

## What You Need to Know

More construction companies, already under pressure from stretched supply chains and labour shortages, are expected to face insolvency in 2022. Parties should include a broad definition of “insolvent” in contracts, as even if the counterparty is not insolvent for the purposes of the Corporations Act 2001 (Cth) (Corporations Act), the courts will apply the broader contractual definition when considering if there has been a contractual default triggering termination rights.

## Introduction

The decision of *Carna Group Pty Ltd v the Griffin Coal Mining Company (No 6)* [2021] FCA 1214 in the Federal Court of Australia provides helpful views on:

- The benefit of drafting a broad definition of “insolvent” in commercial contracts
- When a party has committed an “insolvency default breach” by being unable to pay its debts when they fall due

## Background

In January 2014, Carna Group Pty Ltd (**Carna**) entered into a contract with the first respondent (Griffin Coal Mining Company Pty Ltd) (**Griffin**) to provide mining services to Griffin (the **Contract**).

Griffin is a coal mining company in Western Australia, with its operations in the southern town of Collie. Carna was a family company providing earth-moving services, before expanding into mining services.

On 3 December 2014, Carna purported to terminate the Contract based on breaches allegedly committed by Griffin in that there were multiple delayed or failed payments, with Griffin always owing between AU\$5 million and AU\$11 million in late payments to Carna in at least May, June, July, August and September 2014.

Carna contended that Griffin was “insolvent” within the meaning of subparagraph (g) of the contractual definition by 3 December 2014, being the date on which Carna purported to terminate the Contract with immediate effect under cl 17.11. The proper construction and meaning of subparagraph (g) was strongly contested, with Griffin disputing it was insolvent under the Contract.

## Contractual Terms

The Contract comprehensively defined the term “insolvent” by setting out seven specific circumstances that, if one or more applied to either party, will mean that party is “insolvent”. The relevant circumstances were those set out at (a) and (g) of the definition:

“**Insolvent** means, in respect of a party, that it:

(a) is (or states that it is) insolvent (as defined in the Corporations Act);

...

(g) is otherwise unable to pay its debts when they fall due.”

Carna argued that while similar legal tests may be utilised in assessing whether a party is “insolvent” under subparagraphs (a) and (g), it was not necessary under subparagraph (g) to satisfy insolvency under subparagraph (a). Carna contended that all that was required was a factual finding that Griffin was unable to pay its debts when they fell due at the relevant point in time.

On the other hand, Griffin argued that there was no warrant to read subparagraph (g) more broadly than subparagraph (a), as subparagraph (a) was intended to pick up the definition under the Corporations Act, whatever that may be throughout the life of the Contract, while subparagraph (g) sought to immortalise that definition by setting it out.

The Court found that Carna’s construction was to be preferred as the definition disclosed no basis upon which subparagraph (g) was to be confined and read down by reference to subparagraph (a).

## Insolvency Default

It was found that simply being late with one or two payments would not satisfy the requirements of subparagraph (g).

McKerracher J stated that the question to be resolved was not whether or not Griffin was insolvent for the purposes of the Corporations Act, but whether it was unable to pay its debts when they fell due as at the currency of the Contract, and within the meaning of that subparagraph in the Contract.

Carna relied upon the Australian Securities and Investments Commission’s (**ASIC**) Information Sheet 42, which in turn, mirrors the *indicia* set out in *Australian Securities and Investments Commission v Plymin* [2003] VSC 123; per Mandie J, as providing strong indications that Griffin was insolvent by any test, but certainly “insolvent” for the purposes of subparagraph (g) of the definition in the Contract at, and certainly in the months before, the Contract was terminated on 3 December 2014.

Griffin disputed certain factors of Carna's position, as summarised below:

- **Poor cash flow**

In the year ending 31 March 2014, Griffin's cash outlay for its operating activities exceeded AU\$61.7 million. Accounting for cash flow from "investing activities", particularly net movement in related party loans, Griffin's cash in-flow was just over AU\$1.1 million. In the year ending 31 March 2015, Griffin's cash out-flow for its operating activities exceeded AU\$36 million, accounting similarly for "investing activities", particularly net movement in related party loans, the cash in-flow was about AU\$646,000.

Griffin argued that the accounts were signed off by directors and were audited and, therefore, if the cash flow problem was considered endemic, the directors would not have considered Griffin a going concern, nor would the auditors have signed off on the accounts.

McKerracher J dismissed this, stating, "there would rarely be an insolvent trading case or conclusion if this factor alone were conclusive."

- **Parent Company Support**

Griffin frequently did not plan for repayment of its debts and would urgently request funding from its parent company to support its debts, albeit with some delay by the parent company at times to provide that support. McKerracher J accepted that temporary problems are neither uncommon nor conclusive of whether a company can pay its debt when they fall due; however, in this instance, Griffin's liquidity problems were far from temporary and its continued reliance on its parent company was optimistic.

- **Existence of Demands**

Throughout 2013 and 2014, Griffin received numerous letters of demand and statutory demands from the Australian Taxation Office, in addition to a winding up application, and various demands from critical suppliers. Griffin argued that temporary liquidity problems do not demonstrate insolvency and that "ultimately all creditors were paid".

McKerracher J concluded that there was no apparent evidence of this fact and that, regardless, it does not address the problem of failing to pay numerous creditors when the debts fell due, or even within a reasonable period thereafter.

- **Griffin's Continued Existence**

Griffin heavily relied on the fact that it continued to exist at the time of the court hearing (seven years later) and reiterated that there was no basis upon which its troubles at the time could be characterised as anything other than a temporary liquidity problem.

McKerracher J rejected this, stating that Griffin's argument failed to address a fundamental aspect of the matter, being that, not only must debts be paid, they must be paid "when they fall due". Further, Carna had made it clear to Griffin that timely payment was crucial to the operation of the mine, with the Contract terms reflecting this.

The Court ultimately concluded that Carna had established its entitlement under Sch 15 of the Contract to receive payment of AU\$5,116,400.27 by reason of Griffin's Insolvency Default Breach. The Court did, however, reiterate that this finding was in relation to the meaning pursuant to the Contract and not for the purposes of the Corporations Act.

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