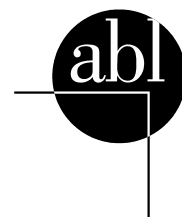


SUBMISSION TO CORPORATIONS AND MARKETS ADVISORY COMMITTEE

SHAREHOLDER CLAIMS AGAINST INSOLVENT COMPANIES

Arnold Bloch Leibler per Leon Zwier*



MELBOURNE
SYDNEY

1 Introduction

- 1.1 This submission is in response to the Australian Government, Corporations and Markets Advisory Committee's (**CAMAC**) request for submissions in response to CAMAC's Discussion Paper, "Shareholder Claims Against Insolvent Companies - Implications of the Sons of Gwalia Decision" (September 2007).
- 1.2 The purpose of this submission is to demonstrate by practical example in the current environment how the High Court's decision in *Sons of Gwalia* (**SOG Decision**)¹ may have the affect of forcing large publicly listed companies into a formal insolvency administration (with all the concomitant loss of employment, disruption to and loss of confidence in the market, as well as costs and expenses) when, but for the SOG Decision, it could have been avoided. This result is contrary to the underlying rationale of corporate reconstruction. And will inevitably result in the cost of capital increasing.
- 1.3 This submission recommends subordination of shareholder claims² in an insolvency administration by legislative amendment to section 563A of the *Corporations Act 2001* (the **Act**) as the appropriate balance between responsible insolvent corporate re-organisation, maintenance of good corporate governance standards and consumer protection.
- 1.4 All of the criminal and quasi-criminal preventative legislative provisions in the Act, the *Australian Securities and Investments Commission Act 2001* (**ASIC Act**) and the *Trade Practices Act 1974* (**TPA**) need not be modified. They act as the most significant deterrent to errant corporate conduct in their present form. Class proceedings do not.

* Arnold Bloch Leibler acted for ING Investment Management LLC in the *Sons of Gwalia* litigation.

¹ *Sons of Gwalia Ltd & Anor v Margaretic* (2007) 60 ACSR 292

² The expression "shareholder claims" used in this submission has the meaning given by Hayne J in the SOG Decision at (2007) 60 ACSR 292, 328: "A person who buys, or subscribes for, shares in a company, relying upon misleading or deceptive information from the company, or misled as to the company's worth by its failure to make disclosures required by law, may have a claim for damages against the company. That claim may be framed in the tort of deceit but, more probably than not, will now be framed as a claim under consumer protection provisions of the Trade Practices Act 1974 (Cth) or investor protection provisions of the Corporations Act 2001 (Cth) (the 2001 Act) or the Australian Securities and Investments Commission Act 2001 (Cth) (the ASIC Act)."

2 Objects of Corporate Reconstruction

- 2.1 The objects of corporate reconstruction in Australia are to provide for the business, property and affairs of an insolvent, or near insolvent, company to be administered in a way that:
- (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
 - (b) results in a better return to the company's creditors and members than would result from an immediate winding.³
- 2.2 Corporate rehabilitation is also designed to be:
- (a) swift;
 - (b) uncomplicated and inexpensive; and
 - (c) flexible.⁴
- 2.3 There are important social goals underlying these objects of corporate reconstruction law, including:
- (a) maximising the chances of employees retaining their jobs and minimising social dislocation;
 - (b) preserving the ability of other businesses to continue trading with the distressed company in the future (thereby avoiding 'domino' insolvencies); and
 - (c) maintaining as much of the 'going concern' value of the company as possible. This final consideration is of direct benefit to the company's members, those said to benefit from the SOG Decision.

3 The SOG Decision as Deterrence?

- 3.1 Supporters of the SOG Decision assert that shareholder class actions deter corporate misconduct. For example John Walker, Managing Director of IMF (Australia) Ltd, states:
- "Enforcement [of shareholder claims] is a valuable deterrent and capable of materially effecting behavioural change across the market."*⁵
- 3.2 Consumers and investors are adequately protected against corporate misconduct by provisions in the Act, ASIC Act and the TPA.⁶ There is no need to supplement these provisions with the additional spectre of class suits by aggrieved investors against distressed or insolvent companies.

³ Section 435A of the Act.

⁴ Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45 1988*, Vol 1 [53] to [54] (**Harmer Report**)

⁵ John Walker, 'Sons of Gwalia - Shareholders as Creditors' (2005) *Australian Insolvency Journal* 4 at 10

⁶ See for example Chapter 6CA and Part 7.10, Div 2 of the Act and Part 2, Div of the ASIC Act.

- 3.3 In Arnold Bloch Leibler's experience the single biggest deterrent against misconduct by company directors is the risk of criminal and quasi-criminal sanctions under the Act, ASIC Act and TPA. Prosecutions may result in jail terms, pecuniary penalties, loss of reputation and loss of qualifications.
- 3.4 In our submission, these consequences are far more powerful deterrents than the prospect of litigation (including class actions) against an ailing company.
- 3.5 The real issue for the legislature is to determine the correct balance between corporate reconstruction law and consumer protection.

4 Serious Problems arising from the SOG Decision - the Centro Example

- 4.1 The SOG Decision generally affects publicly listed companies that do not have securities granted over the whole of their assets.
- 4.2 One such group that falls into this category is the Centro group. The Centro group is a stapled structure consisting of a publicly listed holding company and a registered managed investment scheme. Centro has no secured lenders over the whole of its assets and a vast number of retail shareholders and investors.
- 4.3 Centro is distressed and is currently attempting to re-finance short term debt reported to be about \$3.9 billion.⁷ And Centro is facing shareholder class actions of the type faced by Sons of Gwalia for allegedly misleading the market by the wrong classification of long term debt that should have been classified as near term.⁸

Injection of Capital Impaired by the Sons of Gwalia Decision

- 4.4 The obvious commercial solution to any company in Centro's current difficulty is an injection of capital. The prospects of successfully achieving a capital injection are materially lessened by the existence of the substantial unknown liability represented by the shareholder claims, which, by reason of the SOG Decision, rank *pari passu* with all other creditors and in priority to equity.
- 4.5 These threatened litigation claims are of unknown quantum, severely harmful to the reputation of the Centro group and driven by reputable class litigation lawyers or litigation funders. And unlike ordinary creditors who supply goods, services or finance, they may not have an indirect interest in Centro remaining in existence. They may well prefer lodging a proof of debt in an insolvency administration.
- 4.6 An injection of capital is far more achievable if shareholder claimants are subordinated in an insolvency administration. That subordination presents a commercial opportunity to extinguish or settle those claims

⁷ See for example *The Age*, "Centro hopes to Extend Refinance Date", 15 January 2008

⁸ See, for example, *The Age*, "Centro's new chief in the hot seat as investors seek answers" 18 January 2008.

prior to or by a formal insolvency. This could be achieved by private treaty, settlement of "opt out" class proceedings or a creditors solvent scheme of arrangement. And if these shareholder claimants achieve a better return than that which they would receive in an insolvency administration which would otherwise follow, then courts could play an active role in sanctioning such arrangements.

Other Adverse Consequences of the Sons of Gwalia Decision

- 4.7 The SOG Decision has a number of other adverse consequences on distressed companies apart from limiting its ability to raise equity, including:
- (a) The board of a distressed company, such as Centro, may decide to place the company into a formal insolvency process when considering the company's solvency having particular regard to threatened class proceedings and a perceived inability to meet those claims let alone the costs of defending them. If those claims are subordinated in an insolvency administration they would be considered as such in the board's deliberations;
 - (b) When a company is nearing insolvency its directors must have regard to the interests of its creditors (including shareholder class claimants) and in doing so may be inhibited from making commercial decisions which are in the best interests of the company as a whole but prejudicial to the interests of contingent creditors; and
 - (c) In large corporate insolvencies creditors divide into differing groups. For example, in Centro there are three (3) distinct creditor groups namely Australian bankers, US bankers and US Noteholders. Each group has a different financial interest from the other. The task of the distressed company is to manage its groups of creditors in a transparent and fair process to ensure that it can continue as a going concern and pay all creditors 100c in the \$, maintain employment for the employees and preserve equity for the shareholders and investors. In all large work outs this seemingly easy task is exceedingly problematic. The more sophisticated the corporate group the more difficult it is to manage. The capital expenditure requirements of a group create severe tensions in the process as do asset realisations. For instance:
 - How are surpluses to be disbursed to creditors with differing interests?
 - How can a distressed company disburse surplus funds from assets sales to certain classes of creditors if it does not know if it can meet shareholder claims? The creditor receiving any such payment will also be concerned that the payment may be subsequently "clawed back" as preferential and it may drive the shareholder claimants to drive the company into an insolvency process to preserve the "relation back" day;

- What should a board of a company do if suppliers and financiers will only continue to provide support or extend finance if granted security which elevates all those creditors over say all contingent claims?

If the board provides the security to survive as a going concern contingent creditors may seek to impugn it and (again) seek to force an insolvency process to protect their position at law. And if the board does not provide such security the company will be forced into an insolvency administration;

- (d) The impediments to a capital raising by the threatened class proceedings, the likely unforeseen diminution of returns and the continued adverse press all threaten the likelihood of a successful work out;
 - (e) The “shareholder” creditors are themselves disparate. Those shareholder creditors who have shares in the company will logically support its work out provided they are rewarded as creditors and members by doing so. But those former shareholders who have sold their shares when say, in relation to Centro, they became informed of its true financial position and thereby realised losses, have no interest in the company continuing as a going concern. Those former shareholders may be better served by an insolvency administration in which they prove as creditors ranking *pari passu* with all others and receiving a rateable return for their claims. In that context they will, on advice, lodge the largest possible claims for damages which may include expectation losses, interest, loss of opportunity and other damages;
 - (f) The *pari passu* ranking of shareholder claims creates a window of commercial opportunity for a sophisticated financial entity to acquire more shareholder claims or utilise its own shareholder claims to force an insolvency administration for some collateral purpose; and
 - (g) The shareholder claims are driven by class litigation law firms or litigation funders all of whom are paid from proceeds of settlement or court determinations. Consequently, they cannot be settled without a significant payment to their effective funders. This also increases the cost of resolution to the distressed company.
- 4.8 These consequences are destructive of the objects of corporate reconstruction in that they erode the possibility of corporate rehabilitation outside the context of formal procedures with their associated costs, delays and damage to goodwill.

5 Solution - Subordination

- 5.1 The difficulties presented by the SOG Decision can be solved by a simple amendment to section 563A of the Act along the lines suggested by Kirby J in his judgment in the SOG Decision.⁹
- 5.2 Such an amendment ought to specifically subordinate shareholder claims to the claims of non-shareholder, ordinary unsecured creditors.
- 5.3 Further, the legislative amendment should provide that shareholder claimants be admitted to proof in a formal insolvency procedure for the notional sum of \$1. This would afford shareholder claimants with creditors' statutory rights including voting rights and the right to apply to terminate a deed of company arrangement under section 445D of the Act while at the same time providing the commercial certainty as to the value and status of the claims thereby enhancing the prospects of a successful reconstruction.
- 5.4 We appreciate that the proposed solution of an arbitrary subordination of consumer rights in an insolvency administration is just that. This in our submission represents the correct balance. Solvent companies that mislead the shareholders will face all the current civil, quasi criminal and criminal consequences of doing so. However only in circumstances where the company is insolvent will the civil claims be subordinated to those of other creditors and then only in circumstances where shareholder claimants will remain as creditors with all the current protections concerning the reconstruction process. But corporations are man made. The legislature can draw and re-draw the boundaries as and when it regards it as necessary and appropriate to do so. This proposed subordination is a measured and necessary response.¹⁰

6 Benefits of Subordination

- 6.1 Subordinating shareholder claims in the manner we suggest would promote the objects of corporate reconstruction. It would also restore an appropriate balance between the objects of the consumer protection laws, deterring corporate misconduct and maximising the chances of distressed companies being rehabilitated.
- 6.2 First, such amendment would immediately place limits upon and define the scope of shareholder claims in situations such as the Centro scenario. This would vastly enhance the prospects of reorganising distressed public companies as management would be able to conduct negotiations with a defined class of creditors with ascertainable claims.
- 6.3 Second, subordination would remove from a corporate reconstruction the layer of cost introduced by shareholder class actions;

⁹ (2007) 60 ACSR 292 at 327

¹⁰ As an insolvency practitioner my view is that all shareholder claims should be subordinated to creditors. However this submission advocates a more balanced approach.

- 6.4 Third, shareholder claimants who continue to hold their shares and those who have sold their shares would be more likely to support an informal reorganisation as this will represent the best possible outcome for both classes of shareholder claimants. This is because the shareholder claims are only subordinated in a winding up (or under a Deed of Company Arrangement that incorporates the subordination provision). Consequently, the former members with shareholder claims would have better prospects of redress in respect of their claims if the company remains solvent. This is not the case under the SOG Decision.
- 6.5 Fourth, subordination will maximise the possibility of achieving early settlements with shareholder claimants without the need to engage in protracted litigation or the expensive and time consuming task of estimating the value of each and every claim.

7 Conclusion

- 7.1 Centro is one example of how the SOG Decision is already impeding corporate reconstruction in Australia. In the current volatile market conditions, the ramifications of the SOG Decision are likely to be further manifested.
- 7.2 We submit that legislative amendment subordinating shareholder claims will give distressed companies a more realistic opportunity of rehabilitation. This is in the interests of all stakeholders of distressed corporations (including members).