Baker McKenzie.

Client Alert

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Australia: The Arrium Series (#7) - Novel assessments of loss for negligence, misleading conduct and insolvent trading

In brief

The Arrium Series

Welcome to issue #7 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, issue #5 (which considers the interpretation and application of Material Adverse Change clauses) can be found here and issue #6 (which considers issues in reliance and causation) can be found here.

In this issue

Today's issue - Novel assessments of loss for negligence, misleading conduct and insolvent trading

The methods of assessment of damages contended for by the plaintiffs in each of the two Lender Proceedings, and also the (settled) insolvent trading proceedings, were novel and, in the case of the Lender Proceedings, also extraordinarily complex as the plaintiffs in those proceedings each (unsuccessfully) grappled with the task of proving the likelihood, and likely outcomes, of a counterfactual involving an earlier hypothetical administration.

Relevant legal principles

With limited exceptions[2] and subject to any reductions to be made on account of such matters as contributory negligence (or equivalents) or by reason of any applicable statutory caps or failure to mitigate:

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

[2] such as restitutionary (or "gain stripping") damages and exemplary or aggravated damages (although the latter was still described in *State of NSW v Corby* (2009) 76 NSWLR 439 as a form of compensatory damages)

- an award of damages is designed to be **compensatory**[3], that is, to put the aggrieved plaintiff back in the position they would have been **but for** the harm which caused those losses without any windfall; and

- that is usually done by awarding the plaintiff the amount which fairly represents the court's best available assessment of the plaintiff's **actual** loss, without that being an exact science or necessarily perfect.

The High Court has also determined that the application of this general **compensatory** principle will ordinarily involve a comparison between what actually occurred and a hypothetical state of affairs in which it is assumed the wrong did not occur.[4]

Loss claims in insolvent trading proceedings

In the insolvent trading proceedings brought by Arrium entities and their liquidators against the directors of both Arrium and the Arrium borrower entities, the plaintiffs claimed, in essence, that:

- the total loss suffered in respect of the Impugned Drawdowns exceeded AU$350 million, even though the Impugned Drawdowns were under AU$400 million and lenders (or their assignees) had, or would, receive total distributions exceeding 80 cents in the dollar, including by reference to those Impugned Drawdowns; and

- the claim exceeding AU$350 million (rather than the approximately AU$80 million that a "shortfall" in repayments of 20 cents in the dollar against AU$400 million would represent) was justified because (so it was said) the liquidators had applied large distributions from the sale of Mining Consumables first to pre-existing debts owed to lenders on a "first in/first out" basis.

The liquidators were unable to point to any insolvent trading case where such an approach has been claimed, let alone taken, and the contention stood in stark contrast to the generally accepted method of calculating the loss suffered by creditors by reason of insolvency, which is to simply deduct any dividends received from the total amount of the debt incurred.[5]

Ultimately, the issue remained unresolved, due to the settlement of the insolvent trading proceedings as between the plaintiffs and the defendants on day 34 of the trial, and it will be interesting to see whether similar attempts are made in the future.

Loss claims in Lender Proceedings

The plaintiffs in the Anchorage Proceedings ultimately divided and pressed their damages claim into two distinct parts comprising:

- first, loss alleged to be referable to new debt, which was calculated, in a "traditional" way, as the amount of the Impugned Drawdowns the subject of those proceedings less recoveries in respect of that new debt plus interest and identified in the Arrium judgment as AU$47,510,599; and

- secondly, loss referable to rollovers, which was claimed to be the higher amount (said to represent about 8 cents in the dollar) which the Anchorage Plaintiffs alleged they would have recovered if lenders had not agreed to rollover the debt and the Arrium Group had, instead, gone into administration on 31 December 2015 (rather than 7 April 2016), which was identified in the Arrium judgment as AU$47,728,347.

[3] *Todorovic v Waller* (1981) 150 CLR 402 at 412
[4] *The Commonwealth of Australia v Amann Aviation Pty Ltd* (1992) 174 CLR 64 per Dean J
[5] see, for example, *Ball (in his capacity as official liquidator of Wealthfarm Group Services) v Sinclair* [2015] NSWSC 2103 at [15], *Re Salfa Pty Ltd (in Liq)* [2014] NSWSC 1493 and *In the matter of Substance Technologies Pty Ltd* [2019] NSWSC 612

Although the BoC Plaintiffs' claim was only in respect of new debt, they contended that, but for the alleged misleading conduct:

- those loans would not have been made;
- the Arrium Group would have gone into administration on 7 January 2016; and
- their loss would have been the difference between the amounts actually recovered and the amounts it is said would have been recovered in that earlier, hypothetical administration, which the Arrium Judgment identified as AU$99,647,142 (before discounting and interest).

Interestingly, that amount of AU$99,647,142 is more than double the losses claimed by the plaintiffs in the Anchorage Proceedings in respect of new debt even though the amount of new debt the subject of the latter proceedings was about 2.2 times higher.

For their part, besides denying liability, the defendants contended that no loss had been suffered or proven in respect of rollovers and that the loss claimed by the BoC Plaintiffs ought only be assessed (if at all) simply by reference to the amount of new debt, less recoveries plus interest.

Court findings

The result was that there were many (and mostly very complex) issues in dispute on the assessment of damages and the Court ultimately addressed only some of them (in circumstances where the Court had found for the defendants on liability). The Court's findings included that:

- both sets of plaintiffs needed to **prove** that it was **more likely than not** that they would have received **more** in the (different) earlier administration for which they contended;
- they could **only** do that "by proving how much the lenders would have received" since "it is the difference between that amount and the amount they did receive which represents the loss" on that premise;
- **neither** counterfactual (i.e. an early hypothetical administration on 31 December 2015 or 7 January 2016) was the subject of **sufficient evidence**, including where:
    - there was, for example, **no** evidence establishing that the Arrium Borrowers could **not** have repaid the amounts rolled over on 29 and 31 December 2015 or that Arrium immediately needed the USD 43 million borrowed on 7 January 2016; and
    - it was **not** put to the Arrium directors, under cross-examination, that they would have immediately placed Arrium into administration but for these drawdowns or rollovers;
- rather than suggesting that a voluntary administrator would have been appointed immediately on 31 December 2015 or 7 January 2016 (as the case may be), what **actually happened** between mid-February and late March 2016 suggested the opposite, because it was "apparent" lenders did **not** want to see Arrium go into administration and they had indicated, during that period, that they were **willing** to provide support to **avoid** that happening;
- there was at least a "question" as to whether there is a "sufficient connection" between what was claimed to be losses suffered on advances which were **not** made on the basis of the Impugned Notices and the impugned conduct;
- the BoC Plaintiffs no longer pressed their claim against the CFO in respect of any drawdowns prior to 8 February 2016, nor did they press an entitlement to recover any losses from the Treasurer arising from drawdowns made after she left Arrium on 29 January 2016, but the BoC Plaintiffs did "not explain what adjustments should be made to take into account these facts";
- it was, in those circumstances, **difficult** to:

  - see how the CFO ought be responsible for losses reflecting an earlier, hypothetical administration commencing on 7 January 2016 "when he was **not** responsible for the circumstances which led to that event"; or

  - calculate the loss allegedly caused by the CFO on, and from, 8 February 2016, because, on the BoC Plaintiffs' counterfactual of a 7 January 2016 administration, Arrium would have **already** been in administration "well before that date";

- in those circumstances, the "only way" of assessing any loss (if any conduct had been causative of loss, which it had not) was to take the **difference** between the amount of the relevant drawdowns and the amount recovered in respect of them (i.e. the simple method for which the defendants contended and led evidence), which "raised a question of the appropriateness of the BoC Plaintiffs' … [loss] … methodology generally";

- the plaintiffs' respective loss experts had **not** approached the exercise "correctly", having taken Arrium's actual position as at 7 April 2016 and attempted to work backwards, rather than attempting to establish the Arrium Group's actual position on 31 December 2015 or 7 January 2016 (as the case may be) and work from there; and

- those experts were also asked to make, and made, assumptions which were ultimately **not** borne out by the evidence and could not have all been true (including because the two experts assumed a sale of assets would have occurred at different times), with the result that both groups of plaintiffs **failed** to prove their loss based upon an earlier administration counterfactual.

Ten key takeaways

In summation, the 10 key takeaways from the insolvent trading proceedings and Arrium judgment in the two Lender Proceedings on the issues of damages are as follows:

1. Usually, an award of damages is designed to be **compensatory** (without any windfall).

2. That is usually done by awarding a plaintiff the amount which represents the court's best assessment of the plaintiff's **actual** loss.

3. While the plaintiff bears the **onus** of establishing their actual loss, a court will, if necessary, make a fair (albeit imperfect) estimate based on the available evidence provided it is satisfied there was at least some actual loss.

4. The assessment of loss will **ordinarily** involve a **comparison** between what actually occurred and a (necessarily hypothetical) **counterfactual** in which it is assumed the relevant wrong did not occur.

5. Given the necessarily hypothetical nature of the counterfactual, it will **often** be necessary for a loss expert to make factual **assumptions** as to what would have occurred in that counterfactual (e.g. when an earlier administration would have commenced and why).

6. It is for the party adducing that loss evidence to make **good**, on the balance of probabilities, all of the **material assumptions** upon which the expert they retain relies, by reference to cogent evidence.

7. The more complex a counterfactual and the assumptions upon which it depends, the harder the task of proof, so careful consideration needs to be given as to how a loss expert undertakes their task from the very outset.

8. Logical "disconnects" in a counterfactual, the absence of key information, the failure to make good assumptions, the failure to lead appropriate or sufficient evidence and unexplained or contestable differences in approach as between experts can all result in a complete failure to prove loss on the posited counterfactual.

9. A simpler loss methodology (such as monies advanced less recoveries) will often be preferred for these reasons.

10. In insolvent trading claims, the **usual** method of calculating the creditor loss which determines the recoverable amount is by deducting, from the amount of debt incurred, any recoveries with respect to those debts (plus

interest from, usually, the date of liquidation) but a creditor may be able to improve that result by the way in which they allocate debtor receipts.

Arrium series authors

Mark Chapple
Partner
Sydney
mark.chapple
@bakermckenzie.com

Jayme-Lyn Hendriks
Senior Associate
Sydney
jayme-lyn.hendriks
@bakermckenzie.com

Kathleen Jeremy
Senior Associate
Sydney
kathleen.jeremy
@bakermckenzie.com

Charlotte Hendriks
Senior Associate
Sydney
charlotte.hendriks
@bakermckenzie.com