Arrium: Is it 'commercial reality' to conclude that a company is solvent until it is 'certain that it cannot pay' its future debts?

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The recent judgment of Justice Ball of the NSW Supreme Court in a large case arising from the Arrium insolvency – *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* ('*Arrium*')[1] – addressed an issue often debated but rarely arising for judicial determination: to what degree of certainty (or uncertainty) must a court be satisfied to conclude that a company was solvent at a time when it had a large maturing debt payable in the future?

The case involved a multitude of claims surrounding various representations made by the company and its authorised personnel in 'drawdown' notices that were provided by Arrium as preconditions to the extension of facilities by a variety of financiers (subsequently plaintiffs). One of those representations was that the company was solvent at the time of the relevant drawdown notice. The plaintiffs in one of the claims alleged that this representation was false because, at that time, the company was unable to pay its debts as they became due and payable; those debts included some $870 million of facilities due to mature in 18 months' time (ie, 18 months subsequent to the drawdown notice containing the representation of solvency).

A key issue in the case was whether or not the company was solvent at the date of the drawdown notice representation. The plaintiffs alleged that the company was insolvent at that time, which in turn sustained an allegation of personal liability on the part of the company officers responsible for the drawdown notices containing the representation of solvency.

Therefore, the Court was required to conduct a 'retrospective' assessment of solvency as at a relevant 'snapshot date' (to borrow a term used by Justice Owen of the Supreme Court of Western Australia in the landmark *Bell Group* decision in 2008).[2]

Ball J's approach to assessing solvency in the context of future debts that will become payable

In *Arrium* Justice Ball endorsed the proposition that a plaintiff does not discharge its onus of proving insolvency unless it proves that, as at the 'snapshot date', it is certain that the company could not pay its debts including large future maturing debt facilities. Ball J held that Arrium could not be said to be insolvent at the snapshot date because 'there were a sufficient number of possibilities open to Arrium to deal with its bank debt', including 'the possibility of compromise' with Arrium's lenders and the expectation that 'in some cases, banks may be prepared to accept less than 100 cents in the dollar because they accept that is the best way of maximising their returns on the debt that they are owed.'[3]

The test (or approach) taken by Ball J in *Arrium* appears to depart from established authorities on the assessment of cash flow insolvency and plainly differs from the approach taken by Owen J in *Bell Group* to the 'forward looking' aspect of assessing insolvency under s 95A of the *Corporations Act 2001* (Cth).

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[1] *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025.
[2] *The Bell Group Ltd (ACN 008 666 993) (in liq) and Ors v Westpac Banking Corporation (ACN 007 457 141) and Ors (No 9)* [2008] WASC 239.
[3] *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025 at [298] per Ball J.

Justice Ball's approach in *Arrium* required the plaintiffs to prove, to 'a high degree of certainty' and based upon known or knowable facts at the 'snapshot date', *a prediction* that the company would not pay a debt falling due 18 months later. In *Bell Group* on the other hand, Justice Owen considered that, to conclude solvency as at a snapshot date, it was necessary to be satisfied of a *likelihood* that the company's resources at the snapshot date would generate the necessary cash flow to pay its debts as they became due and payable, including future debts.

These differing approaches raise significant practical questions for a plaintiff (including a liquidator) seeking to prove actual insolvency as an essential element of its claim. For the reasons that follow, it is contended that the approach of Owen J in *Bell Group* better accords with the authorities and the essence of an assessment of solvency as at a 'snapshot date': analysing the quality and extent of the resources upon which a company must rely to meet its debts as and when they become due and payable. With respect, I contend that the approach of Ball J in *Arrium* incorrectly requires a plaintiff to *disprove* a variety of conceivable *possibilities* that the company would find a way to meet a large, future maturing debt.

The proven 'prediction' required by the Court in Arrium

A key paragraph of the judgment in *Arrium* regarding the approach to assessing insolvency is [266] where Ball J stated:[4]

> '*In the present case, the assessment the Court must make is whether it can be said that as from [the snapshot date] … Arrium was unable to pay a debt falling due … [18 months later] ... That is not a question of fact in the normal sense.* ***It involves a prediction based on what was known and knowable as at [the 'snapshot date'] … In order to make that prediction – that is, in order to be able to say as at [the 'snapshot date'] … Arrium could not pay a debt falling due … [18 months later] – there needs to be a high degree of certainty that that state of affairs would come about on the basis of the facts known or knowable at the earlier date.*** *Otherwise, it is not possible to say that as at [the 'snapshot date'] … Arrium was unable to pay debts falling due [18 months later] ... At most all that could be said is that it was unlikely that Arrium would be able to pay debts falling due [18 months later] … But that is equivalent to saying that Arrium was likely to become insolvent, not that it was insolvent, from … [the 'snapshot date'] on*.' (emphasis added)

With respect, the approach previously taken by courts to assessing solvency has *not* required that a plaintiff prove that the company would not have paid a relevant future debt. Rather, a plaintiff needing to establish insolvency (to meet its case) has had to demonstrate that, *on an assessment of the company's debts and resources at the 'snapshot date'*, it was improbable that the company was able to pay its debts as they became due and payable.

Granted, the assessment of a company's debts and resources is 'forward looking' and the further into the future the assessment runs, the less certainty there may be as to whether the company's resources will or will not produce the necessary cash to pay prospective (future) debts (ie, debts that presently exist but which are not payable until a future date). If the future timeframe in which a company's prospective debts will become due and payable is lengthy (eg, 18 months as in *Arrium*), then a court will have to use the same lengthy timeframe to consider the potential for realisation of assets to generate the necessary cash to meet the future debt – ie, assets that would usually be considered too illiquid if the assessment were looking only to the 'reasonably immediate' future.

In *Bell Group*, Justice Owen decided it was appropriate to look forward 12 months from the 'snapshot date' and endorsed an approach that required the Court to assess the likelihood that the

[4] Ibid, [266].

company's resources as at the snapshot date would generate the necessary cash to meet its debts including future debts:[5]

> '*I doubt that there is a "legal test" that can be applied rigidly on each and every occasion that a court is called upon (in effect) to reconstruct a cash flow in order to assess the solvency of a company at a particular time.* ***What I have to do is decide whether or not, as at [the snapshot date], the relevant Bell group companies were able to pay their debts as the debts became due. I have to be satisfied of that on the balance of probabilities****. To get to that point, I am obliged to look at the cash flows and decide whether each disputed item should be included or excluded. But does it mean that I have to be satisfied on the balance of probabilities as to each disputed item? I think not. The question is the weight to be given to the united force of all of the circumstances put together …* ***Generally speaking, I am comfortable with the formulation that it is appropriate to take an item into account if it is likely to materialise.*** *But I am less comfortable with a position that equates likelihood with the balance of probabilities. Certainly, the dictionary definitions of "likely" all include, as one integer, "probable". But there are other meanings, such as "having an appearance of truth or fact; that looks as if it would happen, be realised or prove to be what is alleged or suggested": the Oxford Dictionary. To my mind,* ***a likelihood test does not mean that each and every disputed item has to be established on the balance of probabilities. But nor do I accept the "reasonable prospect" formulation if that is understood as sanctioning an overall conclusion in which none of the constituent parts are established to that level. I think the word "likelihood" is an apt description*** *if it is understood … as "likely to materialise", and … as a view arrived at after assessing the degrees of certainty and uncertainty.* ***In the end, it probably (there is that word again) comes back to commercial reality***.' (emphasis added)

Significantly, unlike the approach of Ball J in *Arrium*, the approach endorsed by Owen J in *Bell Group* does not require a plaintiff to prove to 'a high degree of certainty' that the company would not pay its future debts. The approach of Owen J in *Bell Group* is that a plaintiff has demonstrated that the company was insolvent on the snapshot date if an assessment of the company's resources justifies a conclusion that, as at the 'snapshot date', it was improbable that the company could pay its debts as they became due and payable.

With respect, it is the approach of Owen J in *Bell Group* that accords with established authority regarding the test for insolvency required by s 95A of the *Corporations Act 2001* (Cth). Section 95A provides that a company that is not solvent is insolvent. The essential question is: '*as at the snapshot date, was it more probable than not that the company could meet its debts as they became due and payable?*' If the answer is 'no', then the company was insolvent on the snapshot date.

Insolvent vs 'likely to become insolvent'

In *Arrium* Ball J (in the extract quoted above) indicated that it 'could be said' that the company was unlikely to be able to pay the relevant future debts, but that this simply meant that the company was '*likely to become insolvent*' – not that it *was* insolvent – at the 'snapshot date'. Again, the reasons for judgment of Owen J in *Bell Group* call into question this distinction between 'actual' insolvency on the snapshot date and 'likely' insolvency at a future date.

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[5] *The Bell Group Ltd (ACN 008 666 993) (in liq) and Ors v Westpac Banking Corporation (ACN 007 457 141) and Ors (No 9)* [2008] WASC 239 at [1097] to [1102]. Owen J's conclusion of insolvency on the relevant date was not challenged on appeal: *Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)* [2012] WASCA 157 at [917] per Lee AJA and [2708] and [3195] per Carr AJA.

In *Bell Group* Justice Owen suggested that the term '*would inevitably become insolvent*' is inept *insofar as it is used to describe a debtor's ability to pay a future debt from present resources*:[6]

> *'Take a hypothetical example. A company has one asset, namely $2m in cash on deposit, and it has a debt of $3m that it is paying off at the rate of $1m per month on the last day of each month. Assume that the company has no capacity to borrow money (so cannot increase the asset base of $2m) and has no other income or source of funds. It seems to me that as at the snapshot date and looking 3 months ahead, the entity is insolvent. This is because it is known that in the third month the final instalment on the debt repayment schedule cannot be met. I do not think it would be correct to say that for the first 2 months the entity is solvent because it can meet the instalments due in that period, but that it would inevitably become insolvent in the third month.*
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> *The problems are illustrated by a further example. Using the same basic figures, add a further asset, namely, a piece of real estate that is readily saleable within a three-month period for a net return of somewhere between $0.75m and $1.25m.* ***A value judgment would have to be made as to whether the property would fetch $1m or more. If it would, the entity is solvent. If it would not, the entity is insolvent.*** *In terms of the test that is relevant for this case,* ***I doubt it would be correct to say that the entity would inevitably become insolvent unless the property could be sold within 3 months and for a net return exceeding $1m. If the view were to be formed that the property could not be sold within 3 months or that it would not reach $1m, it would thereupon be insolvent****.'* (emphasis added)

On a 'snapshot date', a debtor is either able to pay its future debts from its resources or it is not able to do so. If it is assessed to be *unlikely* that the debtor can pay its existing prospective (future) debts (upon examination of the debtor's resources) then the debtor is insolvent, *not* 'likely to become insolvent' at a later date.

The requirement of an objective assessment of the quality of a debtor's resources – ie, *the probability or likelihood that a company's resources as at the snapshot date could generate the necessary cash to pay the company's debts (including future debts)* – has been endorsed in numerous authorities including:

- *Sandell v Porter*:[7] In this landmark High Court decision Barwick CJ stated that 'no doubt experts may speak as to the likelihood of any of the debtor's assets or capacities yielding ready cash in sufficient time to meet the debts as they fall due';

- *Metropolitan Fire Systems Pty Ltd v Miller*:[8] The Court assessed that, as at the snapshot date, there was a low likelihood of the recovery of a large amount of outstanding accounts which justified their exclusion from the solvency assessment;

- *Pearce v Gulmohar*:[9] Surplus inventory excluded from the solvency assessment due to an absence of evidence of a prospective realisation program;

- *Treloar Constructions Pty Ltd v McMillan*:[10] A 'bare possibility of funding' was not, 'as a matter of commercial reality', considered to be an available resource to sustain solvency.

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[6] Ibid, [1145] to [1149].
[7] *Sandell v Porter* (1966) 115 CLR 666.
[8] *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.
[9] *Pearce v Gulmohar* [2017] FCA 660.
[10] *Treloar Constructions Pty Ltd v McMillan* (2017) 120 ACSR 130, [2017] NSWCA 72, [121].

The NSW Court of Appeal also rejected a criticism of the relevant insolvency practitioner's expert report – that insufficient regard had been given to a realisable franchise – because 'there was no evidence that the sale of the franchise was ever actually contemplated.[11] The Court also stated that the plaintiff's 'legal onus to prove insolvency … carried with it the evidentiary onus of proof sufficient to establish insolvency or at least to establish matters from which insolvency could be inferred at each of the relevant dates.'[12]

- *Quin v Vlahos*:[13] In this recent decision, the Victorian Court of Appeal held there was insufficient evidence of alternative financial support (including degree of commitment) from a director's wife to support a finding of solvency. The Court also confirmed that 'whilst the legal onus to prove insolvency rests with the party alleging insolvency, the party alleging that an inference that a company was insolvent should not be drawn because third-party funds were available to it bears an evidentiary onus on this issue';[14]

- *Chan v First Strategic Development Corporation Ltd (in liq)*:[15] The Queensland Court of Appeal endorsed the proposition that '**there [must] be a degree of assuredness that the financial support will be forthcoming and at such a level that one could say the company was *able* to pay its debts as and when they fall due, rather than being *possibly able* to do so**. Just as a conclusion that the relevant financial support does not have to be absolutely certain in order to be sufficient to meet the test … equally **the financial support does not have to be absolutely uncertain in order to be insufficient to qualify**.' (emphasis added)

Ball J's approach in *Arrium* relied at least in part on the High Court's decision in *Insurance Commissioner v Associated Dominions Assurance Society Proprietary Limited* (1953) 89 CLR 78, a case in which the High Court concluded that an insurance company was insolvent because it was 'highly probable' – if not 'practically certain' – that within some seven years it would be 'unable to discharge in full claims under maturing policies'. However, nowhere in that decision did the High Court state that a company must be characterised as able to pay its debts (including future debts) unless and until it is 'certain' that it cannot do so. That High Court decision did not endorse a test or necessary standard of 'certain' inability to pay future debts in order to sustain a conclusion of insolvency; rather, *on the evidence in that case*, the Court was satisfied to a degree of certainty that the company's assets were insufficient to meet its future debts.

Why a 'balance of probabilities' approach matters

No opinion is expressed on whether the evidence in *Arrium* would have sustained a different conclusion on the question of solvency according to the 'balance of probabilities' approach preferred by Owen J in *Bell Group* and other authorities. However, it is concerning to see the Court in *Arrium* set a test or threshold standard of 'certainty' that effectively requires a plaintiff to disprove the possibility of a company's debts being paid (or prove to a high degree of certainty that a future debt will not be paid) rather than applying the established standards of *likelihood* and *probability* to assess solvency under s 95A.

[11] Ibid, [144].
[12] Ibid, [142].
[13] *Quin v Vlahos* [2021] VSCA 205.
[14] The Court cited as authority for this proposition *Treloar Constructions Pty Ltd v McMillan* (2017) 120 ACSR 130, 86 [142]–[143], [2017] NSWCA 72.
[15] *Chan v First Strategic Development Corporation Ltd (in liq)* [2015] QCA 28 at [43] per Morrison JA (with whom Gotterson and Boddice JJA agreed).

Creditor protections in our corporations and insolvency laws, including the s 588G duty to prevent insolvent trading and voidable transaction provisions in Part 5.7B of the *Corporations Act 2001* (Cth), will not operate as intended if the state of a company's insolvency is denied for so long as there remains a mere possibility or more than remote prospect of the company generating the necessary cash to meet large, prospective debt obligations.

An English decision that resonates for its focus on the potential prejudice to creditors where insolvency is denied so long as there remains a 'more than fanciful' (but unlikely) prospect of paying future debts is the UK High Court's decision in *Re Cheyne Finance plc*.[16] The Court was required to assess whether a company was insolvent for the purposes of triggering a different distribution regime pursuant to a security trust deed under which receivers had been appointed and the company's investments were being realised. The Court stated:[17]

> '*It is clear from … the Australian decisions that in an environment shorn of any balance sheet test for insolvency,* ***cash flow or commercial insolvency is not to be ascertained by a slavish focus only on debts due as at the relevant date. Such a blinkered review will****, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases* ***fail to see that due to an endemic shortage of working capital a company is on any commercial view insolvent, even though it may continue to pay its debts for the next few days, weeks or even months before an inevitable failure***.' (emphasis added)

The UK High Court then articulated the merit of a 'balance of probabilities' approach to assessing a company's ability to pay its debts (including future debts) as at a snapshot date:[18]

> '*By contrast with a state of mind requisite for a finding of wrongful trading—that is, knowledge that there was no reasonable prospect that the company would avoid going into insolvent liquidation—which is used as a test for directors' personal liability, the insolvency event test is imposed upon the receivers in the trust deed to determine the time at which run-off by fiduciaries with pay as you go is replaced by a pari passu distribution by the same fiduciaries in accordance with the payment priority.* ***If that change is postponed for as long as there is more than a fanciful prospect of payment in full, its consequences may work grave prejudice to senior creditors*** *with later maturing debts out of all proportion to the prejudice to early maturing creditors of becoming subject to pari passu distribution of assets realised to produce best value rather than early cash. The fact that the market for Cheyne's investment portfolio may go up as well as down may well make it hard to say that the prospect of payment in full is only fanciful, even though unlikely.* ***Being satisfied on the balance of probabilities is, in my judgment, typical of the standards on which commercial fiduciaries are accustomed to act when making important business decisions in the best interests of their beneficiaries***.' (emphasis added)

Conclusion: It is not 'commercial reality' to deny insolvency when it is unlikely that a company can pay its future debts from its present resources

A 'balance of probabilities' assessment of the sufficiency of a debtor's resources to meet its debts, including future debts, better accords with the notion of 'commercial reality' than does denying a state of insolvency until such time as it is 'certain' that a company cannot pay its debts. The question of insolvency is one of fact and the sufficiency of a debtor's resources should be assessed

[16] *Re Cheyne Finance plc* [2007] EWHC 2402 (Ch) [2008] 2 All ER 987.
[17] Ibid, [51] per Briggs J.
[18] Ibid, [75] – [76].

according to the balance of probabilities and likelihood, not by reference to notions of ‘reasonable prospects’ or ‘possibilities’ (let alone mere hope).

If the test for insolvency of a company with large future debt commitments is the approach enunciated by Ball J in *Arrium*, why did directors ever need a statutory safe harbour from the s 588G duty to prevent insolvent trading? Perhaps hope is a strategy after all.

We await with interest any news of an appeal.