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CLAYTON UTZ

Clayton Utz Special Issue

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ARTICLE

Long Tail Personal Injury Liabilities: The Australian Response

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Asbestos and other dust diseases are not a new issue. Nevertheless, events over the last few years have catapulted them to the forefront of community and political debate in Australia.

Interestingly, a combination of factors has resulted in this personal injury issue being increasingly viewed through the prism of company law. This has resulted in some radical company law reform proposals.

1. Background

The James Hardie group was an Australian-domiciled manufacturer of asbestos products. In 2001, long after it had ceased to manufacture asbestos products, it relocated to Holland (for tax reasons). It left behind in Australia the group companies which had been the manufacturers of asbestos products; those group companies were hived off from the rest of the group and placed under the control of a standalone company under the terms of a trust. The purpose of this trust arrangement was to use the assets of the former group companies to provide for the payment of claims for asbestos-related illnesses from Australians.

It subsequently emerged that the quantum of claims would outweigh the funds available. The trustee applied to the NSW Supreme Court for directions as to the appropriate course of action. In the course of dealing with that application, the Court held that many persons injured through exposure to James Hardie's asbestos products would have no standing as creditors should the former group companies be placed in liquidation:

> '58 On current authority, persons injured through exposure to asbestos manufactured or supplied by [the group companies] do not have a completed cause of action until damage is suffered and that usually involves manifestation of the disease … .
>
> 59 This type of liability must be distinguished from the case of a contingent creditor [or] a prospective creditor … .
>
> 60 The distinction is vital because whilst contingent or prospective creditors are taken into account in assessing solvency, possible future claims that might crystallise are not. The great probabilities are that if [the group companies] were to go into provisional liquidation now, then the only claims that would be paid by the liquidator would be those which have crystallised and, after paying the doubtless heavy expenses of liquidation, there would be a distribution of surplus funds to the shareholder MRCF which would be used for the purpose of the alleged charitable fund. The future creditors would get nothing and this may very well be the case even if the claim matured the day after the liquidation commenced.'[1]

Australia has a federal system of government. Responsibility for workplace health and safety rests with State legislatures, while the Federal legislature has authority over corporate law (including corporate insolvency). The New South Wales State Government commissioned an inquiry into the James Hardie situation. That committee released its report in September 2004. The report recognised the legal position identified by the Supreme Court and commented that: 'unless some general reform is enacted that permits [corporate insolvency law] to deal with long tail liabilities, future cases will arise that will have to be the subject of ad hoc legislative solution, if serious injustice is to be avoided'.[2]

2. The mass future claim proposal

In October 2005, the Federal Government announced its response to the issues identified by the NSW Supreme Court and the inquiry report. It asked the Corporations and Markets Advisory Committee (CAMAC) to consider and report on a detailed legislative proposal that the Government had prepared. Under that proposal, companies, liquidators and voluntary administrators would be required to take account of (and make provision for) long tail personal injury liabilities even where

Notes

1 *Edwards & Ors v Attorney General & Anor* [2004] NSWCA 272.

2 Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation, September 2004: <www.cabinet.nsw.gov.au/publications/tco_branches>.

the individual claimants were not identifiable. The proposed name for this class of contingency was 'mass future claim'.

A 'mass future claim' would exist where:

- the company had been subject to an unusually high number of claims for payment arising from particular acts or omissions leading to personal injury; or
- more than one company in a similar industry, or other companies with similar business operations to the company in question, had been subject to such claims; and
- there was a strong likelihood of numerous future claims of this type.

Where a mass future claim had arisen, three new rules would come into play, *unless* it was not reasonably possible either to:

- identify the circumstances giving rise to the future personal injury claims and the class of persons who would bring the claims; or
- reasonably estimate the extent of the company's liability under such claims.

The key new rules were:

- an extension of the existing protections for company creditors (eg s 256B of the Corporations Act 2001, which prohibits reductions in share capital that materially prejudice the company's ability to pay its creditors) to encompass claimants under mass future claims;
- a prohibition on transactions which were deliberately designed to ensure that the company did not have the financial capacity to meet mass future claims; and
- a regime under which liquidators would make provision for mass future claims, where required by a court. The size of that provisioning would be calculated on the basis of:
    - estimates of the number of acts or omissions that might give rise to liability under the relevant head of damage;
    - industry analyses;
    - academic studies;
    - independent actuarial analyses;
    - the level of damages awarded for similar claims in Australia or other common law jurisdictions; or
    - 'such other matters as the external administrator thinks relevant'.

If there were insufficient assets in a liquidation to fully fund the provision for unascertained future creditors and repay existing creditors, assets would be divided proportionately.

On 17 July 2007, CAMAC released a detailed discussion paper in response to the Government proposal.

3. CAMAC response

CAMAC's discussion paper contains an extensive analysis of the Government's proposals in the light of both its underlying policy objectives and input by key players (including the peak representative bodies for both the legal and the insolvency professions).

The paper reports a significant number of practical reservations about the original proposals and suggests a large number of alternatives.[3] However, it is fair to say that CAMAC has not come up with a magic bullet solution to the problem.

3.1 Threshold

The Government's proposal turns on the following definition of 'mass future claim':

- either
    - the company has been subject to an unusually high number of claims for payment arising from particular acts or omissions leading to personal injury; or
    - more than one company in a similar industry, or other companies with similar business operations to the company in question, have been subject to such claims;

  and
- there is a strong likelihood of numerous future claims of this type;
- unless it is not reasonably possible to:
    - identify the circumstances giving rise to the future personal injury claims and the class of persons who will bring the claims; or
    - reasonably estimate the extent of the company's liability under such claims.

According to submissions received by CAMAC, this test is too broad, too vague and, in the case of the provisos, too difficult to apply. This leads CAMAC to ask:

Notes

3 In a possible case of damning with faint praise, CAMAC reported that '[s]ome submissions supported the general thrust of the Proposal, although in some cases that support was subject to reservations about its effect on shareholders and creditors'.

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- whether a threshold test is necessary; and
- whether an alternative test may be more appropriate.

CAMAC itself suggests a possible alternative:

- at least one other personal injury claim against the company or against another company in a similar industry has successfully been made (including by way of settlement, with or without a confidentiality agreement) or currently exists with a reasonable likelihood of success; and
- the company knows or ought reasonably to know of the exposure of a significant number of persons to the factors that have given rise to that claim; and
- there is a reasonable likelihood [a balance of probabilities test] that numerous future claims against the company would arise from that exposure.

It also notes and calls for submissions on further alternatives put forward by persons who have already made submissions on the point:

- allowing the Government to declare that the long tail provisions apply to specified industries or products;
- aligning the test with the definition of 'contingent liability' in the accounting standards.

3.2 Solvent companies

The Government's proposal would impact on solvent companies, by extending creditor protections that already apply to capital management procedures such as capital reductions and buy-backs.

CAMAC notes that this does not address other procedures that could impact on a company's ability to pay mass claims, such as dividends and financial assistance for the acquisition of the company's own shares. Contrariwise, it impliedly notes the limited effect that the existing proposal might have on capital management:

> 'However, the proposed restrictions would not necessarily have the effect of precluding a company subject to this provision from managing its capital. For instance, directors could legitimately say, in some circumstances, that buy-backs or capital reductions, undertaken as part of their continuing capital management program, would strengthen the company over time and therefore likely increase, rather than reduce, the funds available to cover [mass future claims] as they arise.'

As an alternative, CAMAC suggests a combination of an enhanced disclosure requirement and existing directors' duties:

> 'A possible alternative approach would be to require solvent companies (whether or not facing a mass future claim) to disclose the existence of [mass future claims] and otherwise rely on general principles of directors' duties to guide boards on how to take [mass future claims] into account in their corporate decision-making, including in relation to capital reductions, buy-backs and financial assistance transactions.'

In addition, it floats the adoption of a version of the US Johns-Manville variation on Chapter 11, applying to companies that, although currently solvent, would be bankrupted by mass future claims. Such a company would be able (with court approval) to set up a trust for mass future claims. That trust would be issued with new voting shares in the company (sufficient to give the trust majority voting control of the company). Mass future claims would only be payable from the trust, at a uniform rate of return.

CAMAC does note some potentially significant downsides to this idea. These include:

- after a period of time, the rate of return may turn out to have been too conservative and may have been based on an underestimation of what the company could afford;
- the dilution of existing shareholders;
- the need for takeover bidders to obtain the cooperation of the trustee.

3.3 Voluntary administration

Voluntary administration is a statutory regime under which financially-troubled companies can obtain a short debt moratorium while an independent administrator negotiates with creditors on a work-out plan (which usually takes the form of a statutorily binding deed of company arrangement (DOCA)).

The Government's proposal would require the administrator and the DOCA to take account of, and make provision for, mass future claims.

CAMAC identifies a number of possible policy objections to this proposal. For example, locking up assets for the payment of mass future claims may reduce the attractiveness of voluntary administration for a company's creditors. It may encourage companies and creditors into unregulated work-out arrangements in an attempt to avoid having to make provision for mass future claims.

CAMAC suggests four alternatives:

- allowing a voluntary administration to make a last and binding financial settlement for mass future claims;
- the status quo – no mandatory provision for mass future claims – on the basis that the recovery pros-

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pects for mass future claims would be enhanced if a company successfully used voluntary administration to return to financial health;

- allowing voluntary administrations to 'opt out' of the mass future claim regime if the company's directors certify that the company has no mass future claims or that mass future claims would not be materially prejudiced by voluntary administration;
- requiring the appointment of a representative of mass future claimants, who could apply to the Court to terminate a voluntary administration if it was against their interests.

3.4 Winding up

The payment of mass future claims (or provisioning for mass future claims) would be the last opportunity for such claimants to receive money from a company which was in liquidation.

The CAMAC discussion paper records many submissions that noted the inherent uncertainty in placing a final value on mass future claims, since they are personal injury claims and the identity and number of future claims will itself be an estimate that may change over time. Among other things, this uncertainty would have deleterious effects on the interests of other creditors, by creating long delays in the settlement and payment of their claims.

In response, CAMAC asked whether this issue could be addressed by requiring the creation of a separate trust for mass future claims, along with a court determination of a definite value of mass future claims. The trustee would then become a creditor of the company for that amount. Future claimants could then claim against the trust fund as their injuries manifested themselves.

If the company had insufficient assets to pay ascertained creditors and mass future claims in full, the assets should be divided proportionately, according to the estimated total value of claims by ascertained creditors and mass future claims.

4. Comment

A number of observations can be made on the current situation.

The first is that there is no legislative action on the immediate horizon. The CAMAC discussion paper has identified a large number of problems with the Government's original concept, but has substituted more questions, rather than an alternative legislative proposal. What is clear is that the laudable desire, to ensure that long tail injury claimants are not locked out of corporate insolvency, must be balanced against other policy considerations in the wider world of corporate insolvency. Working out that balance is going to be a time-consuming process.

The second important point is that the extent of the long tail personal injury problem is unknown. If it is confined to asbestos, then it may be possible to quarantine it and to make policy that does not spill over into corporate insolvency in general. Experience suggests, however, that that is unlikely.

To finish on a positive note, the fact remains that this issue is being addressed in a detailed and thoughtful way. The CAMAC paper has engaged with many of the underlying policy issues and has provided a good launchpad for the debate. There is no simple solution, but the process in which we are currently engaged may help to ensure that there is a viable long-term outcome, rather than a quick legislative 'fix'.

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ARTICLE

Solvent Schemes of Arrangement in the Australian Reinsurance Industry

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Solvent schemes – also known as 'cut off' or 'valuation' schemes – involve a court approved process by which insurers which have written contracts with reinsurers approve the company settling all of their outstanding or future claims by one payment. They have become prevalent amongst UK insurance and reinsurance companies as a way to accelerate the payment of long-tail liabilities.

For reinsurers, solvent schemes can bring an early end to run-off and the repatriation of capital much sooner than if claims are allowed to mature in the ordinary course. This typically occurs where there is both a mature book of business and a clear surplus of assets over liabilities after payment of all liabilities. For cedants, solvent schemes allow them to have their future potential claims valued and paid in full sooner than in the ordinary course.

There have only been a few instances of solvent schemes implemented in Australia. This is explicable by the relatively small amount of mature long tail reinsurance business written by Australian reinsurance companies. However, their support in Australia suggests they are considered advantageous by both cedants and reinsurers. This article considers the nature and processes involved in solvent schemes for reinsurance companies, and the advantages and disadvantages of these schemes for reinsurers and their cedants.

The purpose of a solvent scheme of arrangement

Run-off exists where a reinsurance company has ceased to accept new insurance or reinsurance risks for the entire business or a division of the business, but claims remain unresolved and there are prospects of future claims being made. In the ordinary course of events, these claims are discharged as and when they arise, potentially over an extended period of time.

For a reinsurer that is no longer seeking new business, it is clearly undesirable to prolong the existence of such claims. Solvent schemes can accelerate the payment of these current and future claims and facilitate the winding up of inoperative businesses or bring an end to inoperative books of business in discrete divisions.

There have been only three instances of approved solvent schemes in Australia to date – those implemented on behalf of Mercantile Mutual Insurance (Aust) Ltd ('MMIA'), NRG London Reinsurance Co Ltd ('NRG London') and NRG Victory Aust Ltd ('NRG Victory').[1] In each instance, the reinsurers used a solvent scheme as a way of accelerating the payment of claims under existing reinsurance policies that had been made but not yet finalised, or were expected to be made in the future.

Mercantile Mutual Insurance (Aust) Ltd (MMIA)

The first solvent scheme approved in Australia was the MMIA scheme, which was approved by the Federal Court of Australia in *Re Mercantile Mutual Insurance (Aust) Ltd* (2002) 43 ACSR 676.

MMIA was an insurance company that as at 2002 had discontinued writing new reinsurance business. At that time MMIA was an Australian based division of the international financial services group ING, and prior to 2002 operated in both the general insurance and reinsurance markets.

MMIA and a number of other entities in the ING group decided to streamline their business, by removing books of business that were no longer active and were in run-off. For MMIA, the scheme was designed to apply only to claimants who stemmed from the discontinued non-Australian international reinsurance business emanating mainly from the London market, and discontinued inward reinsurance business. This allowed MMIA to bring an end to the inoperative segments of their business, and redirect funds and management into existing areas of business.

Notes

1 The writers acted for the companies in each of these schemes.

A feature of the scheme was that it was part of a number of different schemes which received concurrent Australian and UK court approval. The Federal Court of Australia granted permission for MMIA to convene the meeting of the scheme creditors in London, and for the parties to elect to have the arrangements governed by English law once approval had been gained.

As the only liabilities of the scheme companies to be subject to the scheme were reinsurance liabilities, the Federal Court accepted that the scheme creditors were all insurance companies (or similar entities) and could be expected to be sophisticated and knowledgeable in their consideration of whether to approve or reject the scheme. The court accepted that the proposed scheme provided a fair mechanism for dispute resolution where a creditor disagreed as to the nominated value of their claim, and that both ASIC and APRA had no objection to the scheme.

NRG London and NRG Victory

As with MMIA, NRG London and NRG Victory were both reinsurers seeking to bring an end to their unresolved insurance claims. NRG London was a reinsurance company incorporated in the UK. It was an active reinsurer until 1991, when it ceased underwriting new risks and was placed into run-off. The Australian branch of NRG London was a foreign corporation, licensed as a general insurer under the Corporations Act 2001. In 1991, the Australian branch of NRG London was also placed into run-off.

NRG Victory was incorporated in Victoria and was an active reinsurer in the Australian market until 1993. The company wrote both life and general reinsurance until 1993, when both activities ceased. At this time, the life insurance business of NRG Victory was transferred to another insurance entity, and the general insurance business was placed into run-off.

With the reinsurance business of both entities proceeding through the lengthy run-off process, the prospect of a solvent scheme that would bring an early end to this was appealing. Both entities proposed schemes that were nearly identical and were able to be dealt with in the one court approval process.

In granting approval, in *NRG London Reinsurance Co Ltd (ABN 77 001 160 792), Re NRG Victory Aust Ltd and the Corporations Act 2001* (2006) 58 ACSR 674, the Federal Court of Australia paid particular regard to three general features of the scheme – that the insurers could be expected to be commercially sophisticated by virtue of being insurance companies or similar entities, the business of both companies had been in run-off for a substantial period of time and there was a clear surplus of assets over liabilities.[2]

The process of implementation

The implementation of a solvent scheme in Australia is governed by Part 5.1 of the Corporations Act 2001 (Cth).

Identifying relevant creditors or classes of creditors

The first step in implementing a solvent scheme is to identify the relevant scheme creditors. Typically this will be defined in the scheme as a person who has a claim against the scheme company, being a liability under a reinsurance contract with the company.

The company must make all reasonable endeavours to identify the relevant creditors. In NRG, the Federal Court of Australia held that the scheme companies were required to establish that all reasonable steps had been taken or would be taken to identify the scheme creditors and to bring the proposed schemes to their attention, and that it seemed likely that the companies' efforts in these respects would be successful.[3]

Applying to the court for approval to convene meeting

Once all prospective creditors have been identified, the scheme company must apply to the court for approval to convene a meeting of the creditors, and for approval of the draft explanatory statement. The scheme company must also notify ASIC of the proposed scheme.[4]

Under section 411(1) and 1(A) of the Corporations Act 2001, the court has the power, upon application, to make orders that the company convene a meeting of creditors or a class of creditors be convened.

The court will also approve the explanatory statement that is required to accompany any notice of meeting that is sent to a scheme creditor.[5] Both the draft explanatory statement and the final statement are governed as to their contents by sections 411(3) and 412(1) of the Corporations Act 2001.

Section 411(3) provides that the draft explanatory statement must:

Notes

2 *NRG London Reinsurance Co Ltd (ABN 77 001 160 792), Re NRG Victory Aust Ltd and the Corporations Act 2001* (2006) 58 ACSR 674 at 676.
3 *Ibid.*
4 See section 411(2) of the Corporations Act 2001 (Cth).
5 The final version of this statement and its contents is required and governed by s412(1)(a).

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(a) explain the effect of the proposed arrangement, noting in particular any material interests of the directors of the scheme company; and

(b) set out such information as is prescribed and any other information that is material to the making of a decision by a creditor whether or not to agree to the scheme.

At the initial hearing, the court will determine whether the manner in which the proposed scheme will operate is so clearly unfair and unreasonable that it should not be allowed to go ahead for consideration.[6] The court will also determine whether there should be only one or multiple classes of scheme creditors, whether the explanatory statement provides adequate disclosure and complies with its statutory requirements and whether the way in which the value of scheme creditors' claims will be determined for the purposes of voting at the meeting is fair and reasonable.[7]

The scheme company will need to demonstrate to the court that the following requirements have been met:

– all reasonable steps have been or will be taken to identify potential scheme creditors and to bring notice of the proposed scheme to their attention;

– the explanatory statement for the proposed schemes provides an adequate description of the nature and purpose of the scheme, as well as its principal advantages and disadvantages;

– the manner in which the proposed scheme will operate is fair and reasonable and that the method by which the value of scheme creditors' claims will be determined is fair and reasonable;

– it is appropriate that there be only one meeting of creditors of each scheme company;

– the way in which the value of scheme creditors' claims will be determined for the purposes of voting at the scheme meeting is fair and reasonable;

– the proposed schemes comply generally with the requirements of the Corporations Act 2001 including adequate notification to ASIC;

– the scheme companies have provided full disclosure about the proposed schemes, and their future intentions, not only to scheme creditors and to the court, but also to APRA and ASIC, and that APRA and ASIC have had full opportunity to peruse the material and give the court a considered assessment of their positions.[8]

Approval by the majority

Once the court has approved the convening of the creditors' meeting and the explanatory statement, notice of the meeting must be given to the scheme creditors.

Typical examples of methods to notify creditors are:

– making enquiries of managers or agents of various underwriting pools;

– sending copies of the scheme booklet to all authorised insurers in relevant geographic areas, and all brokers who may have conducted business relevant to the scheme; and

– advertising the scheme in newspapers in relevant geographic areas.[9]

The scheme becomes binding upon approval at the meeting provided that the following requirements are met:

– the scheme is agreed to by a majority in number of the creditors (or class of creditors) present and voting;

– the relevant majority consists of creditors whose debts or claims against the company amount in the aggregate to at least 75% of the total amount of the debts and claims of the creditors present and voting.[10]

The process by which the value of the creditors' claims will be determined for the purposes of voting at the scheme meeting is generally set out in the explanatory statement.[11]

Final court approval

Once the scheme is approved by the requisite majority, a final application is made to the court for approval of the scheme. Where a creditor is unsatisfied with the result of a valuation at the creditors' meeting, they may raise this concern with the court at the final hearing for approval.

Once a scheme has been approved by the court, a suspension will be placed on all claims against the company. Claims cannot thereafter be commenced or continued against the company unless the scheme is utilised, as the scheme represents the only acceptable procedure by which to resolve such claims.

The claim forms are then sent to all known scheme creditors for them to lodge their claims. There is also a

Notes

6 *NRG London Reinsurance Co Ltd*, supra note 1, 676.
7 *Ibid*.
8 *Ibid*.
9 *NRG London Reinsurance Co Ltd*, supra note 1, 680.
10 Section 411(4) of the Corporations Act 2001.
11 *NRG London Reinsurance Co Ltd*, supra note 1, 686.

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cut-off date imposed on claims once a scheme has been approved. This means that in order to recover a claim amount, creditors must submit their claims by the nominated cut off date. Claims will not be paid where they do not comply with this time period. Under section 1321 of the Corporations Act 2001, however, where a person is aggrieved by any act, omission or decision of a person administering the scheme, they have a right of appeal to the court. This is a final safeguard for a creditor to ensure that there is equitable treatment, and an opportunity to remedy this if it is not the case.

Advantages and disadvantages of solvent schemes of arrangement

Solvent schemes provide a number of advantages for scheme companies and scheme creditors, largely relating to the early resolution of claims and certainty for both parties. In terms of disadvantages, these chiefly concern the limitations in estimating an insurance claim that has not fully crystallised.

Certainty and finality

The principal benefits of a solvent scheme are:

- scheme companies are able to terminate their relevant businesses, avoiding the need for a costly and protracted run-off. This will involve saving a substantial amount of money in administrative, legal, accounting, regulatory and other costs; and
- scheme creditors will be paid in full for the value of their claims, and generally no discount will be applied for the time-value of money.

Limitations in valuation

A potential difficulty with a solvent scheme is the possibility of an inaccurate valuation of a creditor's claim. This is an issue for both the creditor and the company. Where the creditor is granted an amount in excess of the true value of the claim, the company is worse off and the financial benefits of an early resolution of their business may be diminished. As for the creditor, the estimate may be an amount less than that to which they would have been entitled if run-off had continued to its natural end.

With respect to this issue, however, Lindgren J remarked in NRG that '[n]o doubt scheme creditors will take into account this disadvantage, and, on the other hand, the extent of the advantage to them of having money in hand, in determining whether to support the scheme'.[12] The parties will need to have careful regard to whether the advantages of entering the scheme outweigh the limitations on the estimation of a claim.

Protection of scheme creditors

While there are advantages for both the scheme company and scheme creditors in implementing a solvent scheme, the inherent characteristics of such a scheme require a number of protections to be afforded to scheme creditors.

The protection of creditor interests is particularly important when one considers the binding nature of a solvent scheme and the cut off of all claims that are not made within the relevant time period. As such, the courts will typically consider whether the scheme provides adequate protection against these issues prior to granting approval to the convening of the meeting or approving the scheme itself.

The interests of creditors are protected by the key features of the scheme itself. These include:

Sufficient notification of creditors

The company must provide sufficient notification of the scheme meeting and cut off date to the scheme creditors to ensure that all the creditors are aware of the essence of the scheme's provisions and effects, and to provide the creditors with sufficient opportunity to submit their forms for voting and claim purposes.[13] Such notification is essential due to the fact that in order to receive satisfaction of a claim, the claim must be submitted prior to the cut off date imposed by the scheme.

Majority approval and classes of creditors

The scheme must be approved by a required majority of scheme creditors. Where it is regarded by the court that there are a number of groups with different interests, the court will require that numerous meetings are held, with each meeting comprised of the different classes of creditor.[14]

Both the requirement for majority vote and the division of claims into suitable classes increases the protection afforded to the creditor.

Notes

12 *NRG London Reinsurance Co Ltd*, supra note 1, 680.
13 *Re Mercantile Mutual Insurance (Australia) Ltd* (2002) 196 ALR 362 at 370.
14 For a discussion of this see *Re Mercantile Mutual Insurance*, supra note 12 and *NRG London Reinsurance Co Ltd*, supra note 1, 682-686.

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Adjudication of claims

If the scheme is to be approved, it will generally require provision for adjudication in circumstances where the company and the scheme creditor cannot agree on the value of a claim.[15] It is usually the case that the scheme company will instruct an actuary to assist scheme companies with the evaluation of their claims. The actuary will prepare an estimation methodology that is considered to be a sound actuarial approach to the valuation of the majority of claims expected to be made. Most claims will be estimated in line with this methodology, unless it is clearly inappropriate in the particular circumstances.

Generally, upon receipt of a claim form from a scheme creditor, the company will review the amount that the claimant has submitted. If the scheme company agrees with the creditor's valuation, then this amount will be accepted as the relevant claims amount. If the scheme company and creditor cannot agree, the matter will be referred to a nominated scheme adjudicator. The usual process is that the scheme adjudicator will consider all relevant information, may consult with actuaries and lawyers, and then determine the value of the claim.

Reversion to run-off

Most schemes will feature the option of reverting to run-off to guard against any danger that the company will become insolvent due to a high volume or value of claims made by creditors. Solvent schemes will generally provide that if the total amount of all claims exceeds a certain amount, the scheme company will have the option of terminating the scheme and reverting to run-off. This reassures both the creditors and the approving court that the scheme companies will not be rendered insolvent as a result of an unexpectedly high value of claims.[16]

The creditor can thus support the scheme knowing that their support will not result in the company entering insolvency, or if there is any danger of this, that the scheme will be suspended in order to secure funds.

Participation by regulatory bodies

In NRG, the Federal Court of Australia noted that in order to approve the convening of a meeting and the final arrangement, the company would have to establish that the proposed scheme was brought to the attention of not only ASIC, but also APRA.[17]

The sophistication of the creditor

As demonstrated by NRG, the court in making its determination will also have regard to the commercial sophistication of the creditor. In NRG, the Federal Court of Australia considered it relevant that the creditors were all insurance companies and thus could be 'expected to be commercially sophisticated and knowledgeable and ... able to assess where their best interests [lay]'.[18]

Conclusion

Solvent schemes are a useful tool for reinsurance companies which are in run-off. They provide an advantageous mechanism to bring unresolved claims to an end, and to free up both the relevant company and its creditors.

While potential disadvantages exist with the limitations on estimating a claim and the finality of a scheme, these are readily overcome by the precautionary measures the courts require when deciding whether to approve a scheme.

Although to date solvent schemes in Australia have been limited to mature books of business in the reinsurance industry, it is important to note the potential for expansion of such schemes. As regulators become more comfortable with these processes, there is the possibility that they will also become more comfortable with approving schemes for less mature books of business, and, providing the relevant safeguards are implemented, direct insureds.

If the overriding purpose of a scheme is in fact the implementation of an exit strategy which is both fair and commercially acceptable to all the stakeholders involved, an intelligently devised and compliant solvent scheme will produce this result.

Notes

15 *Re Mercantile Mutual Insurance*, supra note 12, 370.
16 *NRG London Reinsurance Co Ltd*, supra note 1, 679-680.
17 *NRG London Reinsurance Co Ltd*, supra note 1, 676.
18 *NRG London Reinsurance Co Ltd*, supra note 1, 684.

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ARTICLE

High Court of Australia Holds Failed Airline Accountable to Global Airline Clearing House

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Introduction

The attack on the World Trade Centre on 11 September 2001 was a crippling event for the airline industry worldwide. But less than 24 hours after the attacks, the Australian airline industry was hit by another crippling event – the decision by the Board of Ansett Australia to place Australia's second largest airline into administration.

Ansett was a dominant player in the Australian airline industry for over 50 years. Its demise left thousands jobless and many creditors unpaid. One such creditor was the International Air Transport Association ('IATA'). IATA, formed in Canada in 1945, acts as a Clearing House for the hundreds of thousands of transactions that occur between airlines worldwide each month in relation to the carriage of passengers and cargo. Ansett joined IATA in 1951. Under the Clearing House system, the netting of monthly transactions in the clearance process would result in each member airline either receiving a single payment from IATA at the end of each month or making a single payment to IATA.

After Ansett was placed in administration, a dispute arose between IATA and the Administrators of Ansett as to IATA's status as a creditor. IATA argued that it was a creditor of Ansett as a result of Clearing House monthly clearances conducted in August to December 2001 (inclusive). The transactions cleared in those clearances had been performed but not cleared through the Clearing House prior to Ansett being placed in administration. The Administrators did not acknowledge IATA as a creditor of Ansett. They argued that the relevant transactions which had been cleared through the Clearing House (and in respect of the balance of which IATA claimed to be a creditor) gave rise to debts owing by and to Ansett (with other airlines). On this basis, the Administrators argued that the clearances purported to deal with the property of Ansett (being the debts said to be owed to it by other airlines) otherwise than in accordance with the insolvency laws by allowing for multilateral netting. Accordingly, the Administrators refused to acknowledge the operation of the August to December 2001 clearances of the Clearing House in so far as those clearances included claims by or against Ansett. The Administrators argued that the proper way of dealing with the transactions, that had not been cleared as at the date Ansett was placed in administration, was for airlines who were 'debtors' to Ansett as a result of those transactions to pay Ansett, and for those airlines who were 'creditors' of Ansett to lodge a proof of debt in Ansett's administration.

IATA commenced proceedings in the Supreme Court of Victoria in 2002[1] seeking to be recognised as a creditor of Ansett. In these proceedings, Justice Mandie found in favour of IATA. The Administrators appealed to the Court of Appeal of the Supreme Court of Victoria[2] who found in favour of the Administrators by a majority of 2:1.

IATA was granted special leave to appeal to the High Court of Australia in April 2007 and, in February 2008, the High Court delivered judgment in favour of IATA by a majority of 6:1.[3]

The proceedings concerned similar issues to those dealt with in the House of Lords decision in *British Eagle International Airlines Ltd v Compagnie National Air France* [1975] 1 WLR 758 ('*British Eagle*'). In *British Eagle*, it was held that IATA's Regulations, as they stood at that time, were contrary to the public policy and the provisions of the UK Companies Act. This finding was based on the majority of the House of Lords' view that the relevant contractual agreements gave rise to debts between individual member airlines in respect of transactions performed for each other. IATA's contractual documents had been amended in the light of *British Eagle* and the amended documents applied in the Ansett proceedings. The other difference between the Ansett proceedings and *British Eagle* was that *British Eagle* was

Notes

1 *International Air Transport Association v Ansett Australia Holdings Ltd (subject to Deed of Company Arrangement)* (2005) 53 ACSR 501.
2 *Ansett Australia Holdings Ltd (subject to Deed of Company Arrangement) v International Air Transport Association* (2006) 60 ACSR 468.
3 *International Air Transport Association v Ansett Australia Holdings Limited* [2008] HCA 3.

placed in liquidation, whereas Ansett was placed in voluntary administration and had subsequently executed a deed of company arrangement.

The High Court of Australia's decision

There were two key issues to be determined by the High Court:

1. whether, on the proper construction of the Regulations and Agreements, the only legal relationship of debtor and creditor that existed was that between Ansett and IATA rather than between Ansett and individual member airlines; and
2. whether the IATA Regulations and Agreements were contrary to the public policy of the insolvency provisions regulated by the Corporations Act 2001 and the Deed of Company Arrangement executed by Ansett.

Each of these issues is addressed separately below.

IATA's Regulations

An airline wishing to attain membership of IATA is required to execute various agreements between the airline, IATA and other member airlines of IATA. These agreements include the Multilateral Interline Traffic Agreements relating to the carriage of passengers and cargo (the 'Agreements'). The Agreements provide for member airlines to perform services for each other by carrying passengers and/or cargo.

Article 8 of the Agreements states that member airlines agree to pay each other member airline in relation to such transactions 'in accordance with the applicable regulations and current clearance procedures of the IATA Clearing House'. Regulation 9(a) of the Clearing House Regulations ('the Regulations') was held by the majority of the High Court to be the critical regulation which sets out the legal relationship between IATA and member airlines and as between each individual member airline. It states:

> 'With respect to transactions between members of the Clearing House which are subject to clearance through the Clearing House ... no liability for payment and no right of action to recover payment shall accrue between members of the Clearing House. In lieu thereof members shall have liabilities to the Clearing House for balances due by them resulting from a clearance or rights of action against the Clearing House for balances in their favour resulting from a clearance and collected by the Clearing House from debtor members in such clearance'

IATA argued that the Agreements and Regulations, particularly regulation 9(a), gave rise to a debtor-creditor relationship between IATA and Ansett only and that no such relationship existed between Ansett and other member airlines in respect of transactions cleared through the Clearing House. Justice Nettle, who delivered the Court's judgment against IATA in the Court of Appeal decision, conceded that 'if reg 9(a) stood alone, it would be hard to resist [IATA's] argument'.[4]

The Administrators argued that Regulation 9(a) did not create a debtor-creditor relationship between IATA and individual member airlines exclusively and that the Regulations and Agreements, when read and interpreted as a whole, in fact created a debtor-creditor relationship between individual airlines. The High Court accepted IATA's argument that the Regulations and Agreements give rise to a debtor-creditor relationship between individual member airlines and IATA (and not between member airlines themselves), and found that this relationship is not contradicted by other terms of the IATA Regulations so as to deny its effect. Chief Justice Gleeson stated:

> 'Regulation 9(a) means what it says. It cannot be ignored. It is not repugnant to some overriding provision. It is consistent with the other provisions. It makes good commercial sense. It should be given effect according to its terms.'[5]

His Honour went on to find that 'the property of Ansett did not include debts owed to it by other airline operators and the liabilities of Ansett did not include debts owed by it to other airline operators'.[6] His Honour used the words of Lord Morris, one of the Lords in the minority in the House of Lords in *British Eagle*, in describing the nature of Ansett's rights:

> 'The relevant property of Ansett was "the contractual right to have a clearance in respect of all services which had been rendered on the contractual terms and the right to receive payment from IATA if on clearance a credit in favour of the company resulted".'[7]

Accordingly, the Court found that pursuant to the terms of the IATA Regulations, 'no liability to effect payment arises between airlines and the only debt or credit which arises is that between IATA and the member airline in

Notes

4 (2006) 60 ACSR 468 at [95].
5 [2008] HCA 3 at [22].
6 [2008] HCA 3 at [23].
7 *Ibid.*

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relation to the final, single balance of all items entered for the relevant clearance'.[8]

British Eagle and the public policy argument

The Administrators sought to rely upon the *British Eagle* decision of the House of Lords to argue that the Clearing House arrangements were 'repugnant' to the insolvency laws governing the administration of Ansett. In *British Eagle*, the House of Lords, by a majority of 3:2, found that the Agreements and Regulations, as they stood at that time, on their proper construction, created a debtor-creditor relationship between individual member airlines. Further, the majority found that the Clearing House system was at conflict with, or an attempt to by-pass, the insolvency laws and, in particular, by seeking to circumvent the principle that creditors of an insolvent company should be paid on a *pari passu* or equal basis. The House of Lords held that it was contrary to public policy to allow the 'mini liquidation' of the IATA Clearing House (in reference to the multilateral netting that occurs in the clearance process) to prevail over the general liquidation with the result that Clearing House members are paid in priority to other creditors of British Eagle. In the Ansett case, Justice Kirby, in his dissenting judgment, illustrated this point in the following way:

> '... creditors of an insolvent company must not "be allowed to leave [their] assigned place in the queue and step ahead of others". Airlines have to deal all the time with passengers and shippers who try to jump the queue. Such conduct is not acceptable at airports or in airline offices. Nor, without clear and express legal authority, is it acceptable in the courts of law or elsewhere, once the provisions of insolvency law have been engaged and apply.'[9]

The High Court recognised that this case differed from *British Eagle* in various respects. Importantly, the terms of IATA's Regulations had been amended since the decision in *British Eagle*. In fact, IATA specifically amended the Regulations after the *British Eagle* decision so as to more accurately reflect the intent of the member airlines to create a debtor-creditor relationship solely between individual member airlines and IATA (rather than between member airlines themselves). The Court also acknowledged that this proceeding arose in the context of an administration pursuant to Part 5.3A of the Corporations Act 2001, rather than a liquidation, as was the case in *British Eagle*.

The Administrators' arguments in relation to public policy were wholly rejected by the majority of the High Court. The Court determined that the IATA Regulations were not, in their current form, repugnant to the insolvency laws governing the Ansett Administration or the terms of the Deed of Company Arrangement executed by Ansett. This finding followed from the majority's finding that the Agreements and Regulations only gave rise to debtor-creditor relationships between each individual airline and IATA. Specifically, the Court found that the rights and obligations of IATA, pursuant to the Regulations, were not affected by the supervening administration of Ansett, and Ansett's Administrators took those rights and obligations (being rights and obligations between IATA and each individual airline) as they found them. Further, the Court stated that the 'rule of public policy [asserted by Ansett] finds no footing in the relevant provisions of the [Act]' and that 'those provisions take effect according to their terms and are not to be supplemented or varied by the superimposition of a rule [of public policy] of the kind alleged.'[10] By rejecting the existence of a relevant 'rule of public policy', the majority gave primacy to the statutory nature of Australian insolvency law. The majority of the Court did not however need to express an opinion on whether, if the true effect of the Agreements and Regulations was as asserted by Ansett, the Clearing House clearances effected after Ansett was placed in administration would have been held to be invalid by reason of an inconsistency with any of the statutory provisions or provisions of the Deed of Company Arrangement executed by Ansett.

Conclusion

The result of the High Court of Australia's judgment is that the Administrators must recognise IATA as a creditor of Ansett and they cannot pursue airlines in respect of transactions cleared in the August to December 2001 clearances.

Aside from these immediate consequences, the judgment is of significant importance in the following respects:

1. the judgment preserves the integrity of the IATA Clearing House and the continued application of the Clearing House Regulations, as a matter of Australian law, to claims relating to members who become insolvent in respect of transactions performed but not cleared as at the date of the member's insolvency;

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8 [2008] HCA 3 at [60].
9 [2008] HCA 3 at [179].
10 [2008] HCA 3 at [93].

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2. the decision of the High Court of Australia, whilst only binding in Australia, will be of persuasive effect as a precedent in Courts of other countries in which similar issues may arise in the future; and
3. the judgment provides some guidance for the formulation of similar multilateral netting arrangements for use in other industries.

The High Court's decision is of significant importance for the international aviation industry as it preserves the integrity of an institution which is efficient and has significant commercial benefits. The judgment may also be of significance in other industries in which clearing houses operate, although the operation of each clearing house (and the manner in which that operation changes in the event of insolvency, if at all) will depend upon the terms of the documents governing its operation.

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ARTICLE

Litigation Funding in Australia

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Australia is currently experiencing what can only be described as a boom in class action litigation.

Ironically, some of that class action litigation is directed at the very people who laid the groundwork for the current boom – liquidators. In order to understand why, it is necessary to look back ten years.

1. Maintenance and champerty

Like many other common law countries, Australia long maintained an effective ban on third party funding of litigation, through the torts of maintenance and champerty. As in the United Kingdom, there was a legislative push to abolish those torts in the latter half of the 20th century. Notwithstanding formal abolition of the torts, it still remained open to Australian Courts to overturn third party funding arrangements on grounds of public policy. For this reason, even in those Australian States where the torts were abolished, there was no significant use of third party litigation funding.

That changed dramatically in 1996. In *Re Movitor Pty Ltd* (1996) 14 ACLC 587, the Federal Court of Australia ruled that a liquidator's statutory power to sell the company's property allowed the liquidator to assign part of the funds recovered from litigation to a third party which had financially underwritten the litigation.

The Court's reasoning was based on what it said was a longstanding exception to the bar on maintenance and champerty: a trustee in bankruptcy may lawfully assign any of the bankrupt's bare causes of action either for a cash payment or on terms that the trustee is to receive a share of the proceeds of the litigation (*Guy v Churchill* (1888) 40 ChD 481). The Court noted that, under the then-current corporations statute in Australia, a liquidator had the power to sell or dispose of the company's property. In the Court's view, there was no reason why this statutory power should not make lawful (i.e., an exception to the principles of maintenance and champerty) the sale of a share in the proceeds of an action to a person with no interest in the litigation on terms that that person was to have control of the litigation.

Movitor was quickly followed by another decision, *Ultra Tune Australia Pty Ltd v UTSA Pty Ltd* (1996) 14 ACLC 1,610. Rather than assigning the fruits of litigation to the third party funder, the liquidator of UTSA wanted to assign the cause of action itself to the funder. In return for this, the funder would, on completion of the proceedings, pay UTSA AUD 300,000 plus 20% of whatever was recovered.

The defendants to the action argued that the liquidator's statutory power to sell a company's property could not be read literally, and that it should be limited by the public policy against maintenance and champerty. This argument was rejected by the Court of Appeal of the Supreme Court of Victoria:

> '[T]here is no warrant for reading down the general words of the law. The reference to sale or disposal "in any manner" makes plain that it is the intention of the legislature that the powers of the liquidator are to be ample. If a liquidator is to realise the assets of the company in liquidation to the best advantage, it would be surprising indeed if the liquidator were able to sell a particular form of the company's assets (its rights of action) to only a limited class of persons – those who are already interested in the outcome of the action concerned.' (at p. 1615)

With these two decisions, litigation funding had arrived in Australia.

Initially, it was limited to the external administrators of insolvent companies: litigation funding for voluntary administrators received the judicial imprimatur in 1998[1] while receivers had to wait a little longer.[2] Although Courts had held that external administrators enjoyed what was effectively a statutory exemption from maintenance and champerty, it was clear that there was broader policy issue at work. Indeed, when the statutory provisions were invoked to allow litigation funding to voluntary administrators (in *William Felton*),

Notes

1 *Re William Felton & Co Pty Ltd* (1998) 16 ACLC 1,294.
2 *Hawke v Efrat Consulting Services* (1999) 17 ACLC 733.

the Judge suggested that public policy could equally – if not better – serve as a legal justification:

> 'It might be thought that in a reasonable appraisal of what Public Policy now requires the law should allow litigation in insolvency situations to be financed by outsiders in return for a share in the proceeds. A decision to allow this is as open to the courts now as in past ages were decisions to accept financing by creditors, by relatives, and by clubs, associations, trade unions and insurers. This would not abandon intervention if actual oppression were shown, and it would put the law on a more satisfactory foundation than attribution to statutory provisions conferring powers of sale. Nor would it allow a trafficking in causes of action, as the need for some form of statutory insolvency administration severely restricts the causes of action which may be dealt with and preserves the prohibition which is central to the law of maintenance: cf. *Roux v Australian Broadcasting Commission* [1992] 2 V.R. 577 at 606 per Byrne J: "Finally, the Court would doubtless be astute to prevent any practice that smacked of trafficking in or speculating in causes of action". The last observation expresses the long-held central concern, which should (I would think) continue to apply except in insolvency situations.'[3]

This train of thought reached its apogee in 2006, when the High Court of Australia upheld the validity of litigation funding, not just in insolvency matters, but across the board, as a policy good which promoted access to justice. In an obiter comment, the majority of the High Court effectively endorsed the following comment by the President of the New South Wales Court of Appeal:

> '[T]he law now looks favourably on funding arrangements that offer access to justice so long as any tendency to abuse of process is controlled.'[4]

As readers may have guessed, the breadth of this obiter reflected the fact that, in the years following *Movitor*, litigation funding had spread well beyond the field of insolvency. In other words, public policy had supplanted the Corporations Act 2001 in providing the necessary exemption from the bar on maintenance and champerty. As will be seen later in this article, this ultimately meant that litigation funding became a kind of Frankenstein's monster for insolvency practitioners and, more worryingly, unsecured creditors of insolvent companies.

For the moment, however, I want to look at how litigation funding expanded from a specialist insolvency tool to an everyday litigation device endorsed by the High Court.

2. The litigation funding industry emerges

Unsurprisingly, commercial operators soon emerged to take advantage of the change in the law brought about by *Movitor* and *UTSA*. As a result, we now have a number of professional litigation funders, the largest of which, IMF (Australia) Ltd, is listed on the Australian Securities Exchange. As well as offering their services to liquidators, litigation funders began to develop a wider market for their services. An obvious target was the emerging field of class actions.

Class actions have been available in the Federal Court of Australia since 1992. However, until the early part of this century, there were relatively few major class actions actually undertaken and carried through to finality. Litigation funders believed that this was due to high litigation costs.[5] Accordingly, they identified class actions as an area into which their industry could expand beyond the relatively limited possibilities offered by the funding of liquidators.

A major potential problem with this strategy, of course, was the fact that, on the basis of *Movitor* and *UTSA*, third party funding of liquidators was authorised by statute. There was no statutory authorisation for the funding of class actions, thus leaving litigation funders (and their clients) open to the risk that Courts would, as a matter of public policy, strike down funded class actions.

It is at this point that the story gets interesting. The test case for establishing the 'legitimacy' of funded class actions began with an attempt by State governments to impose licensing fees on wholesalers of tobacco products. In 1997, the High Court of Australia ruled that the licence fees were excise duties.[6] The Australian Constitution prohibits the States from imposing excise duties, so it followed that the licensing fees were unconstitutional. This decision was handed down a number of years after the States had begun imposing the license fees. Although the fees were imposed on wholesalers, wholesalers had been effectively passing the fee on to retailers by selling tobacco products on terms that the 'invoiced cost' comprised the wholesale price of the products and a further amount representing the licence fee. In a subsequent case, the High Court

Notes

3 At p. 1302.
4 Mason P in *Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd* [2005] NSWCA 83 at [105], cited in *Campbells Cash and Carry Pty Ltd v Fostif Pty Limited* [2006] HCA 41 at [65].
5 John Walker, Managing Director, IMF, 'The Changing Funding Environment in Class Actions' (presentation), 24 October 2007.
6 *Ha v New South Wales* (1997) 189 CLR 465.

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ruled that retailers could recover from the wholesaler, as money had and received, the amount paid for the licence fee and which the wholesaler had not remitted to the taxing authority.[7]

Following this, there were a number of attempts by retailers to recover money from wholesalers. One of those attempts included a class action funded by a litigation funder. The wholesaler opposed the class action on a number of grounds, including the argument that the litigation funding was against public policy and an abuse of the Court process. The wholesaler was successful at first instance.[8] However, that decision was reversed on appeal.[9] The wholesaler then appealed to the High Court of Australia.

The High Court said that there were two potential objections to litigation funding:

– its adverse effects on the processes of litigation;
– the fairness or unfairness of the bargain struck between a funder and the intended litigant(s).

Neither objection, said the High Court, warranted the imposition of a blanket ban on litigation funding. In the first case, any abuse of process caused by litigation funding could and should be addressed on the facts of the individual case, as with any other allegation of abuse of process. On the question of fairness, the High Court said that:

> '[T]o ask whether the bargain struck between a funder and intended litigant is 'fair' assumes that there is some ascertainable objective standard against which fairness is to be measured and that the Courts should exercise some (unidentified) power to relieve persons of full age and capacity from bargains otherwise untainted by infirmity. Neither assumption is well founded.'[10]

Notwithstanding these comments, the High Court upheld the appeal, on the separate ground that the class action had not complied with the relevant rules of court. Accordingly, its dismissal of the objection to litigation funding was, in stricto sensu, an obiter dictum. Nevertheless, it was generally accepted that that obiter effectively lifted any blanket ban on litigation funding per se.

Despite such high level endorsement, it is clear that not all Australian judges are ad idem with the High Court (indeed, two of the seven High Court Justices in *Campbell v Fostif* disagreed with their colleagues on this point). Two recent cases illustrate this.

3. *Cui bono?*

In *Hall & Ors v Poolman & Ors* [2007] NSWSC 1330, a company was in winding up, with estimated debts of AUD 130 million. The liquidators entered into a litigation funding agreement, to fund an action against former directors. During the hearing of the action, the litigation funding agreement came to the attention of Palmer J.

What particularly interested Palmer J was the following information:

– if AUD 2 million was recovered, this would cover the litigation funder's costs
– AUD 3 million would cover the litigation funder's costs and a substantial portion of its success fee
– AUD 4 million would cover the litigation funder's costs, its success fee and AUD 400,000 of the liquidators' costs
– AUD 5 million would cover the litigation funder's costs, its success fee and a substantial portion of the liquidators' costs
– AUD 6 million would cover the litigation funder's costs, its success fee and the liquidators' costs, leaving AUD 500,000 for creditors.

Palmer J queried this, and the liquidators subsequently renegotiated the litigation funding agreement. The renegotiated agreement would, in the case of full recovery, produce a net AUD 3.7 million for creditors. Recovery of anything less than AUD 825,000 would produce a zero dividend for creditors.

When the matter returned to Court, Palmer J looked at the legal status of litigation funding in Australia. After noting the majority comments in *Campbell v Fostif*, he said that those views 'do not yet command universal acceptance'. He went further:

> 'The majority judgment in Campbells requires that I hold that the circumstances of the litigation funding in this case and the derisory return to creditors afford no right of complaint to Mr Irving [the defendant in the proceedings]. He cannot say that the proceedings are an abuse of process. He cannot say that the policy

Notes

7 *Roxborough v Rothmans of Pall Mall Australia Ltd* (2001) 208 CLR 516. As an aside, it may be noted that that High Court also held that a retailer's action for money had and received was not defeated simply because the retailer had recouped the outgoing from others (in Plain English, had included an amount equal to the licence fee in the retail price of the goods).

8 *Keelhall Pty Ltd t/as 'Foodtown Dalmeny' and 6 Ors v IGA Distribution Pty Ltd formerly known as Davids Distribution Pty Ltd & 3 Ors, etc.* [2003] NSWSC 816.

9 *Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd* [2005] NSWCA 83.

10 Gummow, Hayne and Crennan JJ at para. 92.

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of the law discountenances such a proceeding. He cannot say that the law pays any regard to his complaint that the proceeds of a judgment against him will not go to those persons whom the legislature intended to be the beneficiaries of the suit.'

Although he was bound by *Campbell v Fostif* not to dismiss the litigation funding agreement as an abuse of process, Palmer J did not consider himself totally unable to give effect to his clear concerns. He noted that there are two avenues by which the Court can exercise control over liquidators who enter into litigation agreements:

– its powers in relation to costs – in exercising the wide discretion conferred by the Civil Procedure Act, 'the Court must have regard to the principle that the purpose of the Act and the Rules is to promote the just, quick and cheap resolution of the real issues in proceedings in such a way that the cost to the parties is in proportion to the importance and complexity of the matter in dispute ... It is the cost/benefit to the parties themselves which the Court must promote, not the cost/benefit to the parties' litigation funders';

– its power to inquire into liquidators' conduct under s 536 of the Corporations Act – which Palmer J exercised in this case, declaring that he would inquire into the conduct of the liquidators in:

  '– entering into a funding agreement and commencing these proceedings when they were aware that there was a substantial risk that the creditors would receive no, or very little, dividend;

  – permitting costs to amount to approximately $2M;

  – failing to obtain the directions of the Court before proceeding'.

More recently, the New South Wales Court of Appeal ordered a liquidator to provide security for costs in litigation which was being supported by a litigation funder.[11] It is extremely unusual for such an order to be made against a liquidator (because a liquidator is both a natural person and an officer of the Court). Nevertheless, the majority of the Court of Appeal made no bones about the fact that the presence of the litigation funder was a crucial element in its decision. Justice Hodgson said that 'the court system is primarily there to enable rights to be vindicated rather than commercial profits to be made'. Justice Campbell made repeated references to the 'private profit of the funder'.

What both of these cases illustrate is that, *Campbell v Fostif* notwithstanding, there is clearly considerable judicial unhappiness about litigation funding, even when it occurs in an insolvency context. The language of the three judges in the cases quoted shows just how strong that uneasiness is.

If judges are undecided, the same is apparently true of Australian legislators. In November 2005, the Standing Committee of Attorneys-General (SCAG) agreed to examine litigation funding and to consider whether regulation was required. Things started quickly: within six months, a discussion paper was issued. A September 2006 closing date for comments provided hope that the momentum would be maintained.

It may have been a false hope: the discussion paper and the submissions on it seem to have disappeared into a black hole. This was largely confirmed in a June 2008 speech by the Commonwealth Attorney-General, the Hon Robert McClelland MP. He said:

> 'The regulation of litigation funding is an issue currently before the Standing Committee of Attorneys-General.
>
> However, it is important to ensure that business is not burdened with unnecessary extra regulation.
>
> The work to come out of SCAG may be used as a basis for wider consultation on this matter.'

In other words, a final position is not just around the corner.

The Attorney-General also indicated some of his own thinking on litigation funding:

> 'I am concerned that in some cases there appears to have been insufficient disclosure of the funding arrangements to either the Court or those who have been funded.
>
> It may be necessary to consider if adverse costs orders should be enforceable against third-party funders and also whether the funders should have adequate capital to meet those orders.'[12]

So we currently have a situation in which litigation funding – hand in glove with class actions – is booming. While class actions are heavily regulated, control of litigation funding is solely the province of a judiciary which is divided about the intrinsic merit and/or the modus operandi of the litigation funding industry. How is this affecting insolvency practice?

Notes

11 *Green (as liquidator of Arimco Mining Pty Ltd) v CGU Insurance Ltd* [2008] NSWCA 148
12 Australian Financial Review Legal Conference 2008, Melbourne, 17 June 2008.

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4. Litigation funding and the liquidator

As noted above, the litigation funding industry in Australia owes its start to liquidators. Also noted above were recent insolvency cases in which adverse judicial comments about litigation funding were made in the context of actions initiated by liquidators with the financial support of litigation funders. This raises the interesting question whether policy considerations affecting litigation funding should differentiate between funded actions by liquidators and funded actions by other litigants. This was certainly the approach taken in the SCAG's May 2006 discussion paper, which appeared to take the general view that oversight of liquidators' funding arrangements could be left to the Courts.

It is certainly the case that liquidators are different from the average class action litigant. They will, for example, have their own legal advisers in place before entering into negotiations with a litigation funder. They will not be seeking funding in order to recover damages or loss that they have incurred in a personal capacity. Since much of the SCAG paper is devoted to the issue of protecting the interests of funded litigants, these are relevant distinctions. However, as cases such as *Hall* and *Green* show, judicial concern about liquidators' funding agreements is not necessarily restricted to what might be broadly termed 'consumer protection' issues: both cases highlight broader concerns about the relationship of litigation funding to issues of justice, such as the proliferation of litigation and the potential for 'trafficking'. Therefore, it will be interesting to see if we end up with a two-track litigation funding regulatory regime, in which public policy concerns are addressed through statutory controls on non-insolvency funding and judicial oversight of insolvency funding.

While that is clearly some way down the track, one area of non-insolvency funding which has directly impacted on liquidators is that of shareholder class actions in the wake of corporate collapses.

When a listed company collapses, it is increasingly common for litigation funders and/or plaintiff lawyers to determine whether investors in the company may have grounds for launching a class action against the company. One such instance followed the collapse of mining company Sons of Gwalia in 2004.

On 28 June 2007, the unsecured creditors of Sons of Gwalia, met to vote on two rival proposed transactions involving the company's tantalum assets.

(What was surprising (or would have been surprising until recently) was the identity of the creditors who were voting: the majority of them were shareholders in the company, rather than trade creditors or bondholders. This development was the logical outcome of a landmark decision by the High Court of Australia in early 2007. In brief, the High Court ruled that anyone who was misled by a company into buying its shares on market may claim as a creditor if the company subsequently goes into liquidation.[13])

The type of creditors voting on the rival sale proposals for Sons of Gwalia was crucial. In very general terms, one proposal was for a straight purchase of the tantalum assets; the other was a proposal to float a new company and to offer creditors the opportunity to take up shares in that company. A numerical majority of creditors opted for the straight sale proposal. A litigation funder who was supporting the shareholders was quoted in the media as saying:

> 'No-one's an expert in tantalum but everyone's an expert on the difference of having a dollar in your pocket and having it in someone else's pocket.'[14]

An indication of the importance of the shareholders to the vote can be gained from the following figures:[15]

Type of creditor	*Number of creditors*	*Total value of claims*
Ordinary creditor	922	AUD 848.1 million
Shareholder claimant	8,038	AUD 577.0 million

In addition to having a substantial impact on the administrators' disposal of the company's assets, the high number and (until now) relatively unique nature of the shareholder claimants' claims meant that the administrators also had to adopt new procedures when conducting the administration. These procedures had to cover such matters as the assessment of the shareholders' claims and the distribution of any recoveries from litigation between the shareholders, the company, the company's auditors and its former directors. In the case of Sons of Gwalia, this involved major negotiations with the shareholders, litigation funders and creditors, and an agreement to amend the Deed of Company Arrangement to include detailed provisions governing the submission of claims by shareholders, the assessment of those claims, the establishment of two funds for the payment of shareholders and other creditors, and the

Notes

13 *The Sons of Gwalia* case is more extensively discussed below.

14 'RCF wins battle for Sons of Gwalia asset' AAP, 28 June 2007.

15 Sources: Ferrier Hodgson, Deed Administrators' Report Pursuant to Section 445F of the Corporations Act, 2001, Sons of Gwalia Ltd ACN 008 994 287 (Subject to Deed of Company Arrangement) and certain of its subsidiaries as set out in the Schedule (All Subject to Deed of Company Arrangement), 7 December 2007, p 6; Ferrier Hodgson, Circular to Creditors, June 2008.

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institution and funding of litigation against the company's former directors and auditors.

It is, perhaps, ironic that the process of external administration of insolvent companies is now being rendered more difficult by the activities of litigation funders, given that litigation funding was kickstarted in Australia by liquidators. This is an element of corporate insolvency that will only grow in importance in the current adverse economic climate, although there have been calls for the Australian Government to legislate to reduce the opportunity for shareholder class actions against failed companies.

5. After Sons of Gwalia

Section 563A of the Corporations Act 2001 states that:

> 'Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.'

Until recently, it was widely accepted that s 563A embodied a general rule that 'shareholders come last' (i.e., shareholder claims for the lost value of their shares could not be paid out until after full payment of the claims of ordinary unsecured creditors (because it was essentially the same as a return of capital)). Of course, there is rarely enough money to pay out even ordinary unsecured creditors in full, so the postponement of shareholders' claims would effectively render them not worth pursuing.

Sons of Gwalia Ltd v Margaretic [2007] HCA 1 involved a claim by a person who had bought shares in Sons of Gwalia Ltd. That person claimed to have been misled into buying the shares by the company. When the company went into voluntary administration, the shareholder lodged a claim as a creditor, for the lost worth of his shares. On the basis of the conventional understanding of s 563A, any payment on that claim would have been postponed until ordinary unsecured creditors had been paid out. However, the High Court held that a claim by an allegedly misled shareholder would not be caught by s 563A *if the shareholder had bought its shares on market*. The High Court was not asked to rule upon the claims of shareholders who were allotted shares by the company (through an IPO, for example). There is existing High Court authority that claims by allottees are caught by s 563A, but there are some indications in the *Sons of Gwalia* judgment that the High Court may be willing to revisit this issue.

While the High Court decision may have been welcomed by shareholders, it was roundly condemned by what may be described as the 'organised' creditor lobby – most notably bondholders. The Government responded by referring the *Sons of Gwalia* issue to its specialist company law reform body, the Corporations and Markets Advisory Committee (CAMAC).

CAMAC issued its report in January 2009. The Committee recommended that the Government take no action to overturn the High Court decision by legislation.[16]

In broad terms, its rationale was that the (still unproved) possible adverse effects of the decision (on unsecured creditors and on the administration of insolvent companies) did not offset the general corporate governance benefits that the decision had brought:

> 'The provision to shareholders and others over recent years of direct rights of action in respect of corporate misconduct, and the strengthening of the regime for timely and reliable corporate reporting, reflect clear legislative objectives.
>
> In effect, the facilitation of private remedies has added to the enforcement armoury, encouraging self-help by affected parties to complement the enforcement role of the regulators.
>
> Claims by aggrieved shareholders can serve as a market-based deterrence, enforcement and recovery mechanism in support of required standards of corporate conduct.
>
> *Any move to curtail the rights of recourse of aggrieved shareholders where a company is financially distressed could be seen as undermining the apparent legislative intent to empower investors*.'[17]

6. Litigation funding and secured creditors

Another recently emerging problem for liquidators was the inter-relationship between litigation funding and the interests of secured creditors.

When a company goes into winding up, the property available for unsecured creditors does not include property which is subject to a charge.[18] Where a security is fixed on a readily identifiable piece of property, it is easy to distinguish between secured and unsecured property. The picture becomes complicated when the security is a floating charge over all of the company's assets. In

Notes

16 Perhaps unsurprisingly, the recommendation was not unanimous, but there was no minority report.

17 Corporations and Markers Advisory Committee, *Shareholder Claims against Insolvent Companies: Implications of the Sons of Gwalia Decision*, December 2008, pp. 63-64 (emphasis added).

18 E.g., *Roberts Petroleum Ltd v Bernard Kenny Ltd* [1983] 2 WLR 192.

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theory, if the secured debt were large enough, a floating charge could extend to cover all of the assets recovered or realised by the liquidator. This could include the proceeds of legal actions brought by the liquidator, leaving no funds for distribution to unsecured creditors. However, Australian law has, for many years, distinguished between:

– assets which are realised by a liquidator and which are the property of the company (and hence subject to a floating charge); and
– assets which are realised by a liquidator and which are not the property of the company.

The latter group consists largely of the proceeds of legal actions which are statutorily created upon the appointment of a liquidator and which are enforceable only by the liquidator. The two most common of these are:

– actions to recover 'voidable transactions' under Pt 5.7B Div 2 of the Corporations Act – voidable transactions may broadly be described as transactions in the period immediately preceding winding up that are designed to place company assets beyond the reach of creditors; and
– actions to recover 'insolvent trading debts' under Pt 5.7B Div 4 – insolvent trading debts are debts incurred by the company while insolvent and for which the directors of the company are rendered personally liable under Pt 5.7B Div 3.

As noted, the proceeds of litigation in the second group are not the property of the company, and so are not covered by any floating charge over the company's property.[19]

Of course, a liquidator's power to bring proceedings is not limited to voidable transactions and insolvent trading debts: the liquidator is also empowered to bring any causes of action that belong to the company. The important difference is that the proceeds of such actions are the property of the company. Recent litigation in the Federal Court of Australia raised the prospect that this might impact on the availability of litigation funding for liquidators.

7. Meadow Springs

Meadow Springs borrowed money from two lenders on the security of floating charges. The money was used to finance the construction of a block of apartments. Before beginning the project, Meadow Springs had obtained a valuation of the land.

A while later, Meadow Springs went into liquidation.

Meadow Springs' liquidator obtained funding from Australia's largest litigation funder, IMF, to bring a negligence action against the valuer. The litigation funding agreement required the liquidator to pay fixed fees to IMF, plus a percentage of any amount recovered (essentially, a success fee).

The negligence action was settled, and the valuer paid AUD 6 million to Meadow Springs. On that amount, IMF's percentage-based success fee would be AUD 2 million. At this point, the secured creditors emerged to claim that they had a priority claim to the AUD 6 million. The matter went to the Federal Court.

IMF argued that it had a superior claim than the secured creditors, for three reasons:

– it had a superior equity to the secured creditors;
– the liquidator had an equitable lien over the money, which secured payment in favour of IMF;
– the principles of 'salvage'.

At first instance, it was held that the secured creditors' interest under their charges was superior to any claim by IMF.[20]

However, this position was reversed on appeal. The Full Court of the Federal Court held that the litigation funder's success fee was part of the cost incurred by the liquidator in recovering the money from the valuer. As such, it was entitled to priority over the floating charges, under a principle established in a 1933 decision by the High Court of Australia:

> '[A] secured creditor of a company who elects to have its rights decided in the winding up of the company is entitled to be paid principal and interest out of the fund produced from realisation of the assets encumbered by its debt, but only after deduction of the costs, charges and expenses incidental to the realisation of such assets. While the security is paramount over the general costs and expenses of the liquidation, the expenses attendant upon realisation of the assets affected by the security must be borne by the secured creditors. A secured creditor has a specific right to the assets over which its debt is secured, for the purpose of paying the debt. However, if the assets are realised in the winding up, and the secured creditor is a party to the winding up, the proceeds must bear the costs of the realisation just as if the secured creditor itself had begun a suit for the realisation of the assets or had

Notes

19 *NW Robbie & Co. Ltd v Witney Warehouse Co Ltd* [1963] 1 WLR 1324; *NA Kratzmann Pty Ltd (in liq) v Tucker (No 2)* (1968) 123 CLR 295; *SJP Formwork (Aust) Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2000) 34 ACSR 604; *Tolcher v National Australia Bank* (2003) 21 ACLC 587; cf *Jonsson, Milner and Riaps Pty Ltd (in liq) v Tim Ferrier Pty Ltd and Anor* [2001] QSC 010.

20 *Meadow Springs Fairway Resort Ltd (In Liq) (ACN 084 358 592) v Balanced Securities Limited (ACN 083 514 685) (No 2)* [2008] FCA 471.

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realised the assets without suit. ... (see *Re Universal Distributing Company Limited (in Liquidation)* [1933] HCA 2; (1933) 48 CLR 171 at 174).'[21]

(As a final ironical note, it should be pointed out that one of the secured creditors in the *Meadow Springs* case was itself in liquidation, and had entered into a litigation funding agreement to pursue the action against the other litigation funder.)

8. Conclusion

In just over a decade, litigation funding has gone from being persona non grata to having a central role in Australian insolvency practice and, increasingly, in corporate litigation. The ready availability of funding to support aggrieved shareholders has, if not actually changing the 'balance of power' between investors and company management, made the latter considerably more aware of the possibility of facing civil recovery actions for breaches of – or deviations from – statutory disclosure and other governance rules.

Many unsecured creditors of failed companies have also benefited, by and large, from the new ability of liquidators to pursue litigation that, in years gone by, would never have got off the ground because of lack of funds.

But there have also been losers. Most notable have been unsecured creditors of listed companies. Thanks to the *Sons of Gwalia* decision, the funds available for unsecured creditors now have to be shared with aggrieved shareholders of such companies. At the same time, those unsecured creditors probably have to wait considerably longer to receive a dividend, because of the greatly increased workload caused by the lodging of claims by shareholders. The practical outcome of the *Sons of Gwalia* matter itself also shows that shareholders may form a considerable voting block which does not necessarily have the same agenda as other creditors.

Of course, the implications of litigation funding go beyond the merely utilitarian. Despite the High Court's endorsement in *Campbell v Fostif*, it is clear that there is still considerable discomfort in the lower Courts and among some senior politicians about its potential for distorting the litigation process. Although that concern has largely been focussed on non-insolvency funding, the *Meadow Springs* litigation shows that insolvency litigation is not free of the same concerns: ten years ago, the concept of X's funding the liquidator of Company A to contest Y's claim to a share in the proceeds of a recovery action by the liquidator of Company B that Y funded would have appeared fantastical. Now, it may just be the shape of things to come.

Notes

21 *IMF (Australia) Limited v Meadow Springs Fairway Resort Limited (in Liquidation)* [2009] FCAFC 9.

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ARTICLE

Creditors' Claims against Third Parties

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Recent court decisions in Australia have encouraged Australian insolvency practitioners to revisit a corporate insolvent restructuring tool that has largely been dormant for almost 20 years.

They have also revealed a lack of policy coherence in the legislative approach to restructuring.

Background

Australia has two different statutory regimes to facilitate the restructuring of insolvent companies: schemes of arrangement (s 411 (contained in Pt 5.1) of the Corporations Act 2001) and voluntary administration (Pt 5.3A of the same Act). Voluntary arrangement was legislated for in 1993, specifically to provide an alternative to schemes of arrangement. Since that time, schemes of arrangement have only rarely been used in corporate insolvencies.

Both are designed to allow a financially-troubled company to enter into a statutorily-binding debt arrangement with their creditors: one (scheme of arrangement) is a legislatively 'light-touch' regime with a requirement for Court approval providing the prophylactic element for creditors; voluntary administration eschews court approval in favour of a detailed and prescriptive statutory procedure. At first blush, it may appear that this is an embarrassment of riches, and that there is little point in providing two routes to what should be the same outcome. However, as recent developments have shown, some of the differences between the two regimes are no less substantive than procedural.

In brief, the High Court of Australia has held that, where a voluntary administration results in a deed of company arrangement between a company and its creditors, that deed cannot bind the creditors to a compromise in relation to claims they may have against a party other than the company. In the same decision, the High Court provided strong obiter support for a line of lower court authorities to the effect that a scheme of arrangement between a company and its creditors <u>can</u> bind the creditors to a compromise in relation to claims they may have against a party other than the company.

Whether this outcome was ever intended by the Australian Parliament is open to debate. Nevertheless, it has now received the endorsement of the High Court, Australia's highest court and it is therefore the practical reality with which companies and advisors must deal.

Opes Prime

Until 27 March 2008 the Opes Prime Group provided stockbroking services to institutional and private clients, predominantly in the form of securities lending and equity financing.

Members of the Group borrowed shares from clients and on-lent them to various financiers. Under those securities lending arrangements, the financiers provided members of the Opes Prime Group with cash, collateral and other securities. The financiers included ANZ and Merrill Lynch.

In early May 2008, Opes Prime went into liquidation. Some creditors began legal proceedings against Merrill Lynch, ANZ and Opes Prime Group companies. These and other claims were the subject of a mediation between the liquidators, ANZ, Merrill Lynch and the Australian Securities and Investments Commission (Australia's corporate regulator). The mediation produced an agreement between those parties to propose a scheme of arrangement in order to achieve a global settlement of *all* Opes-related claims and proceedings against ANZ and Merrill Lynch. In return, ANZ and Merrill Lynch would hand over cash which the liquidators were to distribute to the creditors in accordance with the scheme. Under the scheme, all of the creditors' claims, including those against ANZ and Merrill Lynch, would be released.

The first step in a scheme of arrangement is an application to the Court for an order convening a meeting of creditors to vote upon the proposed scheme. If the creditors vote for the scheme, it then goes back to Court for an order of approval. Once that approval has been obtained, the scheme is binding upon all creditors, regardless of whether they voted in favour of it. This meant that, in the case of the Opes Prime Group, creditors of Opes Prime who also had claims against ANZ and Merrill Lynch would have those claims barred by the scheme, even if they wished to pursue them.

Unsurprisingly, therefore, when the Court was initially asked to order the convening of the creditors'

meetings, some creditors argued that a scheme of arrangement could not take away whatever causes of action they might have against the financiers. In his judgment dismissing the creditors' objections, Finkelstein J noted that there was one Australian case which said that a scheme could not prevent a creditor pursuing a claim against a third party, and a number of overseas cases to the contrary (*In the matter of Opes Prime Stockbroking Limited* [2009] FCA 813).

His Honour opted to follow the overseas authorities. He made it clear that this was not a holding that a scheme could always be used to kill off third party litigation. There must, he said, be a 'sufficient nexus' between the creditors' claims against the third parties and their claims against the company. In this regard, he pointed particularly to the fact that the creditors' claims against the financiers were intricately linked to their claims against Opes Prime:

> '[P]rovided there is a sufficient nexus between a release and the relationship between the creditor and the scheme company, the scheme can validly incorporate the release. There is a sufficient nexus here for any number of reasons, including, most importantly, that the creditors' claims against the Opes companies and their claims against the banks largely (and in many cases completely) overlap, the schemes are in settlement of interlocking claims and, in the absence of the release, none of the claims would be compromised.'

The creditors subsequently met and voted, by the required majority, in favour of the scheme. The scheme then went back to Court and was approved (In the matter of Opes Prime Stockbroking Limited (No 2) [2009] FCA 864). A disgruntled creditor then took the unusual step of appealing against the approval. The Full Court of the Federal Court of Australia dismissed the appeal, essentially on the same grounds as the judge at first instance:

- provided there is a real nexus between the two sets of claims, a s 411 scheme can legitimately require creditors to release claims against third parties, with the qualification that the creditor must receive some benefit under the scheme;
- the fact that a third party will receive a benefit under a scheme doesn't mean it is unfair. (*Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited* [2009] FCAFC 125).

At almost the same time as the Opes Prime scheme was wending its way through the Federal Court, a separately constituted bench of the same Court was considering what appeared, on the surface, to be a very similar situation. This case concerned the Australian effects of the collapse of Lehman Brothers.

Lehman Brothers

The case concerned a number of Lehman Brothers entities, including Lehman Brothers Australia and overseas Lehman entities which were creditors of Lehman Brothers Australia. A number of investors had invested in collateralised debt obligations sold to them by Lehman Brothers Australia.

When the Lehman Brothers empire collapsed, Lehman Brothers Australia was placed in voluntary administration. The voluntary administrators proposed a deed of company arrangement under Pt 5.3A.

A deed of company arrangement bears a number of similarities to a scheme of arrangement: each is a creature of the Corporations Act 2001, each requires a vote by creditors, and each will bind all the company's creditors, regardless of whether they individually voted in favour of it.

However, there are also a number of important differences. A scheme of arrangement only becomes binding on creditors when it is approved by a Court. A deed of company arrangement, by contrast, becomes binding once the creditors have voted for it and the company has executed it; no court approval is required.

Although there is no requirement for court approval before a deed of company arrangement becomes effective, creditors do have a statutory right to ask the Court to overturn a deed.

Under the deed of company arrangement proposed for Lehman Brothers Australia, Lehman Brothers Australia assets were to be liquidated and the proceeds distributed among its creditors in the following order:

- investors who had bought CDOs from Lehman Brothers Australia;
- other creditors of Lehman Brothers Australia (other than Lehman Brother entities);
- Lehman Brother entities.

In return for receiving priority, the CDO investors would be required to forgo any claims they might have against other Lehman Brother entities. As with the Opes Prime scheme of arrangement, those releases would be imposed upon the creditors regardless of whether they had voted in favour of the deed.

A number of creditors launched a court challenge to the validity of the deed. In a unanimous decision, a Full Court of the Federal Court ruled that the Lehman Brothers deed of company arrangement was not allowable under the Corporations Act. It held that a deed could bind claims that a creditor had against a company, but not claims that the creditor might have against third parties.

The Full Court decision was based on the principle that a statute should not be interpreted as allowing an interference with legal rights unless it is clear that the legislature intended that result. It did not find such a

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clear intention in the statutory provisions governing deeds of company arrangement.

Civil war on the Federal Court

The Full Court handed down its decision in *City of Swan v Lehman Brothers Australia Ltd* [2009] FCAFC 130 on 25 September 2009. By that stage, the differently-constituted Full Court had already handed down its decision in relation to Opes Prime.

As the Lehman Brothers Full Court was at pains to point out, the Opes Prime decision related to statutory schemes of arrangement, rather than deeds of company arrangement, and so was not directly applicable to the Lehman Brothers issue. The Full Court also drew what it saw as an important distinction between schemes of arrangement and deeds of company arrangement, based upon the different procedural steps involved in each:

> 'Part 5.1 of the Act which deals with company arrangements and reconstructions, provides a significant supervisory role for the Court including convening scheme meetings and approval of the proposed scheme(s). In contrast Pt 5.3A provides for important procedural steps to be taken without Court supervision. In the light of that difference it would not be surprising to find greater latitude in what might be provided for in respect of compromises and arrangements under Pt 5.1 than in a deed of company arrangement under Pt 5.3A.'

Despite this, the Lehman Brothers Full Court proceeded to make clear its view that the Opes Prime decision was wrong, accusing it of overlooking 'basic principles of statutory construction' and of failing to examine Australian precedents to the effect that a scheme of arrangement cannot interfere with creditors' rights against third parties. It rather dismissively referred to the 'nexus' test laid down by the Opes Prime decision as 'an undemanding test of a mere nexus'.

Australia has a Federal system of Government and it is not unknown for the Court of one State to disagree (sometimes robustly) with the Court of another State. However, such open disagreement among the senior levels of the unitary Federal Court is extremely rare. Strictly speaking, of course, the Lehman Brothers Full Court's adverse comments about the reasoning of the Opes Prime Full Court were obiter dicta. Academically, this meant that the law in Australia was clear:

– schemes of arrangement could bar creditors' claims against third parties (because that was the ratio of the Opes Prime Full Court decision); but

– deeds of company arrangement could not bar creditors' claims against third parties (because that was the ratio of the Lehman Brothers Full Court decision).

The reality, however, is that, as elsewhere in the common law world, the doctrine of stare decisis is no longer a rigid rule in Australian Courts. It was not beyond the bounds of possibility that a single judge decision following the Opes Prime decision could be overturned by a Full Court or Court of Appeal which preferred the obiter comments of the Lehman Brothers Full Court.

For that reason, there was considerable interest when the Lehman Brothers Full Court decision was appealed to the High Court of Australia, the most senior court in Australia.

Lehman Brothers in the High Court

In *Lehman Brothers Holdings Inc v City of Swan & Ors*; *Lehman Brothers Asia Holdings Limited (In Liquidation) v City of Swan & Ors* [2010] HCA 11, the High Court dismissed an appeal against the Full Court ruling that a deed of company arrangement cannot bar creditors' claims against third parties.

The High Court's reasoning was relatively narrow and technical. It turned upon the wording of s 444D of the Corporations Act:

> 'The determinative question in these appeals is what is meant by the provision of s 444D(1) that a deed "binds all creditors of the company, *so far as concerns claims arising on or before the day specified in the deed*" (emphasis added).'

The High Court held that the only 'claims' referred to in s 444D are claims against the company:

> '[T]here is no textual footing for reading the word "claims", in the "so far as concerns" clause in s 444D(1), as including claims against persons other than the subject company.'

That was enough, in the High Court's view, to dispose of the matter. Nevertheless, it was clearly cognisant of the disagreement between the different Full Courts about the question whether a scheme of arrangement could bar creditors' claims against third parties, because it then turned its attention to that issue:

> 'Pt 5.3A (and, in particular, s 444D(1)) stands in sharp contrast with Pt 5.1 of Ch 5 of the Act, which regulates arrangements and reconstructions. The provisions of Pt 5.1 (which derive ultimately from the Joint Stock Companies Arrangement Act 1870 (UK)) make a compromise or arrangement binding on creditors (or on a class of creditors) if agreed to by a majority in number of the creditors (or class) whose debts or claims aggregate at least 75 per cent of the total amount of the debts and claims of the creditors (or class of creditors) present and voting, and if approved by order of the Court. Unlike s 444D(1), the provision of Pt 5.1 which makes certain compromises or arrangements binding on

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creditors (s 411(4)) does not qualify the extent to which creditors are bound. Beyond noting this contrast, it is neither necessary nor appropriate to go on to consider whether Pt 5.1 of the Act could have been engaged to achieve the result sought to be achieved by the Deed under consideration in these appeals. *Nothing in these reasons should be understood as endorsing the criticisms made in this matter in the Full Federal Court of the earlier decision of the Full Federal Court in Fowler v Lindholm.*' (emphasis added)

The High Court is constitutionally barred from handing down binding rulings on matters which are not in dispute before it. Accordingly, these comments are only obiter dicta. However, until the question of the binding power of a scheme of arrangement is agitated in a live matter before the Court, it is likely that lower Courts will read these comments as a prima facie indication that the High Court disagrees with the Lehman Brothers Full Court's comments about the reasoning in the Opes Prime decisions.

Conclusion

The end result of all this litigation is that, until the High Court rules otherwise, schemes of arrangement can bar creditors' claims against third parties, but deeds of company arrangement cannot. From a practical point of view, therefore, insolvency practitioners now have a clear choice of options when dealing with insolvent companies whose creditors also have claims against third parties.

The picture is not quite so clear at a policy level. During the Lehman Brothers litigation, there was argument about Parliament's intention when it legislated for deeds of company arrangement. As the High Court concluded, there was actually no indication that Parliament had ever actively considered the effect of deeds of company arrangement on claims against third parties:

> 'In the course of argument, the Court was taken to a great deal of extrinsic material which was said to bear upon the question of how s 444D(1) should be construed. It is neither necessary nor desirable to rehearse the detail of those arguments. Nothing that was said in the report of the Australian Law Reform Commission concerning its General Insolvency Inquiry [38] (the "Harmer Report"), the draft Bill that was incorporated in the Harmer Report, or the several exposure drafts and explanatory memoranda relating to the legislation which now comprises Pt 5.3A of the Act, assists in resolving the disputed questions of construction and application of s 444D(1). Those sources do not assist because in none of them was any direct consideration given to the point which must now be decided.'

Given that, as the High Court acknowledged, schemes of arrangement have their origins in an 1870 English statute, the chances of determining whether such schemes were or were not originally intended to bar third party claims are equally slim.

There are a number of possible policy responses to this situation.

- simply accept the law as the Courts have now laid it down;
- construct a coherent and self-evident rationale for the differing effects of schemes of arrangement and deeds of company arrangement;
- initiate a debate on whether and in what circumstances creditors' claims against third parties should be barred by a formal and binding arrangement.

To date, unfortunately, there has been little indication of any willingness to pursue the third option.

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ARTICLE

Biting the Hand that Feeds You

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Like their counterparts everywhere, Australian company directors are subject to a number of duties and responsibilities.

According to an Australian Government survey in 2008, the duties which cause them least concern are the duty of care and the duty of good faith. However, 67% of them have a medium-to-high concern about their personal liability for 'insolvent trading'.[1]

'Insolvent trading' is the Australian version of fraudulent trading – with a sting. Directors are personally liable for debts that their company incurs while insolvent, unless they can prove that they had reasonable grounds to expect that the company was solvent. Action can be taken against directors by liquidators, creditors and the Australian Securities and Investments Commission. There is no requirement to prove that the directors had any intention to defraud creditors.[2]

Insolvent trading has been credited with producing significant improvements in standards of corporate governance in Australia. This is because Courts have held that, in order to establish that they had reasonable grounds to expect that their company was solvent, directors must demonstrate that they had an understanding of the company's financial position (or had systems in place to ensure that they had the information necessary to have that understanding). In other words, directors cannot escape liability by claiming ignorance of the company's finances.

On the other side of the coin, company directors have repeatedly argued that the insolvent trading regime is too strict. They claim that it forces directors to appoint a liquidator or other external administrator (and thus avoid potential insolvent trading liability) rather than to attempt to put a rescue plan in place for the company.

No matter which side one takes in the debate, it is clear that the threat of insolvent trading liability is a major concern for company directors. It is also a particular source of concern for company creditors.

Shadow directors

It may seem counter-intuitive that creditors should be worried about a statutory provision that makes directors liable for company debts. However, there is one group of creditors which potentially straddles the line between directors and creditors: shadow directors.

The concept of 'shadow director' in well-known in corporate law systems based on the English model. In Australia, it finds statutory expression in the definition of 'director' in the Corporations Act:

> '"director" of a company or other body means:
>
> (a) a person who:
>
> (i) is appointed to the position of a director; or
>
> (ii) is appointed to the position of an alternate director and is acting in that capacity;
>
> regardless of the name that is given to their position; and
>
> (b) unless the contrary intention appears, a person who is not validly appointed as a director if:
>
> (i) they act in the position of a director; or
>
> *(ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.*
>
> Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company or body.' (emphasis added)

The most obvious candidate for the role of shadow director as defined in para (b)(ii) would be the 'eminence grise' (a businessperson who appoints puppet directors to his company). However, the breadth of para (b)(ii) has long given rise to concerns about the extent to which a third party dealing with a company may fall within

Notes

1 The Treasury, Survey of Company Directors, 18 December 2008: <www.treasury.gov.au/content/Company_Directors_Survey/Survey Summary.html>.

2 See Part 5.7B Div 3, Corporations Act 2001.

the definition. In recent years, as informal insolvency work-outs gained in popularity, that concern has been focussed on the position of creditors who participate in (or even initiate) such work-outs. The negotiation of a work-out differs from the normal discussions between directors and creditors in that it will usually involve matters of internal company management. It is this aspect of work-out negotiations that give rise to concerns about a creditor becoming a shadow director.

Of course, the other element which compounds this concern is the fact that a work-out implies some significant degree of financial distress on the part of the company. For participating creditors, this carries the threat that assuming (however unwillingly) shadow director status may be tantamount to automatic liability for insolvent trading.

The role of bankers

The issue was first raised in Australia in *Emanuel Management Pty Ltd & Ors v Foster's Brewing Group Ltd & Ors* [2003] QSC 205. The liquidator of the company alleged that one of its bankers had become so involved in its financial affairs and management that they had become its shadow directors:

> 'The plaintiffs allege that between 1988 to 1995 [the bank executives] instructed and directed the Emanuel Family Directors (who) ... were accustomed to act and did act on those directions or instructions. Reliance is placed on evidence of regular joint meetings between those [bank] executives and the Emanuel directors between 1990-1994 and to directions given at those meetings. It is alleged at the time of giving those directions the executives were employed by one or other of the Fosters' defendants and that they gave those directions on the instructions of the [bank] ... .'[3]

It is the nature of shadow director cases that much depends upon the facts of the case. In Emanuel, the liquidator's case was dismissed on the basis of the Court's rather straightforward finding that the founder and controller of the company simply didn't take instructions from banks:

> 'Mr Emanuele's behaviour cannot fit the plaintiffs' description of the relationship between him and [the bank]. It shows him not to be receptive to requests from [the bank] and prepared to argue with its senior officers when he thought that his companies' interests were being affected. This conduct is the antithesis of the relationship denoted by the description `shadow directorship'. Mr Emanuele was confronting the entity with whose directions or instructions he was supposedly accustomed to act. He was, on occasions, actively if surreptitiously, working against the interests of that entity.'[4]

Despite this factual basis, the Court did give some consideration to the legal question whether and in what circumstances, a bank could become a shadow director. It adopted a proposition put forward by Millett J in a 1991 speech, to the effect that a bank will not, in the ordinary course of things, be a shadow director:

> 'Millett J ... noted that when a corporate customer of a bank appears to be in financial difficulty the bank will probably send in an investigator; demand reduction of its debt; demand security or further security; call for information such as valuations, accounts and budgets; request the customer's proposals for the reduction of the debt, including such things as a schedule of proposed sales and will give advice to the customer on ways to improve its position. Millett J went on:
>
> > "In doing all these things, the bank may well expect its demands to be met, first because they are likely to be commercially sensible, and secondly because the customer has no option if it wants its facility continued. But that is not enough to constitute the bank a shadow director ... A bank has no business to be managing its customers' affairs, but it is entitled to attach conditions to the continuation of its support. So long as it does nothing that a bank does not normally do in telling its customer what it requires if it is to continue banking facilities, and leaves the decision to the customer whether it will comply or not, ... it cannot be held to have become a shadow director. ... Unless the relationship between the bank and its customer is such that the decision to stop trading or go into liquidation is one that the bank, and only the bank, can take then ... the bank cannot be liable."'[5]

As a practical matter, the Court also made the point that there might be conceptual difficulties in claiming that a particular banker was a shadow director in a situation where the company had several financiers and all were acting in the same way:

> '... if [the bank]'s conduct amounted to instructing or directing the board of the Emanuel group then so did those other financiers whose conduct with respect to their mortgaged properties was not qualitatively

Notes

3 At [236].
4 At [371].
5 At [236].

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> different. It is an unlikely result that the board of the Emanuel group was subject to the simultaneous direction and instruction of three or four separate lenders.'[6]

Further confirmation that creditors, even tough creditors, will not readily be held to be shadow directors came in the recent New South Wales Supreme Court decision in *Buzzle Operations Pty Ltd (In Liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233.

Background to *Buzzle*

Buzzle was formed on 3 July 2000, by acquiring the stock and merging the businesses of a number of resellers of Apple products. It was intended that Buzzle would float on the Australian Stock Exchange.

Each of the resellers had Reseller Agreements with Apple under which they purchased stock on credit (on security). Because Apple was the main supplier to and a secured creditor of both Buzzle and the merging resellers, its consent was required to the merger of the businesses and stock.

Apple took part in some discussions, meetings and communications surrounding the merger. It made clear to Buzzle what its financial expectations were, and what Buzzle and the resellers had to do in order to maintain its co-operation and its agreement to enter into a reseller agreement with Buzzle.

The merger took place mid-September 2000. However, the stock exchange float did not happen and Buzzle's business failed. In March 2001, Apple appointed receivers to Buzzle. A year later, a liquidator was appointed to Buzzle. In December 2004, the liquidator commenced proceedings in the NSW Supreme Court against Apple and one of its directors.

The liquidator claimed that:

- Apple's negotiations and communications with Buzzle had made it a shadow director of Buzzle and thus, liable for its insolvent trading debts; and
- Apple's charge was void under s. 267(1) of the Act, because Apple was a relevant person (which includes an 'officer') at the time the charge was taken and had taken steps to enforce the charge within six months of its creation (by appointing investigating accountants to Buzzle).

These two claims were legally quite distinct. The first relied upon the extended definition of 'director' noted above, which is to be found (with minor variations) in corporate legislation around the world. The second turned on a different legal issue: was Apple an 'officer' of Buzzle within the meaning of s. 9 of the Act:

> '(b) a person:
>
> (i) who makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
>
> (ii) who has the capacity to affect significantly the corporation's financial standing'.

This raises quite different legal issues from the question whether a person is a shadow director, and so, for the purposes of this paper, it is only necessary to note that Buzzle's liquidator failed in this part of his claim.

Was Apple a shadow director?

The Court's first task was to set out its view of the law of shadow directors. In the course of this, it handed down a number of propositions that are of general application.

How many directors does a shadow director have to control?

One recurrent topic in discussion of shadow directorships is whether it is necessary that the alleged shadow director controlled every member of the board, or whether it is sufficient to show that the alleged shadow director controlled a mere majority of the board.

In this case, the Court said that control of a 'governing majority' is sufficient to make one a shadow director.

This led the Court to consider another much-debated issue – whether a person can be both a shadow director and a de facto director (a person who acts as a director even if not formally appointed to the board). This is the subject of considerable judicial debate in England and Wales: see *Secretary of State for Trade and Industry v Aviss* [2006] EWHC 1846, *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638, *Secretary of State for Trade and Industry v Deverell* [2000] BCC 1,057, *Re Kaytech International Plc* [1999] BCC 390, *Re Hydrodan (Corby) Ltd* [1994] BCC 161, etc. Perhaps the leading Australian authority on this question was the decision of the Supreme Court of Queensland in *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd & Ors* (*supra*), where it was said that:

> 'The terms do not overlap. They are alternatives, and in most and perhaps all cases are mutually exclusive.'[7]

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6 At [380].

7 The 'mutually exclusive' line of argument also appears in some of the English authorities, most notably in Millett J's judgement in *Hydrodan*.

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The Court in *Buzzle* disagreed with this line of reasoning on the basis that, since a shadow director only need to control a governing majority of the directors, there is no conceptual difficulty in such person's being also a de facto director:

> '[T]hat conceptual difficulty only arises if to be a shadow director ... all of the directors must be accustomed to act in accordance with the shadow director's instructions or wishes in respect of all aspects of management. The objection to a person being both a de facto and a shadow director appears to be that one cannot be accustomed to act in accordance with the instructions or wishes of oneself.'

Extent of control

As well as the issue of the number of directors that a shadow director must 'control', the Court considered whether the control has to extend to every aspect of the company's business and whether a person would become a shadow director through issuing instructions to the company's executives.

On the first question, it said that 'there is no inconsistency with a person being a shadow director, and on the other hand the board exercising some discretion or judgment in areas in respect of which the shadow director does not give instructions or express a wish'.

On the second, it said that, if a person issued instructions to a company's executives (as opposed to its directors) and those directions were followed, that person would not, by virtue of that action alone, be a shadow director (although he could be a de facto director). It recognised that this issue could be clouded where the executive was also a director. In that situation, said the Court, it would be necessary to look at the capacity in which the executive director received the instructions: 'instructions given or wishes expressed to a director in his or her capacity as a working executive, as distinct from an instruction or wish relating to the director's performance of his or her function as a director, is [sic] not relevant'.

Causal connection between instructions and directors' actions

The Court cautioned that a person would not be held to be a shadow director on the basis of a mere coincidence between his wishes or instructions and what the directors later did. In other words, the directors' actions had to be consequent upon, rather than merely subsequent to, the wishes or instructions:

> 'There is good reason for this. If a person is a shadow director, he, she or it owes statutory duties to act in good faith in the best interests of the company, and with the reasonable care and diligence of a director of the company. A shadow director is also liable to statutory liabilities, such as the liability of a director for insolvent trading. When the definition is construed in the light of the purpose of subjecting a person who is not appointed, and does not (or might not) act as a director, to the statutory duties and liabilities of a director, it makes good sense that there must be a causal connection between the acts of the directors and the instructions of the putative shadow director for the definition to be satisfied.'

This is best illustrated by an example of 'non-causal' behaviour from the judgment itself:

> '[T]he plaintiffs allege that Apple instructed the directors to arrange for Buzzle's employees to prepare financial reports, prepare a plan for collection of Buzzle's accounts receivable, and employ resources for debt collection. These were basic steps for the operation of any business and things that the directors were in any event attempting to do.'

Commercial pressure v directors' duties

From the point of view of creditors who deal with distressed companies, the trickiest issue is determining the dividing line between applying commercial pressure and becoming a shadow director.

It is interesting that the Court in this case took a fairly robust view on this issue, placing particular emphasis on the fact directors are required to act in the best interests of their company. If, in the exercise of their discretion, they decide that it is in the company's best interests, to comply with the creditor's demands, that is not sufficient to render the creditor a shadow director:

> '[T]he reason that third parties having commercial dealings with a company who are able to insist on certain terms if their support for the company is to continue, and are successful in procuring the company's compliance with those terms over an extended period, are not thereby to be treated as shadow directors within the definition, is because to insist on such terms as a commercial dealing between a third party and the company is not ipso facto to give an instruction or express a wish as to how the directors are to exercise their powers. Unless something more intrudes, the directors are free and would be expected to exercise their own judgment as to whether it is in the interests of the company to comply with the terms upon which the third party insists, or to reject those terms. If, in the exercise of their own judgment, they habitually comply with the third party's terms, it does not follow that the third party has given instructions or expressed a wish as to how they should exercise their functions as directors.'

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Conclusion

This *Buzzle* decision is welcome as a comprehensive examination of an issue which, given current economic circumstances, is highly topical and about which there is comparatively little judicial comment.

Doubtless, it will also be welcomed by creditors. It confirms the impression, already given in Emanuel, that Australian Courts are not overly eager to bring creditors within the shadow director fold .

That said, it should be noted that the decision is currently under appeal to the Court of Appeal of New South Wales. Once that appeal is concluded, the parties have the option of applying for special leave to appeal to Australia's highest court, the High Court of Australia.

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ARTICLE

Creditors versus Shareholders: *Primus Inter Pares*?

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Legislation recently passed by the Australian Parliament aims to restore the traditional subordination of shareholders to the creditors of failed companies.

The legislation is designed to overturn the 2007 High Court of Australia decision in *Sons of Gwalia Ltd v Margaretic*; *ING Investment Management LLC v Margaretic* [2007] HCA 1. The High Court held that shareholders who claimed to have been misled into buying shares in a company could rank equally with unsecured creditors in the company's liquidation.

Slow death of a doctrine

The theoretical basis of the doctrine of the maintenance of capital of corporations was the bargain between equity investors in, and creditors of, limited liability companies. Equity investors gained protection from personal liability, but had to accept that, if the corporation failed, creditors had first call on the capital that the investors had invested in the company.

The underpinnings of this theory are amply illustrated by *Oakes v Turquand* (1867) LR 2 HL 325:

> 'it would be monstrous to say that ... a shareholder ... having held himself out to the world as such, and having so remained ... could, by repudiating the shares on the ground that he had been defrauded, make himself no longer liable.'

Of course, the doctrine of maintenance of capital has not always been applied in any absolute way. In Australia, for example, the closing years of the 20th century saw considerable erosion in the form of the legalisation of share buy-backs and the issue of no par value shares. Nevertheless, the doctrine has never been fully and officially overturned.

At the beginning of the 21st century, the doctrine manifested itself in two important ways:

– s 563A of the *Corporations Act 2001* (Australia),[1] which postponed payment of the claims of shareholders qua shareholders until all other creditors have been paid out in full;

– the rule in Houldsworth's case (*Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317), which was that a subscribing shareholder could not recover damages from the company for fraudulent misrepresentation in connection with the subscription for the shares – the shareholder's only remedy was to seek rescission of the contract of allotment of shares (which would remove his name from the shareholders' register of members) and thereby to receive restitution of his application money.

In Australian company law, all unsecured creditors rank equally in a liquidation (with a few exceptions, such as the costs of winding up or the payment of employee entitlements). If there are insufficient funds to pay all creditors the full amount of the debts owed to them, the creditors are paid *'pari passu'*. However, as mentioned above, this general proposition was altered by s 563A. At the beginning of the 21st century, this read as follows:

> 'Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.'

Section 563A was traditionally regarded by liquidators as being a rule that 'shareholders come last'.

As noted above, the rule in Houldsworth's case is that a subscribing shareholder can only claim a return of his subscription money (on the grounds of misrepresentation, for example) if he rescinds his subscription contract. Rescission is a problematic solution if the company is insolvent. In Oakes, the House of Lords held that, once the winding up of a company has begun, a shareholder cannot rescind the subscription contract under which he acquired his shares. It would, therefore, seem to follow that a shareholder who subscribed

Notes

1 And its English equivalents, such as s 74(2)(f) of the *Insolvency Act 1986* (Eng) ('Insolvency Act'). In broad terms, a similar principle informs corporate insolvency law in the USA in the form of s 510(b) of the Bankruptcy Code.

for shares could not lodge a claim against the company once the company was in liquidation.[2]

Sons of Gwalia

The continuous disclosure rules of the Australian Securities Exchange (ASX) require listed companies to make immediate disclosure to the market of information that would have a material effect on the price of the company's securities.[3] Sons of Gwalia was listed on ASX.

Mr Margaretic bought shares in Sons of Gwalia on market in August 2000. A day after his name was entered on the register of members, voluntary administrators were appointed to Sons of Gwalia. Sons of Gwalia reportedly had USD 845 million-worth of unsecured creditors, including US noteholders allegedly owed USD 284 million.[4]

Mr Margaretic claimed that Sons of Gwalia had failed to disclose its financial problems to ASX, as required by the continuous disclosure rules. He asserted an entitlement to damages arising from his purchase of shares in the company.

The voluntary administrators proposed a Deed of Company Arrangement (DOCA) to Sons of Gwalia's creditors. A DOCA is a statutory compromise between a financially-troubled company and its creditors. The Corporations Act makes a DOCA binding on the company and its creditors, but does not prescribe the terms of the deed. The DOCA proposed for Sons of Gwalia effectively included a term identical to s 563A of the Corporations Act. If the deed were approved, the conventional understanding was that the s 563A clone in the DOCA would postpone Mr Margaretic's claim for damages to the debt claims of other unsecured creditors.

Mr Margaretic asserted an entitlement to rank equally with other unsecured creditors. He and the administrators went to court. The central issue for the court was whether an on-market purchaser of shares was postponed by the deed provision that mimicked s 563A. The case thus became a proxy for a debate over the meaning of s 563A.

At first instance and on appeal, the Federal Court of Australia held that shareholders who claimed damages for an on-market purchase were not restrained by s 563A and so could rank equally with other creditors in respect of such claims.[5]

The administrators then appealed to the High Court of Australia, Australia's highest court. On 31 January 2007, the High Court dismissed the appeal.[6]

What the High Court said

By a majority of 6-1, the High Court held that Mr Margaretic's claim was not postponed by s 563A.

There were a number of separate judgments, but the overall view of the majority was that there is no overriding principle that 'shareholders come last', and that any common law rule tending to that conclusion could override the words of the statute.

The leading judgement of Hayne J discussed what was meant by s 563A's reference to 'a debt owed ... to a person in the person's capacity as a member of the company':

> '[T]he obligation which Mr Margaretic seeks to enforce is not an obligation which the ... Act creates in favour of a company's members. The obligation Mr Margaretic seeks to enforce, in so far as it is based in statutory causes of action, is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct and the company's liability to suffer an order for damages or other relief at the suit of any person who has suffered, or is likely to suffer, loss and damage as a result of the contravention. In so far as the claim is put forward in the tort of deceit, it is a claim that stands altogether apart from any obligation created by the ... Act and owed by the company to its members. Those claims are not claims "owed by a company to a person in the person's capacity as a member of the company". For these reasons, s 563A does not apply to the claim made by Mr Margaretic.'[7]

Implications

Not unsurprisingly, the High Court's decision in Sons of Gwalia created a lot of debate.

Notes

2 The High Court of Australia followed Houldsworth's case in Webb Distributors v Victoria (1993) 179 CLR 15 (Webb Distributors). That case had concerned a claim for damages allegedly arising from misleading or deceptive conduct in a prospectus. The company itself was in liquidation at the time of the claim.

3 ASX Listing Rule 3.1. There are, of course, exceptions for matters such as incomplete business negotiations, but these are not relevant to Sons of Gwalia.

4 Sons of Gwalia Deed Administrators' Report Pursuant to section 445F of the Corporations Act, 14 June 2007.

5 *Sons of Gwalia Limited (Administrator Appointed) (ACN 008 994 287) v Margaretic* [2005] FCA 1305 ; *Sons of Gwalia Ltd v Margaretic* (2005) 149 FCR 227 at [51], [61] and [131].

6 *Sons of Gwalia Ltd v Margaretic; ING Investment Management LLC v Margaretic* [2007] HCA 1.

7 *Sons of Gwalia Ltd v Margaretic; ING Investment Management LLC v Margaretic* [2007] HCA 1 at [206].

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Bondholders and other traditional creditors argued that the ruling reversed longstanding principles underlying business incorporation and limited liability (as noted above, the incorporation 'bargain' – that, in return for effective immunity from liability for the company's debts, shareholders ranked behind creditors in the distribution of an insolvent company's assets).

It was argued that bondholders and other unsecured financiers would increase the cost of credit to cover the need to share the company's assets with a new class of creditors. Alternatively, they might simply withdraw from the Australian market completely:

> 'Connecticut lawyer Evan Flaschen acts for US bondholders, including institutions which are owed $450 million by Sons of Gwalia, ING among them.
>
> "The concern is that in any case shareholders will have the incentive to assert these claims," says Flaschen, from Hartford firm Bingham McCutchen.
>
> ...
>
> Flaschen says the response among US lenders is to put Australia in the too-hard basket. He says his clients are not interested in the finer points of the Federal Court decision or the lesson from the HIH decision that there is a real hurdle for shareholders to prove they relied on statements from the company when deciding to buy.
>
> "They can put their money anywhere they want. Why should they put it in Australia if this is how this issue is treated? What else can happen? The nuance about reliance or whatever, they don't care, it's not worth it to them."
>
> ...
>
> A pullback in the US would limit the ability of the big Australian banks to sell their debt if they prefer not to stick around to manage a floundering loan.
>
> Flaschen also predicts higher prices for Australian debt and, for some low-rated companies, difficulties issuing bonds at all.'[8]

Liquidators expressed concern about the delays caused by having to process large numbers of new and complex claims.

Shareholders, class action lawyers and litigation funders countered with the argument that the longstanding rule of 'shareholders come last' did not or should not apply where the shareholders had only become or remained shareholders because of misleading conduct by the company itself. They pointed out that such claims were unrelated to the rights and obligations of shareholders qua members of the company.

Some commentators also pointed out that Sons of Gwalia was something of a *'perfect storm'*:

- relatively unusually, it involved a failed company which had considerable valuable assets (ensuring a significant return for creditors and thereby holding out the hope of a return on investment for the litigation funders who would be running a class action for the shareholder-claimants);
- as a listed company, Sons of Gwalia was subject to the ASX continuous disclosure rules, thus creating a potential cause of action which would not be available for shareholders in the overwhelming majority of failed companies, which are unlisted.

Some comfort was also taken from the aftermath of Soden's case in England (or, more accurately, the lack of an aftermath).[9] The House of Lords decision is Soden did not appear to have resulted in a flood of shareholder claims against insolvent companies.[10]

What happened in Sons of Gwalia

The events that actually transpired after the High Court decision appear to show that, regardless of the merits of the competing theoretical positions, the decision did have real world impacts.

On 28 June 2007, the unsecured creditors of Sons of Gwalia – now including some of its shareholders – met to vote on two rival proposed transactions involving the company's tantalum assets.

In very general terms, one proposal was for a straight purchase of the tantalum assets; the other was a proposal to float a new company and to offer creditors the opportunity to take up shares in that company. A numerical majority of creditors opted for the straight sale proposal. A litigation funder who was supporting the shareholders was quoted in the media as saying:

> 'No-one's an expert in tantalum but everyone's an expert on the difference of having a dollar in your pocket and having it in someone else's pocket.'[11]

Notes

8 Elizabeth Sexton, 'Riff-raff slip into the creditors' queue', *Sydney Morning Herald*, 20 March 2006.

9 *Soden v British & Commonwealth Holdings plc* [1997] 4 All ER 353.

10 One theory is that this may have been, at least in part, to the fact that there was no litigation funding industry in the UK when Soden was decided.

11 *RCF wins battle for Sons of Gwalia asset* AAP, June 28 2007.

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An indication of the importance of the shareholders to the vote can be gained from the following figures: [12] [13]

Type of creditor	*No. of creditors*	*Total value of claims*
Ordinary Creditor	922	USD 848.1 million
Shareholder Claimant	8,038	USD 577.0 million

As well as having a substantial impact on the administrators' disposal of the company's assets, the high number and complex nature of the shareholder claimants' claims required the administrators to adopt new procedures when conducting the administration.

Initial Government response

The Australian Government refrained from making any comment on the issues raised by Sons of Gwalia until the litigation had run its full course through the court system. Once the High Court had handed down its decision, the Government referred the matter to its specialist corporations law advisory body, the Corporations and Markets Advisory Committee (CAMAC).

The reality for CAMAC was that there were only two viable alternative conclusions: retention of the status quo (misled shareholders rank equally with unsecured creditors) or reversion to the status quo ante (shareholders come last). Despite this, CAMAC's December 2008 report, managed to canvass four options:

– 'maintain the current legal position, which treats aggrieved shareholders as ordinary unsecured creditor claims
– postpone those claims behind conventional unsecured creditor claims;
– maintain those claims as creditor claims but subject them to a monetary cap; or
– prohibit claims by aggrieved shareholders altogether.'

The reality, of course, is that the third and fourth options were not realistic. The suggested cap on shareholder claims was 10% of the net assets available for distribution to the unsecured creditors. Apart from the fact that this would not overcome one of the perceived problems with the High Court's decision – the complexity of handling shareholder claims – the cap would be a strong disincentive to litigation funders' assuming of shareholder-claimants' cases in Australia. A cap would therefore, in most cases, be a de facto prohibition on claims by shareholders.

CAMAC itself recognised that banning aggrieved shareholder claims altogether would be contrary to the current trend towards providing greater protection to investors.

In the end, therefore, CAMAC, faced with a choice between the status quo and the status quo ante, opted for the former:

> 'While members were not of the one view, the Advisory Committee as a whole is not persuaded of the need for change.'

The second Government response

The CAMAC report confirmed that there was no magic solution that would satisfy both sides of the debate.

In the face of this, it is perhaps not surprising that the Government did not respond to the report for over a year. What was surprising was that its response, announced on 19 January 2010, was to reject CAMAC's recommendations:

> '"Any direct benefits to aggrieved shareholders arising from non-subordination are outweighed by the negative impacts on shareholders generally as a result of restrictions on access to, and increases in, the cost of debt financing for companies,' Minister Bowen said.
>
> "The Government also remains concerned that the Sons of Gwalia decision has the potential to further increase uncertainty and costs of associated with external administration.
>
> "The decision has also been taken in light of the decision's potential negative impact on business rescue procedures."'[14]

Notes

12 Under the Corporations Regulations, a motion is only passed at a creditors' meeting if:
– it receives the support of the majority of creditors measured by *both* their numbers *and* the value of their claims;
– it receives the support of the majority of creditors measured by *either* their numbers *or* the value of their claims, *and* the chairman of the meeting votes for it.

13 Sources: Ferrier Hodgson, Deed Administrators' Report Pursuant to Section 445F of the Corporations Act, 2001, Sons of Gwalia Ltd ACN 008 994 287 (Subject to Deed of Company Arrangement) and certain of its subsidiaries as set out in the Schedule (All Subject to Deed of Company Arrangement), 7 December 2007, p. 6; Ferrier Hodgson, Circular to Creditors, June 2008.

14 The reaction to the Government's announcement was not overly enthusiastic, to put it mildly. Australia's leading financial newspaper, the Australian Financial Review was neutral-to-positive, with two stories headlined: 'Bowen says shareholders win' and 'Gwalia reversal gains industry approval'. Other major newspapers were less positive: 'Shareholders lose, banks win in new law' (*Sydney Morning Herald*); 'A slap in the face for shareholders as High Court judgment is reversed' (*The Australian*); 'Chris Bowen's decision will deny mistreated shareholders any recourse against the company' (*The Australian*); 'Shareholder rights eroded' (*Herald Sun*).

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Draft legislation was released for comment two months after this announcement and the resulting amendment Bill was introduced into Parliament just over a month later. The calling of a general election then delayed the passage of the Bill, which was not finally passed and operative until 18 December 2010.

Overview of the amendment Act

The amendment Act aims to address three issues raised or highlighted by the Sons of Gwalia situation.

The first issue was the finding of the High Court that shareholder-claimants' claims were not postponed by s 563A. The Act effectively reversed this decision by replacing s 563A with a new provision which provides that the payment of all claims in relation to the buying, selling or holding of shares is deferred to the payment of all other creditors' claims.

The Act then moved to address an issue highlighted by Sons of Gwalia, even though it was not a matter raised in the litigation: the voting rights of shareholder-claimants. The Sons of Gwalia litigation and the subsequent events (detailed above) showed that, no matter what their ranking vis-à-vis more conventional creditors, shareholder-claimants were undoubtedly creditors of their company (at least insofar as they had a claim against the company for misleading conduct in relation to their shares). The Act contained provisions aimed at curtailing shareholder-claimants' voting rights.[15]

Finally, the Act overturns the principle in Houldsworth, by removing any restriction on the ability of a shareholder to recover damages against a company based on how they acquired the shares or whether they still hold the shares.

The amendment Act in detail

As noted above, the key provision in the Act is a new s 563A:

> '563A Postponing subordinate claims
>
> (1) The payment of a subordinate claim made against a company is to be postponed until all other claims made against the company are satisfied.
>
> (2) In this section, subordinate claim means:
>
> (a) a claim for a debt owed by the company to a person in the person's capacity as a member of the company (whether by way of dividends, profits or otherwise); or
>
> (b) any other claim that arises from a person buying, holding, selling or otherwise dealing in shares in the company.'

The title of this new section is somewhat misleading: it postpones the payment of claims, rather than the claims themselves. As a result, therefore, the new s 563A does not address one of the major practical considerations arising out of Sons of Gwalia: the ability of claimant shareholders to use their votes as creditors in creditors' meetings. That issue is addressed by a new s 600H:

> 'A person whose claim against a company is postponed under section 563A is entitled:
>
> (a) to receive a copy of any notice, report or statement to creditors only if the person asks the administrator or liquidator of the company, in writing, for a copy of the notice, report or statement; and
>
> (b) to vote in their capacity as a creditor of the company, during the external administration of the company, only if the Court so orders.'

That these provisions aim to prevent shareholder-claimants' swamping creditors' meeting is made very clear by the Government's Explanatory Memorandum which accompanied the Act:

> '[T]here could be 5,000 aggrieved shareholders, all of whom would be entitled to be provided with information by the liquidator and to attend and vote as creditors at meetings, notwithstanding that upon subordination they may have no real interests in the outcome of the liquidation. Given their numbers and the limited funds available, their votes could significantly affect the efficacy of the liquidation and reduce the returns to other creditors. The amendments provide that such shareholders would now receive reports to creditors only after making a written request, and would now not be entitled to vote as creditors unless the Court grants leave.'

Finally, the abrogation of Houldsworth is achieved by the insertion of a new 247E:

> '247E Shareholding does not prevent compensation claim
>
> A person is not prevented from obtaining damages or other compensation from a company only because the person:
>
> (a) holds, or has held, shares in the company; or
>
> (b) has subscribed for shares in the company; or

Notes

15 Of course, the Sons of Gwalia matter merely drew attention to the fact that, under the already-existing law, shareholder-claimants could vote with other creditors. The litigation did not create any new law in that regard.

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(c) has a right to be included in the register that the company maintains under section 169.'

This wording is very similar to s 111A of the Companies Act (Eng), introduced after Soden.

Problems with the amendment Act

Despite the time taken for its drafting, the amendment Act contains a number of problems.

The first of these is that the Parliament refrained from an outright ban on voting by shareholder-claimants. Instead, it opted to allow them to apply to a Court to be allowed to vote. The new s 600H does not provide the Court with any guidance on how it is to exercise its power. Faced with a new statutorily-unrestrained discretion, Australian Courts will normally have recourse to the official explanatory materials accompanying the amending statute and to the underlying history of the legal issues which prompted the amendment.

Unfortunately, they will not find much guidance in the case of s 600H. The Explanatory Memorandum to the Bill (quoted above) does not give any indication of the circumstances in which the Court might grant voting rights to shareholder-claimants. The only relevant comment is that allowing 5,000 shareholder-claimants to vote and to receive reports from liquidators 'could significantly affect the efficacy of the liquidation and reduce the returns to other creditors'.

This is not, presumably, intended to indicate that 5,000 is some kind of threshold figure, below which shareholder-claimants might be allowed to vote. The only policy objective discernible from the Explanatory Memorandum, therefore, is the more general one that shareholder-claimants' voting rights should be restricted because of their potential effect on unsecured creditors. This suggests that courts should only grant voting rights where the exercise of those rights would not affect the returns to other creditors – which rather begs the question of granting voting rights at all.

The issue of voting rights also lies at the heart of two other problems with the Act.

Application to voluntary administration

Sons of Gwalia was in voluntary administration. Voluntary administration is an insolvency regime established by Pt 5.3A of the Corporations Act. It allows a financially-troubled company to appoint an external administrator to take control of the company and, within a short timeframe, report to creditors on whether the company should be wound up or whether it should enter into a DOCA (as noted above, a binding debt arrangement between the company and its creditors). A DOCA becomes binding upon the company and its creditors when a majority of creditors vote to adopt it and the company executes it.

While the company is under the control of the voluntary administrator (i.e., before the vote by the creditors), there are no statutory rules for the payment of creditors or the order in which creditors are to be paid. The voluntary administrator will identify creditors for the purpose of voting on a DOCA, but has no power to pay those claims. A DOCA may (and usually does) set up a regime for the payment of claims (including which claims will be paid and the order in which they are paid). With only a few exceptions, the rules for the payment of creditors and the order of payment are set by the DOCA itself (the contents of which, in theory at least, are determined by the creditors, rather than by the Corporations Act).[16]

Both voluntary administration and DOCA therefore differ from liquidation: when a company is in liquidation, the Corporations Act requires the payment of creditors and provides a statutory order in which they are to be paid. That statutory order of payment for companies in liquidation now includes s 563A.

As noted above, the new s 600H purports to restrict the voting rights of shareholder claimants. It applies to a 'person whose claim against a company is postponed under section 563A.' However, as discussed, s 563A does not affect the payment of claims in voluntary administration or under a DOCA (unless the creditors vote to incorporate it into the DOCA). Does this mean that the new s 600H does not apply to creditors' voting rights in voluntary administration or under a DOCA?

It appears that the intention of the legislature was to prevent shareholder-claimants' voting without court approval in a voluntary administration or under a DOCA:

> 'The Bill inserts a definition of external administration clarifying that the reforms to voting rights and the right of creditors to receive reports, as contained in the Bill, apply to voluntary administrations, deeds of company arrangement, voluntary and involuntary liquidations, provisional liquidations and schemes of arrangement.'[17]

Despite this intention, it is more than arguable that the wording of s 600H does not achieve the intended effect. In order to give effect to the section, a court would have to read it as applying to 'a person *the payment of* whose

Notes

16 It will be recalled that the Sons of Gwalia litigation was triggered by a DOCA which, by incorporating the then-section 563A, purported to postpone the payment of claims by shareholder-claimants.

17 Revised Explanatory Memorandum to the Corporations Amendment (Sons of Gwalia) Bill 2010.

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claim against a company *would be postponed* under s 563A *if the company were being wound up under this Act* and *if the claim were being made in that winding up*'.

It is not beyond the bounds of possibility that a court would baulk at such a major rewrite of a statutory provision.

Schemes of arrangement

Like many other jurisdictions with roots in English company law, Australia has a court-supervised statutory corporate reconstruction regime called 'scheme of arrangement'.

This is considerably older than the voluntary administration regime, although it shares some of the same policy objectives (e.g., allowing a financially-troubled company to enter into a binding arrangement with its creditors). Two key elements of a scheme of arrangement under s 411 of the Corporations Act are:

- a separate scheme is required for each class of creditor;
- a scheme will only be binding on a class of creditor if the Court orders that a meeting of that class be held and the meeting ordered votes in favour of the scheme.[18]

During the passage through Parliament of the Sons of Gwalia Bill, the Bill was examined by a Parliamentary Committee. The Committee appears to have concluded that shareholder-claimants would not be bound by a scheme of arrangement if they were not able to vote on it. The Committee's reasons for reaching this conclusion were somewhat confused. It is unclear whether it believed that:

- non-voting shareholder-claimants would not be bound by a scheme because their inability to vote would mean that they would constitute a separate class of creditor and, since the class could not vote on the scheme, would not be bound by the scheme; or
- non-voting shareholder-claimants would not be bound by a scheme because, even though they might belong to the same class as other unsecured creditors, a scheme would only be binding on creditors who had an entitlement to vote on it.

The second proposition does not appear to be supported by the wording of s 411. In fact, when one looks at the evidence presented to the Committee by the Government Department responsible for the Bill, it appears that the first proposition is the correct one:

> 'It is Treasury's understanding that [these] concerns may be addressed by amendments that would have the effect of providing that a [scheme of arrangement] would be binding on [shareholder-claimants] who had not been given leave to vote, despite the fact that a meeting of *that class of creditors* had not been ordered by the Court ... .'[19] (emphasis added)

As a result, amendments were made to the Bill to address this issue. Those amendments took the form of a new s 411(5A):

> '(5A) If the compromise or arrangement:
>
> (a) involves creditors of the Part 5.1 body with subordinate claims (within the meaning of subsection 563A(2)) [i.e., shareholder claimants]; and
>
> (b) is approved by the Court;
>
> those creditors are also bound by the compromise or arrangement despite the fact that a meeting of those creditors has not been ordered by the Court under subsection (1) or (1A).'

The reference to 'the fact that a meeting of those creditors has not been ordered by the Court' supports the view that shareholder-creditors constitute a separate class of creditor. However, if this is correct, the necessary condition required by the opening words of the new provision is a nullity. As already pointed out, a scheme will only bind a single class of creditors. If it is correct that shareholder-claimants are a separate class and if the court has not ordered a meeting of that class, then there is no scheme that 'involves' those creditors within the meaning of s 411(5A)(a).

Conclusion

The Sons of Gwalia situation was never going to be a simple one. It highlighted the fact that you cannot incorporate two apparently contradictory policy objectives in the same piece of legislation. At the end of the day, if there is only a limited pool of funds available for distribution to the victims of a corporate collapse, some difficult policy decisions have to be made.

In the end, the Australian legislature decided that investor protection had to take second place to ensuring the ready availability of credit to Australian companies. Whether the result will be good for companies, creditors and investors in the long term remains to be seen.

That said, it is difficult to reconcile the five year timeframe within which this issue played out with the deficiencies in the drafting of the legislative response.

Notes

18 These are necessary, but not sufficient, conditions: see s 411 for further details.

19 Australian Government, The Treasury, Letter to Senate Standing Committee on Legal and Constitutional Affairs, 12 November 2010.

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ARTICLE

Insolvent Unit Trusts in Australia

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The Australian unit trust industry recently experienced financial difficulties. The formal legal process of handling those difficulties has revealed gaps in the Australian regulatory map.

This article highlights some of those problems and the government's response to them.

Background

It is not yet clear whether the sector's current problems arise from the GFC or whether (and to what degree) they are the result of purely domestic factors. In respect of the latter issue, it is possibly relevant that Australia has, since the mid-1980s, been moving its retirement incomes policy from a largely State-funded one to one in which retirees are encouraged to fund their own retirement, with the state's resources being reserved for a social safety net. The result has been a significant expansion of retail (or 'Mum and Dad') investment activity, either directly or through the medium of private sector pension funds.

One thing which is clear is that one segment of the sector has been noticeably affected by financial stress: agricultural unit trust schemes. These involve the vending of financial interests in agribusinesses.

As the cases discussed below show, the collapse of these schemes has shown that there are gaps in the Australian regulatory regime for handling the insolvency of unit trusts in general. This is surprising, because the statutory requirements for unit trusts were completely rewritten in 1998, largely in response to the near collapse of the unlisted property trust segment of the unit trust industry in 1991. That statutory regime was extensively reviewed and given a clean bill of health in 2001.[1]

Despite this, the current round of collapses has seen a major increase in litigation in the sector, as liquidators seek court directions on the performance of their duties.

The single responsible entity model

To some degree, the problems arise from the statutory model for unit trusts.

Until the 1998 amendments, unit trusts operated on a system of split responsibility. A trustee held the trust property and a separate manager managed the trust business. As well as holding the trust property, the trustee was responsible for ensuring that the scheme manager properly discharged its duties.

A key change in 1998 was the formal abolition of the split between trustees and scheme managers. In a strictly legal sense, the trustee and scheme manager were abolished and replaced by a single 'responsible entity'. The objective was to overcome the possibility of a 'responsibility gap' between trustees and scheme managers, which could result in defaults in the operation of the trusts. A less important change was the rebranding of unit trusts as 'managed investment schemes'. As a matter of practice, responsible entities are now commonly referred to as 'REs' and managed investment schemes as 'MISs' (a convention which will be followed in this article).

Despite the fact that it is not required by statute, most MISs are structured as trusts. The RE holds the scheme assets on trust and is liable to investors for the operation of the scheme. However, it is common for the management function to be outsourced (although ultimate responsibility remains with the RE).

Chapter 5C of the Corporations Act 2001 (Cth) contains the main provisions governing MISs. Only seven of the 68 sections in Ch 5C deal with insolvency. They effectively provide that a MIS can be wound up in accordance with its constitution (if the constitution contains such provisions) or by order of a court.

The recent round of litigation arising from the collapses of schemes has showed that the legislation does not satisfactorily answer two questions:

– who should actually liquidate an insolvent MIS?
– who should pay for the liquidation?

Notes

1 Review of the Managed Investments Act 1998, Commonwealth of Australia, December 2001.

Responsibility for liquidating an insolvent MIS

It is common to refer to an MIS as being 'insolvent' or an 'insolvent trust'. In fact, the Corporations Act defines 'insolvency' in terms which apply to corporations, rather than MISs: since an MIS has no legal personality, it cannot incur the debts the inability to pay which is the basis of the definition of insolvency.

Scheme property is held and scheme debts are incurred by the RE (which has a right of indemnity from scheme property in respect of these debts). 'Insolvent MIS' therefore, actually describes an MIS in which the scheme property is insufficient to meet the scheme liabilities to scheme creditors, whether or not the RE itself is solvent.[2]

Part 5C.9 of the Act provides that an RE is required to ensure that an MIS is wound up in certain circumstances. Curiously, the Act does not specify that insolvency is a ground for winding up. However, there is a general 'just and equitable' ground for winding up.[3] The Courts have held that insolvency provides a reason for winding up on this ground.[4]

The Corporations Act also does not specifically provide a procedure for dealing with an insolvent MIS (in the terms referred to above) in circumstances where the RE is also insolvent in its own right.[5]

What normally happens is that an external administrator (voluntary administrator, receiver or liquidator) is appointed to the insolvent RE. That external administrator then either handles the liquidation of the MIS himself or applies to the court to appoint of a separate liquidator to the MIS.

In once recent decision, the court appointed a liquidator to the insolvent MIS. It also awarded priority to the RE and the other parties to the winding up application for their costs, out of the MIS's assets, ahead of the costs of the liquidator of the MIS. Presumably as a result of this, no liquidator would be found for the MIS. As a result, the liquidator of the RE was appointed liquidator of the MIS.[6]

Appointing the same person as liquidator of both the RE and the MIS may appear to have some advantages, along the lines of those which are perceived to arise from appointing the same person to be the voluntary administrator of a failed company and then, when the company enters liquidation, its liquidator. These apparent advantages result from not having to 'reinvent the wheel', by utilising the RE liquidator's knowledge of the operation, finances and problems of the MIS.

On the other hand, appointing the same liquidator to both the RE and the MIS can give rise to problems.

The first of these is that the liquidator of the RE is the liquidator of the RE company. As such, his function is to protect the interests of the creditors of that company (and, if there are any funds left over after paying the creditors, the interests of its shareholders). In contrast, the liquidator of a MIS must look to the interests of the investors in the scheme itself.

The Court in *Capelli v Shepard* addressed this problem by appointing a committee of management (drawn from the ranks of creditors). The job of the committee of management was to direct the liquidator to apply to the court for directions if any conflict arose. Such an application was subsequently made in *Environinvest Ltd v Great Southern Property Managers Ltd*.[7]

The MIS in question required the RE to lease the land on which the scheme conducted its business. The conflict arose when the liquidator was deciding whether to disclaim the lease. A disclaimer was in the interests of creditors of the RE, but could adversely affect the rights and entitlements of members of the MIS.

In normal circumstances, the simplest way out of this conflict would have been for the liquidator to have resigned as liquidator of either the RE or the MIS. That course was not really open, however, because:

– as previously noted, no-one was willing to take over the liquidation of the MIS; and
– the members of the MIS were happy with the liquidator's conduct of the liquidation and apparently did not want him to resign.

The court ultimately declared that the liquidator was permitted to disclaim the lease, notwithstanding the potential conflict with his role as liquidator of the MIS.[8]

Notes

2 The question whether a RE which is otherwise solvent could itself become insolvent because it is operating an insolvent MIS in the sense defined above can be a complex one, because of the general principle that the RE is personally liable for debts that it incurs in respect of a MIS unless the creditors have agreed to limit their recourse to the scheme property. So a RE may find itself exposed to any shortfall which, among other consequences, might then adversely impact upon its regulatory capital position.

3 s601ND(1)(a).

4 *Capelli v Shepard* [2010] VSCA 2.

5 The other common situation is of an insolvent RE and a solvent MIS which is still viable and where the members still wish to continue.

6 *Capelli v Shepard*, supra, note 4.

7 *Environinvest Ltd v Great Southern Property Managers Ltd (No 2)* [2010] VSC 323.

8 For a very useful summary of events in the Environinvest winding up, see *Re Environinvest Ltd (No 4)* [2010] VSC 549. This case concerned the liquidator's application for to finalise the winding up of some of the relevant schemes. The Court took the opportunity to recount the major events in the winding up and to comment on some of the practical issues faced by the liquidator in dealing with a scheme which involved the growing of trees on third party property.

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Conflicts also appeared to arise in *Timbercorp Securities Ltd v WA Chip & Pulp Co Pty Ltd*.[9] There, the liquidators of the RE of an agricultural MIS applied to extend the time limit for deciding whether to disclaim a lease which it held for the purpose of the MIS. Concerned about the effect of disclaiming the lease on the investors in the MIS, the liquidators applied to the court. The court's took the opportunity to remind the liquidators of the duties that they owned as liquidators of the RE:

> 'The liquidators seem to be of the opinion that by reason of ss 601FC and 601FD they are required to look after the interests of investors [in the MIS] even if that be at the expense of other creditors. In my view that is wrong. There is nothing in ss 601FC or 601FD that overrides the liquidator's duty to those interested in the winding up. It would be quite extraordinary were that to be the case. I think the liquidators should readjust their priorities.'

Costs of liquidation

A liquidator of a company is normally entitled to be paid his or her remuneration out of the funds of the company. The situation is not so clear in the case of an MIS when both the RE (which has a right of indemnity against trust assets) and the MIS are insolvent.

Can the liquidator of the RE use the RE's assets to pay the cost of liquidating the MIS?

Rubicon Asset Management Ltd[10] concerned the insolvent RE of a number of insolvent MISs. All the scheme assets were charged, with the result that the RE's right of indemnity against trust assets and its ability to recoup the costs of winding up the schemes were worthless. The RE asked the court to allow it to use its own funds to wind up the MISs.

Although this would adversely affect the RE's own creditors by reducing the pool of funds available to the RE's unsecured creditors, the Court held that this only went to the exercise of its discretion, and did not affect its jurisdiction to make the order. Accordingly, the court made the orders sought by the RE.

The court held that most of the RE's liabilities were in fact liabilities incurred as trustee of the schemes themselves. Even if the order diminished the amounts available to the RE's creditors' entitlements, that outcome would be justified by the RE's obligation (if it was insolvent) to wind up its schemes in accordance with the constitutions of the schemes.

One RE – many MISs

It is very common for a single company to be the RE for multiple MISs. If those MISs all become insolvent, the extent of the insolvency (and the available cash) may vary between the MISs. In *Trio Capital Ltd (Admin App) v ACT Superannuation Management Pty Ltd*,[11] the Court was asked whether the voluntary administrator of an RE could 'raid' the assets of one MIS to pay for the costs of liquidating another.

The RE's assets were not sufficient to pay the administrator's costs and remuneration for administering the RE and the MISs. The administrator therefore sought court approval for a structure under which the cost (including his remuneration) of administering those MISs which had no assets could be recovered from the MISs which had assets.

The application highlighted a policy conflict:

- the statutory corporate insolvency regime (of which voluntary administration is one arm) depends upon there being an high level of assurance that external administrators will be paid;
- on the other hand, each MIS (insofar as it was a trust) was a separate legal structure, and the administrator of a trustee of multiple trusts is required to act in the best interests of each trust.

The court considered these issues and concluded that the interests of the members of MISs with assets took precedence over the administrator's remuneration. The result was that the RE's own assets should be applied to paying the administrator's costs and remuneration relating to administering the RE and the MISs, in the same proportions. The funds of each MIS should then be applied to meeting the unmet costs and remuneration attributable to the cost of administrating that particular MIS

Conclusion

There have been a number of responses to the spate of litigation concerning insolvent REs and MISs.

The Australian Securities and Investments Commission has addressed one component of the problem – insolvent REs. In a September 2010 consultation paper, the Commission proposed to use its regulatory powers to impose tighter financial controls on REs of registered MISs (ie, those with more than 20 investors).

This would not address the wider conceptual problems revealed by the cases discussed in this article.

Notes

9 *Timbercorp Securities Ltd v WA Chip & Pulp Co Pty Ltd* [2009] FCA 901.
10 *Rubicon Asset Management Ltd* (2009) 74 ACSR 346; [2009] NSWSC 1068.
11 *Trio Capital Ltd (Admin App) v ACT Superannuation Management Pty Ltd* [2010] NSWSC 941.

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Accordingly, in November 2010, the Australian Government directed its specialist corporate law reform body (CAMAC) to investigate and report on a wide range of issues, including:

- whether the current statutory framework is adequate for the winding up of MISs, and agribusinesses in particular, and whether it provides the necessary guidance for liquidators, creditors, investors and growers;
- what legislative amendments should be made if the current legislative framework does not provide the necessary legislative tools with respect to the arrangements for dealing with non-viable MIS;
- whether the current temporary RE framework[12] enables the transfer of viable MIS businesses where the original RE is under financial stress, and if not whether it should be reformed or replaced;
- whether REs are unable to restructure a financially viable MIS and if the current legislative methods available to companies under the Corporations Act should be adapted to managed schemes.

CAMAC has been given a reporting date of 30 September 2011.

Notes

12 The sole role of a temporary RE is to call a meeting of scheme members for the purpose of appointing a new RE. If one is not appointed at such meeting then the scheme must be wound up. It has rarely been used in the 12 years since the Chapter 5C regime was introduce, largely because there is a fear of the unknown financial situation of the MIS and the risk that the putative temporary RE may become personally exposed for any shortfall in scheme property, adversely affecting the solvency of the temporary RE itself.

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ARTICLE

An Administrator's Power to Compulsorily Transfer Shares[1]

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Introduction

The compulsive power of the Court to transfer shares upon a deed administrator's application[2] has the potential to interfere considerably with shareholders' proprietary rights. In light of its significance, there is surprisingly little discussion regarding the scope and ambit, or limitations upon, the exercise of the power and only one (unreported) decision of the Supreme Court of Western Australia providing any guidance as to when such applications will succeed.[3]

Presumably this is because the power will mostly be exercised in circumstances where no value remains in shares if the value of debts exceed asset values. This is known as the Debt Residual Value, or 'DRV' in the shares.

This article discusses another formulation of the relevant test, that is considering whether, on the guidance offered by section 444GA(3), there are circumstances where the proper test is to consider the inferred value of the shares, having regard to both to the DRV and to the company's growth prospects post project (Contingent Residual Value, or 'CRV'). The question is of relevance because in many circumstances of near-insolvency, parties may propose a project or restructure aiming to revive the company. Sometimes, the circumstances that have led the company into administration are not terminal in the sense that a capital raising or other program might have been available to cure liquidity concerns, but the directors were either not confident of the success of the capital raising or were not prepared, on the present state of our insolvent trading laws, to expose themselves to personal liability for trade debts if the capital raising failed.[4] Whatever the reason for the appointment of administrators, if a rehabilitation can be successfully undertaken, existing equity in the business (shares) will retain some value.

The capital raising will have some dilutive impact on the value of shares, but the essential point is that whereas a DRV would have yielded a nil value on day one of the administration, the CRV would yield something more, and would be assessed having regard to the contingencies attending the capital raising program. Distilled to its essence then, our question is whether the potential value to shareholders of the company's projects should be a relevant consideration?

Potentially 'yes', though in most cases the DRV and CRV analysis will yield much the same outcome unless the shareholder is prepared to fund any required capital raising to satisfy existing unfunded obligations (ie: to bring what remains of the company out of administration using an appropriately structured debt management program incorporated in a deed of company arrangement).

However, there are circumstances where the CRV will, in circumstances where shareholders hold other economic interests in a project dependent on the shareholding interest or in the company itself, be the applicable test. In those circumstances, emphasis on the meaning of 'unfair prejudice' to members' interests within s444GA(3) may lead to a result where the CRV has some inferred value above nil, requiring the Court to value the economic interests of the member before deciding whether to grant leave to confiscate their property under s444GA.

A Power of Transfer – section 444GA

Section 444GA[5] provides that a deed administrator may transfer shares in a company with consent of the owner or with leave of the court.

Notes

1 Originally published by Cameron Belyea, partner of Clayton Utz and Tracy Chew, associate of Clayton Utz in *Insolvency Law Bulletin*, 2010, Vol 10, No 7 (March), revised for inclusion in this publication (April 2011).
2 Section 444GA of the Corporations Act 2001 (Cth).
3 *Weaver and others as Joint and Several Deed Administrators of Midwest Vanadium Pty Ltd v Noble Resources Ltd* [2010] WASC 182.
4 Treasury released a white paper calling for submissions on amending the law to incorporate, inter alia, a modified business judgments rule to provide certain safe harbours in favour of directors of financially stricken entities making business judgments with the assistance of appropriate financial advisors. Submissions closed on 2 March 2010.
5 Section 444GA was inserted by item 29 of the Corporations Amendment (Insolvency) Bill 2007 and took effect on 31 December 2007.

Before its insertion, deed administrators lacked power to sell shareholders' shares without their consent.[6] Section 444GA was inserted because, inter alia:[7]

- it may be essential to a DOCA's success that a share sale proceeds, e.g., a DOCA based on an investor acquiring all (or a minimum proportion) of the company's shares in return for a lump-sum payment to creditors; and
- often, the shares of a company under administration will have little residual value and shareholders will not participate in distributions, therefore, arguably, their consent to the transfer is not required.

The Explanatory Memorandum recognises that such power may be open to abuse, in particular:

- a DOCA involving creditors swapping their debt for equity may unfairly advantage creditors if the company's underlying business is strong; and
- such power could unfairly prejudice shareholders where the company retains some residual value.

Accordingly, section 444GA(3) provides:

> 'The Court may only give leave under subsection (1) if it is satisfied that the transfer would not unfairly prejudice the interests of members of the company'.

In assessing whether a member is 'unfairly prejudiced' by the proposed share transfer, the court must consider the impact of a compulsory share sale *where there may be some residual value in the company*.[8] In *Gambotto*,[9] the High Court (commenting generally on shareholders' rights in compulsory acquisitions) suggests that a high standard of proof will be required to establish the consideration payable to the shareholder at least meets the 'residual value' of the shares before a Court can forcibly confiscate shares.

On standard statutory interpretation principles, it is instructive that the expression 'unfairly prejudicial' also finds voice in Pt 2E.3. There, the Court has broad powers to adjust the rights of members, or even to wind up the corporate structure where some impugned conduct is 'oppressive to, unfairly prejudicial to, or unfairly discriminatory against' a member 'whether in that capacity or in any other capacity'.

Section 444GA(3) uses a slightly different formulation, requiring the Court to have regard to 'the interests of members', without necessarily limiting that 'interest' to 'shareholding interests'. It would seem to follow, and this is an analysis consistent with Pt 2E.3 that in considering whether a compulsory transfer is 'unfairly prejudicial', the Court ought consider all economic interests of the member in an entity and have regard to the totality of those interests in determining the 'residual value' of the shareholding.

Residual value

Where the company is insolvent in the sense that the company has no ability to continue to use its assets or associations with stakeholders to fund ongoing operations, shareholders are no longer residual claimants and their residual interest is zero.[10] In those circumstances, 'residual value' in insolvency relates to available assets rather than potential future assets or earnings.

More generally, the residual interest of a company to its shareholders, in accounting terms, is the surplus of assets over liabilities. In finance circles, residual value for an insolvent company is typically 'what's left after all definite obligations have been satisfied'.[11]

The DRV appears to accord with the general accounting and finance usages of residual value. Arguably the legislation intended for it to be more difficult to establish unfair prejudice, as section 444GA(3) refers to members in the plural rather than the singular.[12] Adopting the DRV would be consistent with this. It was the approach taken in the *Windimurra* decision, Martin CJ opining:

> 'The recapitalisation, in order to be undertaken, would require the provision of a benefit to flow to the investor who takes the risk involved in injecting further capital into a project that has already revealed the risks of such a course. It would be extremely unlikely for an investor to take that risk on the basis that existing shareholders (whose risks of ownership and investment have already materialised and resulted in the loss of all value) could receive some free-carried benefit from further investment in which they take no risk.'

Notes

6 *Mulvany v Wintulich* (unreported, Fed C of A, O'Loughlin J, SG 3184 of 1995, 29 September 1995, BC9507148); *Cresvale Far East Ltd (in liq) v Cresvale Securities (subject to DCA)* (2001) 37 ACSR 394.

7 See paragraphs 7.49 to 7.59 of the Explanatory Memorandum to the Corporations Amendment (Insolvency) Bill 2007.

8 See paragraph 7.58 of the Explanatory Memorandum.

9 *Gambotto v WCF Ltd* (1995) 182 CLR 432.

10 Dr Colin Anderson and Dr David Morrison, 'Seen but not heard? The significance of shareholders under Pt 5.3A of the Corporations Act' (2008) 16 *Insolv LJ* 222.

11 Financial Innovation in Corporate Law, quoting Robert Charles Clark, Corporate Law (1986) at 18.

12 Supra n. 10; section 232 of the Corporations Act which refers to 'a member or members'; section 445D(1)(f) of the Corporations Act which refers to 'one or more such creditors'.

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Adopting this as a general statement would mean that most, if not all, section 444GA applications involving balance sheet negative assets will be successful. It is respectfully suggested that Martin CJ was not intending in *Windimurra* to outline an absolute test, but instead a test that, on the circumstances there before the Court, indicated that the shares in the company 'had no value'.

An absolute test based on balance sheet deficiency would make it easier for administrators to compulsorily transfer shares to remove any blocking stakes to projects which may be crucial to the company's continued survival. In most administrations, the necessity for an external project only arises if the company will have no or minimal residual value without such a project.

Indeed it is fair to say that in most administrations, DRV will be negative or zero and hence the same sort of result as was delivered in Windimurra would presumably be delivered on future applications of this nature.

However, it seems inappropriate for DRV to be commensurate with 'unfair prejudice' in all cases involving insolvent companies. It would mean that almost every section 444GA application would be approved. This would render section 444GA(3) of little value except in those relatively rare cases where a company placed into administration because of cashflow problems still retains an excess of assets over liabilities.

The converse (that the CRV would mostly be positive) is not the case if appropriate discount factors are applied. That is, if a contingency is, e.g., a condition that the investor obtain 100% control (and this condition is not expected to change), then the discount factor would be zero, as there would be no chance of the contingency occurring, or even if it does, shareholders would achieve no value from the project as they would no longer own any shares. Such application of the discount factor would resolve the anomaly in adopting the CRV that a shareholder can obtain value from a project which requires 100% investor ownership of shares. However, the CRV approach affords higher protection to shareholders as, if there is a chance of the deal succeeding without the share transfer, some residual value to shareholders will still remain.

The CRV approach is not without difficulties. How should the discount factor be calculated? Attributing a number to the probability of contingencies occurring may require expert consideration, which may entail higher costs an insolvent company may not be able to afford. The probability of a contingency, e.g, an investor agreeing to invest or secured creditors approving the proposal, largely depends upon the circumstances of the companies involved, much of the details which are known only to that company. Therefore, computing the probability of a project succeeding is highly subjective and prone to information asymmetries which may make the exercise potentially inaccurate.

Also, the likelihood of contingencies occurring will probably change over time as circumstances change. There needs to be a time frame on the assessment of the CRV, or re-evaluation of discount factors over time. Will the administrator decide on these notional dates for re-evaluation, and how are they to be decided (e.g. a date following an extensive sales campaign)?

Although the CRV appears to be, theoretically, a more realistic approach to shareholder value, the open-endedness of the above issues may make it practically difficult for the court to accept such approach to residual value.

Oppression remedies

Further guidance on defining 'unfair prejudice' may be drawn from the application of the oppression remedies under sections 232 and 233 of the Corporations Act, which provides members with statutory remedies if the actions of the company are, inter alia, unfairly prejudicial to a member (section) of the company.

'Unfairness' in section 232 is assessed against commercial unfairness, which includes a lack of reasonable commercial justification for the course taken.[13] Applying this test may make it difficult for shareholders to allege unfair prejudice in an administration, as share transfers are usually justified for the purposes of securing investor participation in a project which will aid the continuation of the company's business, which the administrator is directed to give primary consideration to under section 435A.

However, the court's powers under sections 232 and 233 should not be lightly exercised, especially when a lack of probity or want of good faith is not established.[14] Therefore, even if there is no residual value (whether applying the DRV or CRV), if the circumstances around the share transfer indicate a lack of good faith, this may perhaps amount to unfair prejudice under section 444GA(3). Borrowing this rule, unfair prejudice may exist where, e.g., shares are transferred to creditors where the company's underlying business is strong, or if there exist other feasible projects which do not involve a share transfer. (This is consistent with the Explanatory Memorandum, the former scenario recognised as one where section 444GA may be open to abuse.)

Although the rules regarding oppression may be applied in interpreting unfair prejudice, it is important to note that the former relates to the oppression of a shareholder group vis-à-vis other shareholder groups.

Notes

13 *Morgan v 45 Flers Avenue Pty Ltd* (1987) 5 ACLC 222, cf: *Marks v Roe* (unreported, VSC, Mandie J, 28 May 1996).

14 *Shamsallah Holdings Pty Ltd v CBD Refrigeration & Airconditioning Services Pty ltd* (2001) 19 ACLC 517.

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It may be that, because in an insolvency creditors' interests are given primacy and there is no differentiation *between* shareholders, the oppression tests cannot be applied to the differential treatment of creditors/shareholders without careful consideration.

Residual value may not be the only test in establishing unfair prejudice. Interpretation rules direct that the words of the section be considered before external sources such as the Explanatory Memorandum. Under section 444GA(3), the court may only give leave if the transfer will not unfairly prejudice shareholders' *interests*. Thus, even if residual value is narrowly construed, if the shareholder can establish another interest which is unfairly prejudiced, they could arguably prevent a section 444GA transfer.[15]

There is scope for the broader word 'interests' to encompass a consideration of other rights in the project. An example might be where the shareholder has rights to receive commodities under a preferred offtake or marketing program, the continuation of which require the shareholder to maintain a particular economic interest in the project. In this regard, shareholder interests differ from the company's residual value, depending on the interpretation of residual value. This was expressly rejected in *Windimurra*, the Court holding that in that particular case, the off-take arrangements were not relevant to that party's interests in its capacity as member, citing *Lehman Brothers Holdings Inc v City of Swan* [2010] HCA 11.

Different considerations may arise on differing facts. Arguably, if it can be shown that another viable project is available which does not require the share transfer, the shareholders have an interest in that other project being chosen. This is a transferable measure of wealth creation or confiscation.

Finally, there remains the possibility of the court not finding unfair prejudice even where a residual value exists. The shareholder may have been given another benefit in exchange for their interest, e.g., money or money's worth. It may be difficult to establish unfair prejudice in such scenarios.

Potential defences

Even if the court interprets 'unfair prejudice' narrowly, various defences are available. Members, creditors, ASIC and any other interested person are entitled to oppose a section 444GA(1) application.[16] Other than the section 444GA(3) defence, potential defences include that:

(a) the DOCA (or a provision in it) is oppressive or prejudicial to, or unfairly discriminatory against one or more creditors, or is contrary to the interests of creditors as a whole;[17]

(b) the share transfer is not in the best interests of creditors as a whole;[18] and

(c) the DOCA should be terminated 'for some other reason'.[19] (This gives the court wide discretion,[20] although it was anticipated that the court's powers would be exercised very rarely.)[21]

However, the above defences relate to creditors' interests (which may differ significantly from shareholders' interests), although the Explanatory Memorandum notes that the section 445D defences are open to creditors who are also members subject to a section 444GA application.[22]

Also, 'unfair prejudice' in section 444D is different to that in section 444GA(3) (section 445D referring to unfair prejudice to *creditors*). Therefore, if section 444GA(3) is not established, the court may still strike out the DOCA under section 445D.

Shareholders probably cannot oppose the application on policy grounds alone (i.e. that section 444GA detracts from shareholders' fundamental proprietary rights), as Parliament expressly placed companies' survival above shareholders' proprietary rights by enacting section 444GA.

Conclusion

Although section 444GA has the potential to significantly affect shareholders' rights, little guidance has been provided on its application. However, there is evidently room for 'unfair prejudice' to incorporate the value of the company to shareholders post a restructure

Notes

15 See also *Gambotto v WCF Ltd* (1995) 182 CLR 432, where it was held that finding unfair prejudice where there is no residual value will require a high standard of proof, and the shareholder must point to other interests he or she may have, e.g., valuable rights attaching to those shares which remain notwithstanding the company' dire circumstances.

16 Refer section 444GA(2) of the Corporations Act.

17 Refer section 445D(1)(f) of the Corporations Act.

18 Refer section 437F of the Corporations Act.

19 Refer section 445D(1)(g) of the Corporations Act.

20 *Dean-Willcocks v GSA Formwork* [1999] NSWSC 166 at [17].

21 Refer paragraph 602 of the Explanatory Memorandum to the Corporate Law Reform Bill 1992.

22 Refer to paragraph 7.59 of the Explanatory Memorandum which notes that the parties may be able to challenge the DOCA under section 445D of the Corporations Act.

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or project, protecting shareholders' interests without detracting from the fundamental objective in administrations: the company's survival.

We must now await any further judgments or ASIC guidance confirming the application of this power. The issue may ultimately be a policy debate, balancing shareholders' interests and the perceived benefit of any proposed project to the company. In light of the number of reconstructions in the current economic climate, it may only be a matter of time before relevant guidance is provided.

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