Consultation Paper 372

Guidance on insolvent trading safe harbour provisions: Update RG 217

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I propose to address only one aspect of the consultation, but it is the cornerstone of many questions that arise in both corporate and personal insolvency: what is "insolvency"?

In my view Section 95A of the Corporations Act 2001 is worded correctly. The problem has evolved from judges' and other commentators' reluctance to interpret the wording of the section in its entirety. In many judgments and commentaries the word "all" is either ignored completely or glossed over. When that word is given its obvious meaning Section 95A accords with both the historical common law and common sense.

The vagueness resulting from many recent judgments necessarily produces uncertainty for the key stakeholders with consequential economic cost, both directly and for the broader economy.

RG 217.18 is no doubt modelled on the commentaries and judgments. Because "all" should not be overlooked, I suggest that "may be relevant" in RG 217.19 be changed to "is relevant" to more appropriately capture the intent of Barwick CJ's judgment in *Sandell v Porter (1966)* 115 CLR 666 at paragraph 670:

> *"The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity."*

While it is true that the company's assets must be able to be reduced to cash in order to pay creditors, it is misleading to call the assessment of solvency a cash flow test.

If a company can demonstrate an ability to pay its debts in the short to medium term, but does not have the resources to pay one or more longer term debts, then it is not able to pay <u>all</u> its debts.

The Chancery Division of the High Court in the UK summarised the Australian position *in the matter of Cheyne Finance PLC (in Receivership) and in the matter of The Insolvency Act 1986* [2007] EWHC 2402 (ch) at paragraph 51:

> *"It is clear from a brief review of 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 view 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."*

Referring to *Anchorage Capital Masters Offshore Ltd v Sparkes* [2023] NSWCA 88 Taline Chater, Special Counsel at Minter Ellison, in a presentation titled "Long term debts and assessing insolvency" says:

> *"The test of insolvency is directed to a* present *inability to pay all debts as and when they become due and payable, including debts that will become payable in the* immediate *future."*

Notwithstanding the reference to "all debts" she then goes on to question how far into the future the assessment need explore. Admittedly, this was in the context of a company (group) that apparently had positive net assets i.e. it would pass the net assets test[1]. However, when assessing insolvency there is no rational basis for overlooking longer term debts. To ignore them in an insolvency assessment will often end up resulting in a transfer of economic benefit from longer term creditors to near term creditors.

As the Supreme Court of New Zealand said in *Richard Yan and others v Mainzeal Property and Construction Limited (In Liquidation) & other* [2023] NZSC 113 at paragraph 361;

"… this does not mean that directors of an insolvent company, when deciding whether to trade on, can legitimately set off against the risk to future creditors (essentially those who will be out of pocket at liquidation) the advantages to current creditors of continued trading."

Subject to clarifying any measurement issues, the net asset test provides a snapshot of a company's ability to pay <u>all</u> its debts. In most insolvencies the balance sheet provides a compelling conclusion of insolvency because it shows that, in the absence of fresh capital or future profits, the company does not have the resources to pay all the debts. The *Anchorage* case was rare in that, having passed the balance sheet test, the cash flow test became very relevant.

Most companies that end up in liquidation or voluntary administration did not have positive net equity at the relevant time and are unable to demonstrate reasonable reliance on future profitability or availability of capital. Accordingly, assessing liquidity becomes irrelevant as the company was not going to be able to pay <u>all</u> its debts.

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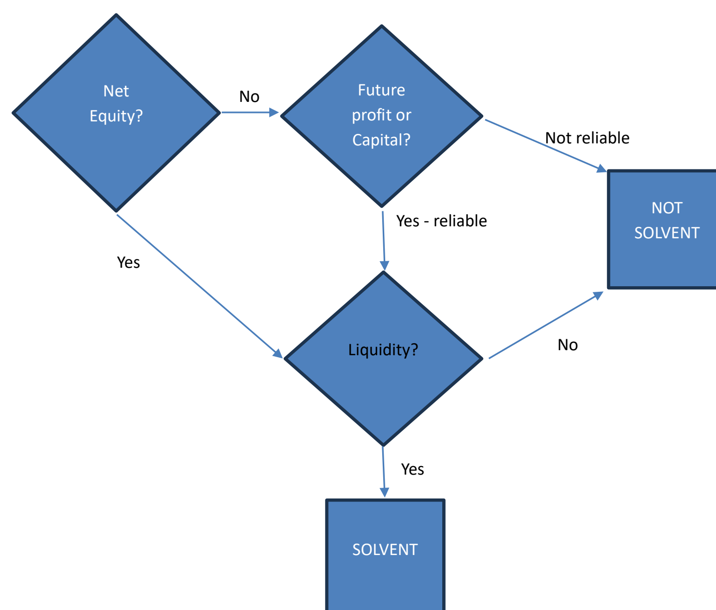
[1] The 'net asset', 'net equity', or 'balance sheet' test terms are used interchangeably. While not necessary to address for the purposes of this discussion arguments about measurement and definition will often arise.

The following flowchart provides a simple guide.



Summary

Logically, and I submit what Section 95A says, to be solvent a company must be able to pass both the cash flow test and the net equity test. In doing so, the company will be demonstrating an ability to pay its debts when they fall due and its ability to pay <u>all</u> its debts.

I do not profess to know how to persuade the judiciary to 'get back on the reservation' when interpreting Section 95A, but in the meantime I would suggest adding (d) to RG 217.19:

(d) whether sufficient capital can be introduced, or profits generated, to eliminate any deficit in net equity.

Clarifying the test for insolvency will:

1. Deprive defence lawyers of [their currently ample] 'wriggle room';
2. Increase the number of appropriate outcomes;
3. Free up significant court resources;
4. Improve the economy by reducing cost and modifying (correcting) behaviours.

Section 95A is not directing the courts to effectively transfer economic benefit from longer term creditors to near term creditors. To ignore the word "all" undermines one of the most fundamental aspects of insolvency law.