Submission to the Senate Legal and Constitutional Committee on the Corporations Amendment (Sons of Gwalia) Bill 2010

1. Introduction

Allens Arthur Robinson is pleased to provide this submission to the Senate Legal and Constitutional Committee on the Corporations Amendment (Sons of Gwalia) Bill 2010 (the ***Bill***). Our submission concerns the following provisions of Schedule 1 of the Bill:

(a) item 4 titled 'Application provision – postponed claims'; and

(b) item 2 titled 'Section 563A'.

2. Item 4 – Application provision – postponed claims

2.1 Summary of suggested amendment

Proposed item 4 of Schedule 1 to the Bill titled 'Application provision – postponed claims' provides that:

(1) Section 563A of the Corporations Act 2001, as amended by this Schedule, applies to a claim that arises after this Schedule commences.

In other words, claims against a company which 'arise' prior to the Schedule commencing will continue to enjoy the priority afforded to them in accordance with the principles in *Sons of Gwalia Ltd v Margaretic*[1] (***Sons of Gwalia***) even if the external administration in which they are made begins after the Schedule commences. As such, the adverse effects of the decision in Sons of Gwalia (identified in the Explanatory Memorandum) will continue to operate for what might be a substantial period of time following the commencement of the Schedule.

The proposed amendment to section 563A is an amendment to a provision of the *Corporations Act 2001* which operates in relation to external administrations. It is therefore appropriate that the transition provision operates by reference to the commencement date of the relevant external administration and not by reference to when relevant claims arose. We therefore submit that the wording of the provision should be amended to read:

(1) Section 563A of the Corporations Act 2001, as amended by this Schedule, applies to a claim made against a company if the external administration of the company commences after this Schedule commences."

2.2 Rationale for suggested amendment

There are two main reasons underlying our suggested amendment. First, it will ensure that there is no delay in realising the benefits the Bill is designed to achieve. Secondly, it will

[1] *Sons of Gwalia Ltd v Margaretic* (2007) 232 ALR 232

avoid potential shareholder claimants in the same external administration being treated differently - with some being subordinated and others not.

2.2.1 Benefits of the Bill will be delayed

The Explanatory Memorandum identifies the following objectives of the proposed reforms:

(a) improving the availability of credit to companies and reducing risk premiums charged by lenders;

(b) removing the need for lenders to rely on onerous terms and conditions when providing credit;

(c) reducing the complexity and cost to lenders of assessing and monitoring risk associated with corporate misconduct that misleads investors; and

(d) improving the efficacy of external administration, including the promotion of business rescue attempts.

If the current proposed transition provision is adopted, the realisation of these benefits will be delayed for a considerable period, and possibly until all shareholder claims which arose prior to the enactment of the Bill are statute barred. As long as these pre-existing claims are afforded priority in accordance with the principles in Sons of Gwalia, credit providers lending funds on an unsecured basis to listed entities will continue to be concerned about their exposure to non-subordination in an external administration. Similarly, the complexity and cost to lenders of assessing and monitoring risk will also continue to be an issue whilst the prospect that these claims will rank equally with their own debts in an insolvency remains present.

The continuance of these issues following commencement of the amending legislation (theoretically for a period of up to 6 years, as limitation periods progressively expire), will delay the benefits sought to be achieved in connection with the improvement in the availability of credit, the reduction in risk premiums imposed by lenders, and provision of finance without the need for additional terms or security to address the risk of potential unsubordinated shareholder claims.

Under the current proposed provision, until these pre-existing claims work their way through the system, lenders may continue to be deterred from participating in business rescue attempts which require debt funding to succeed. In addition, external administrations of listed entities will continue to be burdened with the forensic, legal and logistical burdens and costs which shareholder claims impose on those administrations.

Under our suggested transition provision, as soon as the Schedule commences, lenders can disregard these claims in terms of assessing risk in an insolvency scenario. Similarly, insolvency administrators can proceed with new appointments without the need to consider claims which might exist which pre-date the commencement of the amending legislation, except, of course, in the rare circumstance where ordinary unsecured creditors are likely to be paid out in full. Under the current proposed transition provision, unsecured creditors will continue to bare the burden of these claims for a substantial period of time after the amending legislation becomes operative.

2.2.2 Inconsistent treatment of shareholder creditors in the same external administration

An associated problem with the current proposed transition provision is that aggrieved shareholders making claims within the same external administration will be subject to different priority regimes depending on whether their claim arose prior or subsequent to the commencement of the Bill.

The following liquidation scenario illustrates this issue:

> Assume the relevant Schedule commences on 1 November 2010 and Company A's liquidation subsequently commences on 1 February 2011. The liquidator examines the affairs of Company A and it transpires that Company A made false and misleading disclosures of material information to the market on two dates - 1 October 2010 and 4 January 2011. Shareholders bring claims for compensation based on Company A's breaches. Assuming that a claim arises when the shareholder purchases their shares in reliance on the misleading information, Company A's misleading conduct gives rise to two potential groups of shareholder claims - the shareholders who purchased shares in the period 1 October to 1 November 2010 in reliance on the 1 October misleading conduct (the ***pre-amendment shareholders***) and the shareholders who purchased shares in the period 4 January 2011 to 1 February 2011 in reliance on the 4 January misleading conduct (the ***post-amendment shareholders***).

Under the current formulation, whereby the amended section 563A only applies to claims which arise after the amending legislation commences, the pre-amendment shareholders' claims will be ranked according to the current Sons of Gwalia priority, whereas the post-amendment shareholders' claims will be ranked under the new priority regime and be postponed. This leads to the incongruous result that aggrieved shareholders with similar claims are dealt with inconsistently within the same liquidation and their claims are assigned different priorities.

Our suggested formulation, whereby the application of the amended section 563A to shareholder claims depends on the date of commencement of the external administration, rather than when a claim arises, will avoid this result. All aggrieved individuals bringing claims for damages in relation to shareholdings after the enactment of the Bill and in the same external administration, will be treated on the new priority basis set out in the Bill. Similarly, all claims made against a company in an external administration which commenced prior to the enactment of the Bill, will be dealt with according to the current Sons of Gwalia priority regime.

3. Item 2 – Section 563A

3.1 'Subordinate claims'

It is proposed that the new section 563A(2) of the *Corporations Act 2001* titled 'Postponing subordinate claims' will provide that:

(2) In this section, subordinate claims 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.

We also note paragraph 1.8 of the Explanatory Memorandum which states:

> *1.8 The Bill changes this position so that any claim brought by a person (not just a shareholder) against a company that arose from the buying, selling, holding or otherwise dealing with a shareholding is to be postponed in an external administration until after all other claims have been paid.* [Schedule 1, item 2, section 563A].

This approach is necessary because most equity investors do not become 'members' directly; they are not entered in the register, but hold the beneficial ownership through nominees and custodians, who are entered on the register, and are the 'members' for the purposes of section 563A. Further, many equity investors invest through warrants and other rights with respect to shares.

We understand that the broad language used in paragraph (b) of the proposed section 563A(2) is designed to cover this issue. However, it does not succeed because paragraph (b) only deals with holdings and dealings in the shares themselves, rather than interests in shares and rights with respect to shares. To 'hold shares' has been held to mean being the legal owner (*Dalgety Downs Pastoral Co Pty Ltd v FCT*[2]).

We suggest paragraph (b) of the proposed section 563A(2) should read:

> *(b) any other claim that arises from a person buying, holding, selling or otherwise dealing in, or with respect to, shares in the company or interests in, or rights with respect to, shares (issued or unissued) in the company, including rights against any person to acquire or dispose of shares or interests in shares in the company.*

3.2 Claims against subsidiaries

The Bill should also subordinate claims against subsidiaries. This will ensure that claims by shareholders are not picked up by class order deeds of cross guarantees issued by the company and its subsidiaries. These guarantees are commonly issued by groups of companies under class order 98/1418 issued under section 341 of the *Corporations Act 2001*, in order to save the companies having to produce individual accounts for each company in the group. They make all companies liable for 'claims' in insolvency against each other company in the group. As currently drafted, this would pick up shareholder claims even though they are subordinated at the holding company level. The result would be that shareholders have claims against subsidiaries which rank equally with creditors of those subsidiaries.

[2] *Dalgety Downs Pastoral Co Pty Ltd v FCT* (1952) 86 CLR 335

We believe that one of the preferable models generally to follow is provided by the American legislation. Since 1978 in the USA, section 510(b) of the US Bankruptcy Code has subordinated claims arising from the purchase or sale of securities. This gives claims the same level of subordination as the underlying interest the claim was based on and that should extend to claims against subsidiaries as they are parties to class order deeds of cross guarantee or a similar general guarantee.

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