REVISED SUBMISSION ON CORPORATIONS AMENDMENT (SONS OF GWALIA) BILL 2010

To: Senate Standing Committee on Legal and Constitutional Affairs

From: Corporations Committee

Business Law Section

Law Council of Australia

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1. This paper contains the submission of the Corporations Committee of the Business Law Section of the Law Council of Australia (**the Committee**).

2. The Committee notes that the Bill generally adopts the position favoured by the Committee in its submission to CAMAC dated 13 December 2007.

3. The Committee has previously commented on the exposure draft of the Bill and it reiterates its comments in that regard. Please see the Committee's letter dated May 2010 to the Manager Governance and Insolvency Unit, Corporations and Financial Services Division, The Treasury.

4. However, following recent reconsideration of the Bill, the Committee submits that the Bill requires amendment to resolve a number of drafting and practical issues. Some of the following comments repeat its earlier comments in response to the exposure draft of the Bill.

5. Subject to the Committee's comments in paragraph 6, for consistency with other provisions of Subdivision D of Part 5.6, Division 6, and with the proposed s563A(2)(a), the Committee suggests the proposed s563A(1) should refer to 'all other debts owed by or claims made against' a company.

6. However, the Committee suggests the proposed s563A(1) should be amended to read:

   "The payment of a subordinate claim made against a company is to be postponed until all other *debts* or claims *admissible to proof against the company under s553* are satisfied."

   This will avoid any argument as to whether a claim by a member *as a member* (e.g. for a return of capital) is included within the s563A(1) description of the claims to which subordinate claims are postponed: which at the moment is too broad being all 'claims made against a company' other than those within the definition of subordinate claims. That is, s563A (as presently enacted) subordinates *debts* owed to members to all "debts owed to or *claims made by* persons *otherwise* than as members of the company". That qualification has been lost in the wording of the proposed s563A and leaves an unintended lacuna whereby a 'subordinate claim' is arguably subordinated to all other claims (including those by members for a return of capital).

7. To complicate matters further, there is another possible (but presumably unintended) interpretation of s563A(2)(b) being that claims by members for return of capital on winding up fall within the new language of s563A(2)(b) as a claim arising from a person *holding* shares in the company. For clarity, the phrase "*and that is admissible to proof against the company under s553.*" might be added into s563A(b)(2) as well.

8. The proposed s563A(2)(b) may be too widely stated, in that it could refer to a claim by *a person* against a company arising from *another* person dealing in shares. The provision could read: "any other claim *by a person* that arises from *that* person…".

9. The presumed effect of the language in s563A(2) is that the postponement of claims falling within s563A(2)(b), is to a status equal with claims falling within s563A(2)(a). For example, a liquidator would treat a claim for misleading and deceptive conduct in relation to the issue of shares as equal with a claim by that or any other member for a declared dividend. If that is not the policy objective, then s563A may require further amendment to clarify that claims of the type in

s563A(2)(a) are postponed until claims of the type in s563A(2)(b) are satisfied (or vice versa).

10. A related ranking issue is the treatment of statutory interest on claims. At present, statutory interest accrues pursuant to s563B(1) and is postponed to claims enunciated under the existing s563A. The proposed amendments do not contemplate any change to s563B. Without any such change, it is difficult to interpret section 563B(2) consistently with the new proposed s563A.

11. The questions that need consideration are as follows.

    (a) Where does statutory interest under s563B(1) rank as against a "subordinate claim"?

    (b) Are the subordinate claims described in the proposed s563A(2)(a) to be distinguished from those described in s563A(2)(b) for purposes of answering the question in (a)? and

    (c) What is the relative ranking of statutory interest on subordinate claims? (This will depend in part on the answers to the questions above).

12. Section 563B(2) should be amended to provide *either* that:

    (a) statutory interest on claims (other than subordinate claims as defined in s563A(2)) is to rank ahead of all subordinate claims; *or*

    (b) all statutory interest on any claim is to rank behind subordinate claims.

13. Once the ranking of statutory interest generally under s563B has been determined then the status of statutory interest on subordinate claims should be considered.

14. If it is decided that any statutory interest should rank behind subordinate claims (and presumably at least the interest on those claims should rank behind the claims) then consideration should be given to whether there should be any distinction between those types of claims in s563A(2)(a) and s563A(2)(b). As noted in paragraph 9, on the presently proposed drafting it seems that claims of the type in s563A(2)(a) and s563A(2)(b) would rank equally with each other, and so presumably interest on each of those types of claims should then rank next, and equally with each other.

15. The point made at paragraph 5 above also arises in the opening words of the proposed s600H, if the suggestion in that paragraph is adopted the Committee suggests the opening words of s600H refer to 'a person whose *debt or* claim against a company'.

16. The proposed new s600H(a) provides that any person with a subordinate claim (as defined in s563A) is entitled 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 etc. Paragraph (b) of the proposed s600H goes on to prevent that person from voting in their capacity as a creditor during the *external administration* of the company, other than by Court order.

17. The term "external administration" is not defined in the Act. But variations of that wording appear throughout the legislation and not all with a consistent meaning. For example:

    (a) section 9 includes a definition of *externally administered body corporate* (which includes a body corporate that is being wound up, is in

receivership, is under administration, is subject to a deed of company arrangement or has entered into a compromise or arrangement with another person (query if clarification is desirable to include explicit reference to schemes of arrangement under part 5.1);

(b) section 580 sets out a definition of *external administration matter*; and

(c) there are references to *external administration* in some other existing sections of the Act, for example, ss283BG and 283CD (where the term apparently does not include receivership but is not otherwise defined).

The term is, however, used as the heading for Chapter 5 of the Act and may be interpreted as referring to all forms of administration covered by Chapter 5 including schemes of arrangement and members' voluntary winding up.

18. This raises issues that have not been the subject of previous submissions.

19. Consideration must be given to the application of s600H in the context of a Scheme of Arrangement. Some submissions in relation to that issue follow, but this may need to be the subject of further consultation.

20. The postponement that is/will be effected by s563A is confined to the context of winding up.[1] That is, a 'subordinate claim' remains owing and payable by a company and the proposed amendments do not provide for the extinguishment of a subordinate claim in any circumstances. This is an issue in the context of any attempt to reconstruct an insolvent company that faces significant claims of the nature described in the proposed s563A(2)(b). Formal reconstruction of an insolvent company can be attempted by implementation of a DOCA or a Scheme of Arrangement under part 5.1 of the Act. The Bill does not adequately address issues arising in the context of schemes of arrangement.

21. The Committee knows, from the events leading to this Bill, that the intention of s600H(b) is to deprive those persons with a 'subordinate claim' from being able to vote as creditors in the context of a voluntary administration, without the leave of the court.

22. On that basis, the other creditors of a company could conceivably vote to approve the execution of a Deed of Company Arrangement (**DOCA**) by a company a term of which could be that the subordinate claims are to be extinguished. Persons with subordinate claims under s563A(2)(b) are still 'creditors'[2] and so will be bound by the DOCA, under s444D, even though they were not entitled to vote in relation to the DOCA, under s600H(b).

23. The ability of creditors with a subordinate claim under s563A(2)(b) to have such a DOCA set aside under s445D would depend on whether the DOCA was unfairly prejudicial or unfairly discriminatory (s445D(1)(f)) or whether effect could not be given to the DOCA without injustice (s445D(1)(e)). In circumstances where a DOCA is being implemented to effect a genuine reconstruction of an insolvent company, the issue will be whether the creditors with subordinate claims are receiving at least as much as they would receive on a winding up of the company. It is here that the postponement proposed by s563A(2)(b) is relevant. If the unsubordinated creditors are receiving less than full satisfaction of their debts and claims then the extinguishment of a subordinate claim (by the DOCA)

[1] Section 563A appears in part 5.6 of the *Corporations Act* the heading to which is "Winding up generally".
[2] As determined by the High Court in *Sons of Gwalia Ltd v Margaretic; ING Investment Management LLC v Margaretic* [2007] HCA 1.

is unlikely to be *unfairly* prejudicial given that there would be no return to creditors with a subordinate claim on winding up.

24. However, the situation is different in the context of a scheme of company arrangement. The process for approval of a scheme of arrangement involving a compromise between a company and its creditors (**creditors' scheme**) requires approval by each class of creditor affected by the scheme. The effect of s411(4) is that a compromise under a scheme is only binding on a class of creditors if it has been approved by the specified majority of creditors in *that class.*

25. Unless all creditors (including those with a subordinate claim) will receive the same return under a creditors' scheme (which is problematic in itself), it will be necessary to convene a separate meeting of creditors with subordinate claims (as a class) and the scheme will need to be approved by the specified majority of creditors in that class *if any compromise under the scheme is to bind them* under s411(4).

26. The Bill does not provide any mechanism to bind creditors with subordinate claims to a compromise under a creditors' scheme of arrangement (without convening a meeting of and obtaining approval from that class of creditors). Therefore, an insolvent company will be unable to use a scheme of arrangement to achieve an effective compromise with its unsubordinated creditors if it also has creditors with substantial 'subordinate claims' under s563A(2)(b) (and does not seek separate approval from that class of creditors), as those subordinate claims will survive any 'reconstruction' effected by the creditors' scheme.

27. This raises the broader policy issue as to whether the claims described in s563A(2)(b) should be able to be made against the company at all (see paragraph 15 and surrounding discussion in the submissions of the Insolvency and Reconstruction Law Committee of the Business Law Section of the Law Council of Australia to CAMAC dated December 2007).

28. If such claims are to continue to be permitted, then it is submitted that the most efficient (in the short term), and least controversial, method of accommodating them in the scheme of arrangement process is to ensure that s600H(b) is expressed clearly not to apply in the context of schemes of arrangement under part 5.1. This will preserve the status quo in relation to schemes of arrangement and thereby permit a scheme to be proposed in a manner that offers some inducement to creditors with subordinate claims to approve a scheme compromising the rights of that class of creditors with subordinate claims. There will, however, continue to be (familiar) issues in relation to convening the scheme meetings of that class, being the identification of and notification to the creditors within that class. But these issues can be addressed, to some extent, in the court approval process inherent in s411(1).

29. Alternatively, perhaps more controversially but more effectively from the perspective of reconstructing companies, additional provisions specific to creditors' schemes could be considered whereby, for instance, s411 could be amended to provide that where a scheme implements a compromise between an insolvent company and its (unsubordinated) creditors and the return to those creditors will be less than complete satisfaction of their debts and claims, then all subordinate claims referred to in s563A(2) which exist at the date of the scheme will be extinguished.

30. There has been a lack of discussion surrounding problems with these subordinate claims in the context of part 5.1 of the Act, no doubt due to the relatively few creditors' schemes since introduction of part 5.3A of the Act.

However, given the likely coexistence of claims both against the company and against third parties arising out of the same circumstances that give rise to a subordinate claim under s563A(2)(b), there may be a resurgence in popularity of creditors' schemes of arrangement in the wake of the recent decisions in *Re Opes Prime Stockbroking* (2009) 179 FCR 20, *Fowler v Lindholm* (2009) 178 FCR 563 and *Lehman Brothers Holdings Inc v City Of Swan* (2010) 240 CLR 509; [2010] HCA 11.

31. In summary, the issues with the Bill in its present form (insofar as the Bill applies to creditors' schemes of arrangement) are that:

    (a) It is unclear if the proposed s600H(b) applies to meetings convened for the purpose of approving a scheme of arrangement between a company and its creditors.

    (b) If the scheme is proposed by creditors or the company itself the company will not be necessarily be in 'external administration' and in that event s600H(b) will have no application (as its application is confined to "during the external administration"), although a scheme may be proposed by a liquidator, in which case s600H(a) or (b) could apply.

    (c) It is unclear whether a company that is already subject to a scheme of arrangement with its creditors is in 'external administration' for the purposes of s600H(b).

32. If the Committee's submission in paragraph 28 above is adopted, the Committee submits that the wording of the proposed s600H ought to be clarified to indicate that s600H applies only in the context of external administrations in the form of voluntary administration, a deed of company arrangement and winding up, both in insolvency and creditors' voluntary winding up.

33. The Committee would, in any event, welcome further consultation in relation to the status of subordinate claims in the context of creditors' schemes of arrangement.

20 October 2010

Attachment A: Profile of the Law Council of Australia

The Law Council of Australia is the peak national representative body of the Australian legal profession. The Law Council was established in 1933. It is the federal organisation representing approximately 50,000 Australian lawyers, through their representative bar associations and law societies (the "constituent bodies" of the Law Council).

The constituent bodies of the Law Council are, in alphabetical order:

- Australian Capital Territory Bar Association
- Bar Association of Queensland Inc
- Law Institute of Victoria
- Law Society of New South Wales
- Law Society of South Australia
- Law Society of Tasmania
- Law Society of the Australian Capital Territory
- Law Society of the Northern Territory
- Law Society of Western Australia
- New South Wales Bar Association
- Northern Territory Bar Association
- Queensland Law Society
- South Australian Bar Association
- Tasmanian Bar Association
- The Victorian Bar Inc
- Western Australian Bar Association
- LLFG Limited (a corporation with large law firm members)

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