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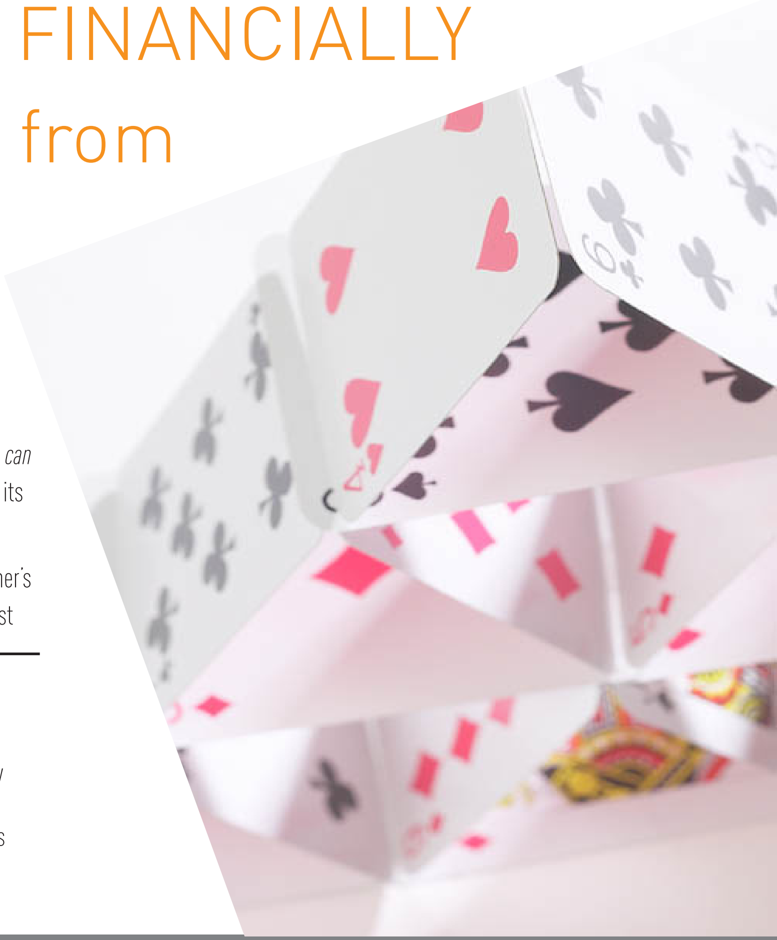
REFINANCING AND WORKOUTS OF FINANCIALLY DISTRESSED COMPANIES: Lessons from The Bell Group Ltd (In Liquidation) v Westpac Banking Corporation[1]

1 Decision No 9, [2008] WASC 239.



INTRODUCTION

"From time to time during the last five years I felt as if I were confined to an oubliette. There were occasions on which I thought the task of completing this case might be sempiternal. Fortunately, I have not yet been called upon to confront the infinite and, better still, a nepenthe beckons. Part of the nepenthe (which may even bear that name) is likely to involve a yeast-based substance. It will certainly involve a complete avoidance of making decisions and writing judgments.

For the moment, in the words of Ovid (with an embellishment from the old Latin Mass): Iamque opus exegi, Deo gratias."[1]

1 For those readers whose English and Latin skills are not as good as Justice Owen's, oubliette is a form of dungeon accessible only from a hatch in a high ceiling, sempiternal means everlasting, nepenthe means a drug of forgetfulness and Iamque opus exegi, Deo gratias means And now I have finished the work, thanks be to God.

With those words, Justice Owen of the Supreme Court of Western Australia concluded his sesquipedalian[2] magnum opus ("*These reasons can only be described as a megillah*"[3]) on the collapse of the Bell group and its aftermath.

His Honour's judgment is a statistician's delight[4] and an English teacher's treat (the above quoted paragraphs are but a minute example) but most

2 Relating to a long word; characterised by using long words.
3 In this context, the Yiddish word Megillah means a long boring tediously detailed account.
4 The hearing took 404 days, there were 166 witnesses, 86,340 documents were tendered in evidence, there were 37,105 pages of transcript and the reasons for decision comprised 2,643 pages.

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importantly a salutary lesson for bankers, directors and their legal advisers of the legal pitfalls involved in refinancing and work-outs of corporate groups on the brink of financial collapse.

Although this judgement relates to events that occurred in the late 80's, early 90's, it is more than an historic footnote given it 'arrived' in the midst of a current global financial crash, the dimensions of which, arguably, have not been seen since the Great Depression.

THE FACTS

The Bell Group Limited (**TBGL**) was the holding company of a large corporate group. The corporate dramatis personae were: Bell Group Finance Pty Ltd (**BGF**), the group's treasury entity; Bell Group NV (**BGNV**), which issued bonds in several fundraising exercises in the Eurobond market, the Bell Group (UK) Holdings Ltd (**BGUK**), the English subsidiary, Bell Resources Ltd (**BRL**) a 39% owned subsidiary and an important cash box for the group and Bell Publishing Group Pty Ltd (**BPG**) which held the group's publishing assets.

In the mid 1980's, TBGL or BGF had banking facilities with various Banks situated in Australia. The facilities were unsecured but supported by negative pledge arrangements. In1986, BGUK took out a loan facility with the 'Lloyds syndicate', a syndicate of 14 Banks situated in Europe, Canada and the Middle East. This facility was also unsecured but supported by negative pledge arrangements.

Between December 1985 and July 1987, BGNV, TBGL and BGF between them issued five separate bond issues, described as 'convertible subordinated bonds' that raised about $585 million. The funds raised via the BGNV issues were on lent by BGNV to TBGL or BGF. The funds raised by TBGL and BGF went directly to each of them. The on-loans were not formally documented.

In October 1987, the stock market crashed. The financial pressure placed on the Bell group as a result eventually led to a takeover of the Bell group by Bond Corporation Holdings Ltd (**BCHL**). The takeover was completed around the end of 1988.

Despite continuing efforts to sell assets and reduce debt, a process started before the stock market crash, it became clear by the middle of 1989 that TBGL and BGF could not repay its facilities.

This sparked a series of negotiations between the Bell group and its various Bankers, which led to the restructure of the group's finance facilities. Completion of the documentation took until July 1990 although most were in place by mid February 1990.

In effect, the restructure involved the replacement of the existing negative pledge facilities, an extension of time to repay all Bank debt by May 1991, the repayment of Bank debt on a pro-rata basis from group asset sales, the subordination to Bank debt of all intra-group indebtedness and the giving of new guarantees and security over assets.

During the course of the restructure, a number of important events occurred:

- the Banks continued to receive grim cash flow projections;
- BCHL lost control of the Board of BRL;
- a Receiver was appointed to an important Bond group subsidiary, which was overturned on appeal in late February 1990; and
- TBGL raised the possibility the bondholders might not be subordinated and might rank equally with the Banks.

In April 1991, TBGL applied for the appointment of a provisional liquidator. Subsequently all group companies were placed into insolvency administrations. The Banks realised their securities and recovered about $283 million from the sale of the group's publishing assets, the sale of BRL shares and the collection of debts. The Banks' debt at 26 January 1990 was approximately $262 million.

THE LITIGATION - BACKGROUND

The proceedings commenced in December 1995. The Plaintiffs comprised TBGL, many of its subsidiaries, the Liquidators and the Trustee for the bondholders in the five convertible subordinated bond issues. The main Defendants were the 'Australian Banks' and the 'Lloyd's Syndicate Banks'. Although directors of TBGL, BGF, BGUK and other companies were initially named as defendants, they were not proceeded against.

The Plaintiffs threw everything bar the kitchen sink at the Defendants. The Plaintiffs sought an array of orders and other relief including the setting aside of the refinancing transactions, confirmation the on-loans were unsubordinated, the return of the monies taken by the Banks upon realisation of their securities, the refund of legal and bank fees, damages, interest and monetary compensation of around $1.5 billion.

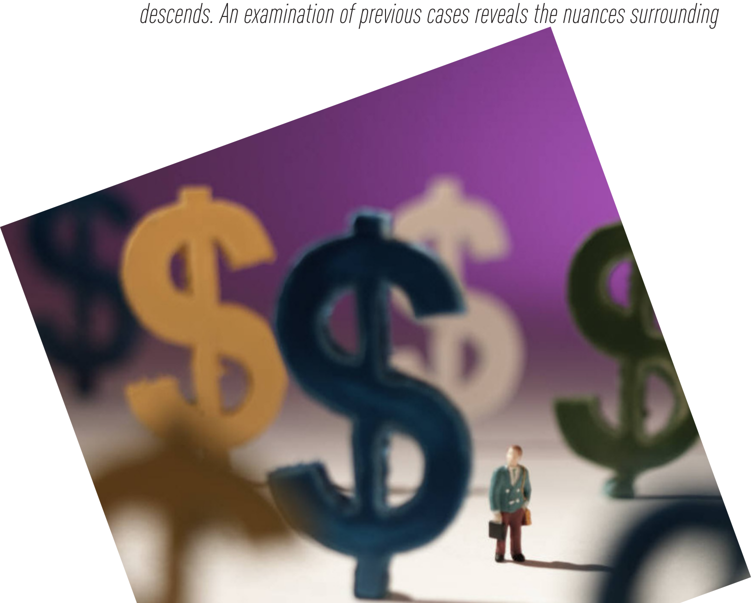
The Banks resisted the orders sought by the Plaintiffs and by cross-claim sought orders, declarations and injunctions to preserve the refinancing transactions, to confirm the on-loans were subordinated, to require the Plaintiffs to pay to the Banks any funds received in the liquidation of other Bell companies and other relief.

THE LITIGATION – CENTRAL ISSUES

Insolvency

Cash Flow test v Balance Sheet test

"The central feature of the insolvency concept is clear: a person is insolvent if he or she is unable to pay debts as they become due. But thereafter, the fog descends. An examination of previous cases reveals the nuances surrounding the concept of insolvency. The application of the concept in individual cases can be both vexed and difficult."



There are two solvency tests: the *cash flow test* and the *balance sheet test*. His Honour confirmed that in Australia the cash flow test was generally viewed as the more appropriate mechanism for assessing solvency and more in keeping with the definitions of solvency in the *Bankruptcy Act* and the *Corporations Act*. However, his Honour indicated the balance sheet test nonetheless remained relevant and could also be used in the right circumstances.

His Honour also confirmed that *"Insolvency is to be judged by a proper consideration of the company's financial position, in its entirety, based on commercial reality"* and that a temporary lack of liquidity was insufficient. Directors could legitimately take into account, besides cash reserves, funds realisable by assets sales, by borrowings and by other reasonable means provided they were not acting on faint hope or an unreal view.

His Honour was satisfied a court could take into account facts available in hindsight (post insolvency) if those facts shed light on the state of affairs at the time and on what was, or ought to have been, known about the state of affairs.[5]

In determining the period to be examined to assess the group's solvency, Justice Owen rejected the contentions of both sides and decided a 12 month period, with the major focus being on the period 26 January 1990 until the end of May 1990, was appropriate.

The Evidence

The Plaintiffs contended the evidence showed that by 26 January 1990, the Bell group companies were beset by "insurmountable endemic illiquidity" that would inevitably lead to their insolvency. Justice Owen, after analysing competing experts' cash flow prognostications, actual and potential sales of assets, collection of debts and the group's ability to raise new funds, accepted the Plaintiffs' contention.

His Honour also found the situation did not improve between May and December 1990 and that the refinancing in January 1990 did nothing to enable the Bell group to pay its debts as and when they fell due.

His Honour, in making his findings, pointed to evidence of:

- the forecast continuing cash flow deficiencies;
- the substantial disconformity between recurrent cash inflows and recurrent liabilities;
- the disconformity between the profits from its only operating business and its overall interest expense;
- the pattern of continuing losses; and
- the absence of assets that could be realised, sold or mortgaged in time to cover the amount due.

The Directors

Breach of Duties and Corporate Benefit

The Plaintiffs alleged the directors failed to act in the interests of the companies, exercised their powers for an improper purpose and failed to avoid a conflict of interest.

They argued, among other things, that the directors:

- failed to have regard to the effect of the refinancing transactions on each company as a whole including its creditors, future

5 Lewis v Doran (2004) ALR 385 and on appeal (2005) 219 ALR 555.

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creditors and shareholders;

- caused each company to enter the refinancing transactions thereby exposing each company to be liable for the debts of BGF and/or BGUK (both of which were then in an insolvency context) to the Banks in circumstances where that had not previously been the case; and
- acted to protect their position of control of TBGL and their financial interests in BCHL and other Bond companies and that this was in conflict with their duties to Bell group companies.

The Banks argued, in effect, that the interests of creditors were essentially irrelevant considerations for directors. Justice Owen rejected this argument. While in an insolvency context (actual insolvency was not required) there was no principle to the effect that directors must take into account the interests of creditors or that their interests were paramount in deciding what was in the best interests of the company, directors must nonetheless consider the interests of creditors.

As for the conflict of interest argument, the pleadings were unclear as to the case being made. The Banks argued the Plaintiffs were alleging a breach based on the directors preferring the interests of a third party instead of a conflict between fiduciary and principal. Justice Owen accepted that a transaction that benefits a third party is not prohibited by the conflicts rule unless, coincidentally, the fiduciary's interest lies in benefiting the third party. He was therefore not prepared to entertain a plea to the effect that where there was a conflict between the interest of others and those of the company, the director could not exercise his powers in the interest of others. On the evidence, this allegation failed.

His Honour, in considering whether there had been a breach of directors' duties, had to decide whether the test to be applied was objective or subjective. The end result was an 'each way bet'; while the court accepted directors and not courts made the commercial decisions and that their subjective intentions or belief were relevant, when considering an impugned transaction, the courts were entitled to look objectively at the surrounding circumstances to test the directors' subjective intentions or belief and to intervene where the decision made was one that no reasonable board could think was in the interests of the company.

Justice Owen found there had been a breach of directors' duties by the Australian and UK directors.

His Honour was satisfied the Australian directors knew the companies were of doubtful solvency or nearly insolvent but not that they were insolvent. They therefore had a duty to consider the interests of creditors but instead considered the interest of only one creditor, the Banks.

Further, these directors:

- focussed their concern on the group and not on the interests of individual companies ('we all survive or we all go down');
- the refinancing transactions were 'step one' in a plan to save the group, yet the plan beyond 'step one' had not been developed or thought out in sufficient detail; and
- two of the three directors were more concerned about the interests of the BCHL group than the Bell group companies of which they were directors.

His Honour also found the directors exercised their powers for an *improper purpose* by causing companies with no pre-existing indebtedness to the Banks to place their assets in jeopardy in the interests of borrowers and guarantors that were insolvent, nearly insolvent or of doubtful solvency. In this sense, the directors failed to ensure there was a *corporate benefit* to the individual companies in entering the refinancing transactions. The "plan" was simply a means to stave off financial collapse and this too was insufficient to ground an argument that the refinancing transactions provided a corporate benefit to individual companies.

His Honour was far less critical of the UK directors. He accepted they had approached their consideration of the refinancing transactions appropriately but "stumbled at the last obstacle" by failing to get reliable financial statements and information to verify the Bell group companies were solvent and that letters of comfort given by TBGL on which they were relying (Justice Owen described this as the *critical factor* in determining whether the refinancing transactions were in the best interests of the individual companies of which they were directors) would be honoured if called on. Instead, they relied on assurances from officers of the Australian Bell group companies and Alan Bond (who was not a director of any company relevant to these issues) to that effect. Those assurances turned out to be wrong.

The Banks

Their Knowledge and Conduct

The evidence showed that as at 26 January 1990, the Banks held a strong suspicion the Bell group companies were insolvent or nearly so and did or must have had serious concerns about the Bell group's ability to continue as a going concern.

As the refinancing negotiations progressed, the Banks, contrary to normal banking practice, sought less and less information about the ongoing financial circumstances of the group such as cash flow information, audited company accounts and company creditors. Tellingly, the Banks waived the requirement that solvency certificates be provided when having pushed for them earlier in the refinancing negotiations.

The Banks after much deliberation about the structure to be adopted for the refinancing transactions settled on the borrowers structure as that would avoid the threat of 'double jeopardy' (the securities being set aside and the Banks having to compete with other creditors in a liquidation) and would leave them no worse off if the refinancing transactions were set aside.

In all of these circumstances, the usual proposition that it was for the directors to determine corporate benefit and that the Banks could rely on their determination did not apply. The banks had too much knowledge of the true situation to argue there was corporate benefit in the refinancing transactions for many of the group companies.

Barnes v Addy[6]

The Plaintiffs alleged the Banks knowingly received trust property within the meaning of the first limb of the rule in *Barnes v Addy*. The second limb of knowing assistance or knowing participation in a breach of fiduciary duty was inapplicable.

For the allegation to be made out the recipient must have had actual knowledge of the trust and the misapplication of the trust property; turned a blind eye to the facts, refrained from making enquiries an honest and reasonable person would make or knew of facts that to an honest and reasonable person would indicate the existence of the trust and the misapplication.

Justice Owen held the relevant 'property' was created and disposed of when the directors, as part of the refinancing transactions, created security interests over company assets that were previously free of any relevant third party interests.

The Banks knew:

- of the legal consequences if the companies went into liquidation within six months of the creation of the securities taken as part of the refinancing transactions (they would be set aside);
- there was a real doubt about whether there was a corporate benefit for all relevant companies; and
- of the parlous financial condition of the companies;

and the Banks recklessly refrained from finding out about:

- the actual financial position of the companies;
- the position of the on-loans;
- the effect of the refinancing transactions on other creditors; and
- whether the directors might be breaching their duties in determining whether there was a corporate benefit to each company that entered into the refinancing transactions.

In these circumstances, Justice Owen found the 'knowing receipt' allegations to be proved.

Form over Substance

The Banks required the refinancing documents, minutes of directors' meeting and resolutions to address the issue of corporate benefit and to positively assert such benefit existed.

The Banks had received legal advice that there had to be a corporate benefit for each company entering into the refinancing transactions and that this would or at least may involve considering the interest of

6 (1874) 9 Ch App 244.

creditors. The Banks instructed the lawyers to draft the documents with this in mind. The minutes of meeting were identical.

Justice Owen found the drafting of the recitals to the refinancing documents and the minutes were a triumph of form over substance. What was crucial was the directors' actual belief as to the existence of corporate benefit; the evidence showed the *Australian directors* did not appreciate what the corporate benefit test involved and therefore could not have made a bona fide decision as to its existence.

Justice Owen found, in contrast, that the UK directors were well informed about the substance of the corporate benefit test and applied themselves diligently to the task of complying with it. There was no form over substance approach by them. As mentioned earlier in this article, the UK directors nonetheless failed in their duties but for other reasons.

The Plaintiffs' Other Claims

The Plaintiffs made a number of other allegations (the kitchen sink referred to earlier) including:

- the Banks conduct in entering into the refinancing transactions engaged in equitable fraud as against the non Bank creditors of the Bell group generally and to the bondholders;
- the refinancing transactions constituted an inequitable and unconscientious bargain (another equitable fraud) on each Bell participant;

Justice Owen found the evidence did not support these allegations.

- Certain of the security documents comprising the refinancing transactions constituted dispositions by certain Bell companies made with an intent to defeat creditors or future creditors contrary to section 121 Bankruptcy Act and equivalent state and territory legislation;

Justice Owen found that because the Plaintiffs had not pleaded an essential element of the cause of action – an actual dishonest intent on the part of the directors – this allegation failed.

- The same set of security documents as above but as entered into by four only of the Bell companies constituted settlements made within two or five years before the commencement of the winding up of those companies under sections 120 (1) or 120 (2) Bankruptcy Act;

Justice Owen found this allegation to be proved.

Justice Owen also found the bondholders interests were subordinated to the Banks and therefore the Banks had not failed to pay due regard to their interests.

CONCLUSION

Final orders have not yet been made. Justice Owen has 'suggested' to the parties that it is not too late for a negotiated settlement. Whether they heed his Honour's words remains to be seen.

The law has moved on since the events the subject of this case. There have been changes to the insolvency laws, to the laws on directors' duties and to corporations law that now allows a company to act in the best interests of its holding company provided the company is not insolvent. It is questionable however, whether any of these changes would have produced a different outcome for the Banks.

There are many lessons to be learned from this saga for directors, bankers and their legal and accounting advisers. Bankers again find themselves in a similar situation to that which prevailed in this case, in managing the 'work-outs' of a number of current major Australian corporate collapses. Whether the lessons have been learned may well be a topic for a later article.

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For further information please contact:

Stephen Newman, Partner
Phone (direct) **+61 3 9608 2219**
Mobile **+61 419 349 423**
Email **s.newman@cornwalls.com.au**