the balance of probabilities, that the company is unable to repay a debt due on some future date because the question and assessment of solvency is one of fact, not likelihood.

8. The assessment as to whether a company can pay a particular debt in the future involves a prediction based upon what was "known and knowable" at the relevant time.

9. There needs to be a "high degree of certainty" that the company would be unable to pay a debt due in the future based on facts which were known, or which ought to have been known, at the relevant time because, otherwise, the most that can be said is that it was more unlikely than not that the debt might not be paid in the future and that is not the same as saying the company *was*, in fact, insolvent.

10. The statements of principle made in other cases that the mere possibility that a creditor *may* agree to accept a lower amount and/or later payment is insufficient and that the debtor bears the onus of proving that a sufficient binding commitment exists must both be treated with "some caution" in the case of companies like Arrium, because:

    a) those statements of principle are normally made in relation to trade creditors who "might well expect to be repaid when due" since they are in the business of being paid for the goods and services they provide rather than in the business of providing credit; whereas

    b) many, if not most, publicly listed companies, like Arrium, rely on borrowings which it would normally be expected would be rolled over or replaced on an on-going basis as they became due for payment, such that the plaintiffs, in that circumstance, bore the onus of establishing, on the balance of probabilities, that "it was unlikely … that the relevant banks would be prepared to extend their loans on some basis".

---

[7] also see *Lewis v Doran* (2009) 219 ALR 555; [2005] NSWCA 243 at [95] per Giles JA (with whom Hodgson and McColl JJA agreed)