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UNSECURED LOANS AND ASCERTAINING CASH FLOW INSOLVENCY

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Key Points

- **The article examines whether the funds which a debtor company from a loan provided on an unsecured basis can be taken into account in determining whether it is solvent on a cash flow basis.**
- **Often companies which are struggling will not be able to obtain secured loans as they will not be able to offer security to an erstwhile lender**
- **English and Scottish authority suggests that unsecured loan funds can be taken into account in determining solvency and English and Australian case law indicates that it does not matter if the lender is associated with the company**
- **Yet, what is required is the genuine and realistic availability of loan funds, as a matter of commercial reality, and there must be a degree of assuredness on the part of the debtor company that a loan will be forthcoming, and the prospective lender is committed to providing the funds.**
- **In determining the level of certainty that the debtor company must have concerning the extension of funds, then the position is assessed objectively from the perspective of the company rather than from that of the prospective third-party lender.**
- **Australian cases hold that just because a loan might be repayable on demand does not mean that a court will necessarily rule out considering the loan in assessing the company's solvency**

Introduction

Ascertaining whether a company is insolvent, that is, unable to pay its debts, can be of critical importance in a number of corporate and financial contexts. For instance, insolvency has been specified, on many occasions, in finance documentation as a condition of default which will mean that the obligations of the company that is insolvent will become due and permit the counter-party to engage in enforcement action. However, more often it is in a hearing of a winding-up petition brought against a company on the basis that it is unable to pay its debts, or where a liquidator has sought to attack a pre-liquidation transaction, that the issue of insolvency is important, and sometimes critical. Determining a company's solvency is often a difficult task. There are several grounds on which a company can be held insolvent under the provisions of the Insolvency Act 1986 ('the Act'), namely s 123(1) and (2), but the two that are subject to the most frequent debate and consideration are those contained in s 123(1)(e) and s 123(2). The former provides that a company is unable to pay its debts if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due, and the latter provides that a company is deemed to be unable to pay its debts if it is proved to the satisfaction of the court that the value of its assets is less than the amount of its liabilities. The former is known generally as 'cash flow insolvency' and the latter as 'balance sheet insolvency.' This article focuses on the cash flow test. When determining insolvency on this basis the courts will consider whether the company is able to pay its debts as they fall due.

What this article examines is one issue that might be raised where a company's insolvency is under consideration. It is whether the funds which a debtor company, alleged to be insolvent, asserts it can obtain from a loan provided on an unsecured basis, can be taken into account in determining whether it is able to be regarded as solvent on a cash flow basis. This is an issue which has caused uncertainty both in the United Kingdom and other Commonwealth jurisdictions and is an issue that feeds into understanding the meaning of being unable to pay debts. It should be added here at the outset that obtaining an unsecured loan could not assist a company in establishing its solvency on a balance sheet basis. This was made clear in the Scottish case of *Milne v Rashid* ([2018] CSOH 23, [2018] 2 BCLC 673, [49]) where the court said that if a company were to meet existing liabilities by incurring further liabilities and taking a loan would add to liabilities of the company, this would not save the company from being regarded as balance sheet insolvent.

The Starting Point

At one time little had been said in the UK case law concerning the meaning of debts falling due for the purposes of assessing cash flow insolvency. That changed with the decision of Briggs J in *Re Cheyne Finance Plc* ([2007] EWHC 2402 (Ch), [2008] 1 BCLC 741), where his Lordship analysed the meaning of cash flow insolvency and considered what debts could be taken into account in ascertaining the insolvency of a company. While there is still some uncertainty as to what future debts might be taken into account, this decision, combined with the later decision of the Supreme Court in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* ([2013] UKSC 28, [2013] 3 All ER 271, [2013] 1 BCLC 613), has given us a better indication of when a company might be regarded as insolvent. In this article we are not concerned with what debts can be borne in mind in determining insolvency, but rather what funds can be identified by a company if it is to demonstrate that it is solvent.

Obviously, the cash on hand that a company has will be able to be considered, but if courts required a company to retain sufficient cash on hand at all times in order to cover all of its debts that could fall due, it could paralyse a company's operations; so much of a company's wealth often is, necessarily, tied up in assets. Slade J in *Re Capital Annuities Ltd* ([1979] 1 WLR 170, 187) said that mere evidence that a company has for the time being insufficient liquid assets to pay debts that are owed, is not by itself proof of the inability on the company's part to pay its debts. His Lordship indicated that courts could take heed of assets which could readily be realised in a few days in determining solvency. The judge was dealing with s 223(d) of the Companies Act 1948 which did not include separate cash flow and balance sheet explanations of an inability to pay debts, as the Act does, and clearly in many ways s 123 of the Act introduced a new approach. However, there is nothing to suggest that the general approach taken by Slade J does not apply to s 123. Indeed, there are cases in Australia that support Slade J's approach and may go even further in permitting assets that might take longer than a few days to realise to be factored into any evaluation of a company's solvency.

In the Australian High Court decision of *Sandell v Porter* ([1966] HCA 28, (1966) 115 CLR 666), the judges said that the debtor was not limited to immediate cash resources but could have recourse to funds available through the sale or mortgaging of its assets. Barwick CJ (with whom McTiernan and Windeyer JJ concurred) said that not all company assets could be considered but only those that could lead to the procuring of funds from a sale or mortgage within a relatively short time. His Honour did not specify what a relatively short time was; this was a matter for the court in each case (at 670). The Court indicated that funds which could be obtained from a mortgage of assets could be considered in determining whether a company is solvent, as the funds provided are secured over company property. Taking into account such funds was all part of the need for the courts to determine solvency by a proper consideration of the company's financial position, in its entirety, based on commercial reality (*Australian Securities and Investments Commission v Edwards* [2005] NSWSC 831, [99]). Lord Hodge made the point in *Mac Plant Services Ltd v Contract Lifting Services (Scotland) Ltd* ([2008] CSOH 158, [2009] SC 125, [76]) that if a company raises funds by selling assets or borrowing it may not improve its balance sheet, but it may nonetheless pay its debts as they fall due. No case has specified in what period assets must be able to be realised to count towards the solvency assessment, but in *Hall v Poolman* ([2007] NSWSC 1330, [2008] BPIR 892, [187]) the New South Wales Supreme Court held that a court could not bear in mind property when it would take six months to realise it and debts were falling due within a month.

It will be recalled that the Australian High Court in *Sandell v Porter* said that funds obtained when the company could grant a mortgage, but it did not consider whether funds obtainable from an unsecured loan could be taken into account. Whether or not funds obtained under an unsecured loan would be considered in deciding whether the borrowing company is solvent or not is an important issue as companies that are in dire straits will rarely be able to attract funds through secured loans as all their property is likely to be already secured to the hilt.

It might be said that funds relating to an unsecured loan could not be considered as the company would be merely replacing one debtor with another, namely 'robbing Peter to pay Paul.' Lewison LJ in *Re Casa Estates (UK) Ltd* ([2014] EWCA Civ 383, [31]), in giving the leading judgment, seemed to imply this when he said that: 'It certainly seems counter-intuitive (to me at least) that a company that manages to stave off cash-flow insolvency by going deeper and deeper into long-term debt is not insolvent.' However, the Supreme Court of Appeal of South Africa in *Express Model Trading 289 CC v Dolphin* ([2014] ZASCA 17, [2014] 2 All SA 513) adopted a different view of a company being able to obtain a loan and said that the ability to raise a loan could in fact indicate its creditworthiness. In like fashion, McPherson SPJ in the Australian case of *Re RHD Power Services Pty Ltd* ((1991) 3 ACSR 261) said that a company's ability to borrow without security may in some circumstances provide compelling evidence of its strong financial standing.

Unsecured Loan Funds

UK Cases

Cases in the UK have been few and far between as far as the subject of this article is concerned and what the courts have said has been relatively brief. The place to begin is the decision of *Re A Company (No. 006794 of 1983)* ([1986] BCLC 261, 262), where Nourse J (as he then was) said, when considering s 223(d) of the Companies Act 1948, that merely because a creditor could prove that a company was only able to pay its debts with borrowed money did not demonstrate that the company was unable to pay its debts. The judge said that: 'I think that if a company can pay its debts only with the help of loans made by others, it is nevertheless prima facie able to pay its debts for the purposes of that subsection [s 223(d)].'

More recent cases, that have been concerned with s 123 of the Act, have taken a similar approach and demonstrate the fact that the difference in drafting between s 223(d) of the Companies Act 1948 and s 123(1)(e) has not produced a different view. In the Scottish Court of Session (Outer House) in *Mac Plant Services Ltd v Contract Lifting Services (Scotland) Ltd* (at [76]) Lord Hodge said that when determining cash flow insolvency it was appropriate to take into account outside funds which would be available to a respondent company. Subsequently, in *Burnden Holdings (UK) Ltd v Fieldling* ([2019] EWHC 1566 (Ch), [289) Zacaroli J said that a company would clearly not be avoiding balance sheet insolvency if it borrowed funds but it might enable it to avoid cash flow insolvency. Earlier, in *Milne v Rashid* (at [49]), the court espoused a view along the same lines as Zacaroli J. What these cases have not done is to explore in detail when unsecured loans might be taken into account. To address this issue, we need to look further afield.

Australian cases

There has been far more jurisprudence on the subject at hand in Australia. This is primarily because in Australia there have been a large corpus of preference cases where the liquidator has had to establish, as a liquidator must in England and Wales (under s 239 of the Act), insolvency at the time the alleged preference was granted in order to succeed in having the preferential transfer avoided. Originally the Australian case law was generally against permitting the consideration of funds from unsecured loans (eg *Norfolk Plumbing Supplies Pty Ltd v Commonwealth Bank of Australia* (1992) 6 ACSR 601) because the relevant Australian provision, prior to 1992, stated that the company had to be able to pay debts from its own money, and unsecured loan funds could not be regarded as the company's own money. The present Australian provision, s 95A of the Corporations Act 2001, does not contain such a restriction, and, it might be added, neither does the UK provision. Section 95A provides for a cash flow test and states that: '(1) A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they became due and payable; (2) A person who is not solvent is insolvent.' Now, with cases decided in relation to s 95A there are clear indications from the Australian courts that funds from unsecured loans are able to be taken into account in judging whether a company was unable to pay its debts, although there are some provisos, as we will see.

One of the first appellate Australian cases to make it clear that unsecured loan funds could be factored into an assessment of a company's solvency, and a leading case on the general issue of what is 'insolvency,' was *Lewis v Doran* ([2005] NSWCA 243; (2005) 219 ALR 555). The New South Wales Court of Appeal in fact upheld the decision at first instance. At first instance ([2004] NSWSC 608, (2005) 219 ALR 555, (2004) 50 ACSR 175) where Palmer J said, and the Court of Appeal agreed, that if the court is satisfied that as a matter of commercial reality the company has a resource available to pay all its debts as they become payable then it will not matter that the resource is an unsecured loan. In the appellate court Giles JA (with whom Hodgson and McColl JJA agreed) said (at [47]) that:

> [T]here is no compelling reason to exclude from consideration funds which can be gained from borrowings secured on assets of third parties, or even unsecured borrowings. If the company can borrow without security, it will have funds to pay its debts as they fall due and will be solvent, provided of course that the borrowing is on deferred payment terms…

This view has been subsequently accepted on a number of occasions across Australia. For instance, in *Leveraged Equities Ltd v Hilldale Australia Pty Ltd* ([2008] NSWSC 190) Hammerschlag J said that the promised provision of a loan which would enable the company to pay its debts could be taken into account in determining whether the company was insolvent or not. Later, in both *Williams v Scholz* ([2008] QCA 94, [110]) and *International Cat Manufacturing (in liq) v Rodrick* ([2013] QCA 372, (2013) 97 ACSR 200), the Queensland Court of Appeal said that a loan could be considered in determining the insolvency of a company even where it is provided by a party who is related to the company. In fact, in the English case of *Re A Company (No. 006794 of 1983)* the debtor company was surviving on loans from associated companies and the prospect of the loan funding coming from associated companies did not dissuade Nourse J from being willing to take loan funds into consideration in deciding solvency.

Certainty of Funds

The foregoing indicates that courts have accepted that unsecured loan funds may be considered in determining whether a company is insolvent or not. Nevertheless, the courts will not take a mere assertion from the company's officers that a loan is going to be granted and that this will permit the company to pay its debts that are due and payable, at face value (eg *First Strategic Development Corporation Ltd (in liq) v Chan* [2014] QSC 60). A court must be satisfied by reference to the commercial realities that the company has a resource available to pay all its debts as they become payable, and it does not matter that one of those resources is an unsecured borrowing (eg *Leveraged Equities Ltd v Hilldale Australia Pty Ltd* [2008] NSWSC 190, [56]). The cases make it plain that a possibility of sufficient loan funds is not enough, what is required is genuine and realistic availability, as a matter of commercial reality (eg *Treloar Constructions* [2017] NSWCA 72, (2017) 318 FLR 58, [125]). There are indications from the majority of the Australian cases that courts, when confronted with the argument over unsecured loans, will consider the likelihood of whether the funds which a company asserts it will be getting will in fact be available to it. What several of the Australian cases emphasise is that before being willing to consider unsecured loan funds, there must be a degree of assuredness on the part of the debtor company that a loan will be forthcoming, and the prospective lender is committed to providing the funds (*Chan v First Strategic Development Corporation Ltd (in liq)* [2015] QCA 28, [42]).

According to the very recent joint judgment of Kyrou, Kennedy and Walker JJA in the Victorian Court of Appeal in *Quin v Vlahos* ([2021] VSCA 205, [139])): 'The key question is what degree of assurance does the relevant company have that funds of that third party will be made available to pay existing debts of the company or debts that the company proposes to incur.' However, this does not mean that there has to be absolute certainty that the loan will be extended. In *Lewis v Doran* Giles JA of the New South Wales Court of Appeal said that while the prospects of obtaining necessary funds from a party must be such as to give the company something more than a chance of paying its debts, that did not mean that the provision of the funds must be completely free of any uncertainty or contingency (at [69]). What there has to be is a sufficient likelihood for the company to rely upon the availability of those loan funds.

In the later Queensland Court of Appeal case of *Chan v First Strategic Development Corporation Ltd (in liq)* ([2015] QCA 28, [43]) Morrison JA (with whom Gotterson JA and Boddice J agreed) concurred with the comments of Giles JA in *Lewis v Doran* and he went on to say that just as the financial support does not have to be absolutely certain in order to be taken into account, the provision of funds does not have to be absolutely uncertain in order to be insufficient to qualify for consideration. The judge said that between the two extremes, namely absolute certainty of provision of funds and little likelihood of such provision:

> the factual circumstances of each case will provide a variety of points at which one might conclude that the financial support was of such a degree of commitment that it was likely to continue, and with the result that the company was able to pay its debts, and therefore that it has sufficient financial support to draw the conclusion of solvency.

Furthermore, his Honour stated that (at [44]): 'there was no benefit in attempting to achieve some precise formula as to likelihood, by reference to which the financial support qualifies or does not.'

In *Quin v Vlahos* the Victorian Court of Appeal supported this view and indicated that, in its view, it remained the law. In this latter case court said that in determining the level of certainty that the debtor company had concerning the extension of funds, then the position was to be assessed objectively from the perspective of the relevant company rather than from that of the prospective third-party lender (at [139]). Thus, even if the directors of a debtor company were, in their minds, certain of getting loan funds that would enable them to pay their debts, these funds would not be able to be considered in determining solvency if the directors' view was not based on objective fact. For example, at first instance in *Chan v First Strategic Development Corporation Ltd (in liq)* the company was held to be insolvent because the prospective lender's degree of commitment was low and so the company could not be assured of getting the necessary funds. The courts will be particularly careful to examine the commitment of any directors of the debtor company who might be willing to provide loan funds (eg *Featherstone v Ashala Model Agency Pty Ltd (in liq)* [2017] QCA 260, [23] – [24], [129(h)], [177]). This is probably because directors might be prone to making all the right noises but not come up with the goods in the end.

Lord Hodge pointed out in *Mac Plant Services Ltd v Contract Lifting Services (Scotland) Ltd,* while accepting the fact that unsecured loans may be taken into account, it could be important that in *Lewis v Doran* and, for that matter, in *Re A Company (No. 006794 of 1983),* the debtor company could show that it had a history of receiving assistance from the source of the loan funds. In this kind of situation, the company's assurance concerning the provision of funds would be quite high, and rightly so on objective grounds. Lord Hodge said that the circumstances are different where there is no such history, and the court is simply invited to speculate on whether such assistance might be or might have been given. The judge was of the view that for borrowed funds to be a factor in the assessment of cash flow insolvency the funds must be available or there must be a significant probability that they would be available in time to enable the debts due and payable to be discharged (at [76]).

Repayment of the loans

The availability of funds in the form of a loan will not enhance solvency where it is given for a very short term, such as 30 days, or payable on demand because it merely substitutes one form of immediate obligation for another (*Australian Securities and Investments Commission v Edwards* [2005] NSWSC 831, (2005) 220 ALR 148, [99]). Nevertheless, in *Coates Hire Operations Pty Ltd v D-Link Homes Pty Ltd* ([2011] NSWSC 1279, [76]) White J said that he did not understand the courts to be saying that it is always necessary to treat a loan payable on demand as a debt that is due or nearly due and not to be taken into account on a determination of solvency. It depends on whether the court is satisfied that demand will not be made within the reasonably immediate future. This view was referred to with apparent approval by the Queensland Court of Appeal in *International Cat Manufacturing (in liq) v Rodrick* ([2013] QCA 372, (2013) 97 ACSR 200, [111]).

The Singaporean Court of Appeal in *Sun Electric Power Pte Limited v RCMA Asia Pte Ltd* ([2021] SGCA 60), was willing to accept arrangements to borrow funds when determining whether any shortfall in liquid and realisable assets and cash flow could be made up by borrowings which would be repayable provided that this was at a time later than the debts fell due. The appellate court in *Lewis v Doran* said that unsecured borrowings are relevant, provided they do not give rise to obligations which the company is unable to meet. However, after saying that, we need to note that later Australian decisions have provided that a loan which is technically repayable on demand will not be treated as immediately due and payable for the purposes of assessing solvency, and therefore able to assist in contributing to solvency, where there is evidence that the lender does not intend to demand repayment prior to a particular event occurring (eg *International Cat Manufacturing (in liq) v Rodrick* [2013] QCA 372, [108], (2013) 97 ACSR 200, 224). Importantly, the funds in *Lewis v Doran* were to be extended on a payment on demand basis and yet the court accepted that the funds could be considered in determining solvency.

Hindsight

Where the court has the benefit of assessing insolvency with the advantage of hindsight, it will tend to be in a better position to evaluate the true bearing of unsecured borrowings on the company's ability to meet its financial obligations (*Williams v Scholz)*. Thus, where a court is considering the solvency of a company in the context of a claim for an adjustment of a transaction under, say, either s 238 (transaction at an undervalue) or s 239 (preference) of the Act, because an inability to pay debts as at the time of the impugned transaction has to be established, hindsight could be of real assistance in deciding whether the availability of an unsecured loan meant that the company was in fact solvent.

Conclusion

When assessing whether a company is insolvent or not on a cash flow basis, as provided for in s 123(1)(e) of the Act, it is clear that not only cash in hand can be considered but so can property that might be sold or mortgaged quite quickly. While in the UK there is no detailed analysis of whether funds obtainable through unsecured borrowing can also be considered in evaluating solvency, what we do have is a clear acceptance by both English and Scottish courts that unsecured borrowings may be considered in deciding whether a company is solvent or not on a cash flow basis. This has also been the view of many Australian courts since the Australian legislation dealing with the meaning of solvency was amended in 1992. The Australian jurisprudence provides that whether loan funds may be taken into account in determining solvency courts will evaluate the certainty of the granting of the funds from the perspective of the company and on an objective basis, and there is some UK authority that supports this kind of approach. In addition, the Australian cases overall hold that just because a loan might be repayable on demand does not mean that a court will rule out considering the loan in assessing the borrowing company's solvency. The UK and Australian cases have also not excluded prospective loans from directors from being considered in determining solvency.