Australian Government
The Treasury

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Ms Julie Dennett
Committee Secretary
Senate Standing Committee on Legal and Constitutional Affairs
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Ms Dennett

**CORPORATIONS AMENDMENT (SONS OF GWALIA) BILL 2010**

I refer to the current inquiry by the Senate Standing Committee on Legal and Constitutional Affairs (the Committee) into the Corporations Amendment (Sons of Gwalia) Bill 2010 (the Bill) and, in particular, to the submissions of the Law Council of Australia (LCA), Allens Arthur Robinson (AAR), Chartered Secretaries Australia (CSA) and Recoveries and Litigation Support (RLS) on the Bill. Treasury has analysed these submissions and makes the following comments in respect to them, as requested by the Committee.

**Law Council of Australia**

*General*

We comments in relation to items 6 to 17 of the LCA supplementary submission.

The Bill provides that section 563A of the *Corporations Act 2001* (the Corporations Act) will, post-amendment, read as follows:

> (1) The payment of a subordinated 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.

Item 6 of the LCA supplementary submission suggests that subsection 563A(1) should be amended to include the additional underlined text below:

> "The payment of a subordinate claim made against a company is to be postponed until all other <u>debts or</u> claims ~~made~~ <u>admissible to proof</u> against the company <u>under section 533</u> are satisfied."

Item 7 of the LCA supplementary submission also suggests that paragraph 563A(2)(b) may be read as referring to non-provable claims in relation to shareholders rights to a return of capital.

A very broad interpretation of the second use of the term "claim" in subsection 563A(1) is unproblematic, provided that all claims sought to be subordinated are caught by the term "subordinated claim" (as defined

in 563A(2)). The wording of 563A(1) provides that the reference to "other claims" is necessarily only the residual claims not covered by 563A(2).

It is our view that subsection 563A(2) definition is broad enough to cover claims for return of capital. Such claims are therefore necessarily excluded from "other claims" in subsection 563A(1).

It should be noted that the effect of section 563A is to rank certain claims below non-subordinated claims. It does not override any other rules regarding the ranking of subordinated claims amongst themselves. It will therefore not have the effect of making return of capital claims rank equally with, say, unpaid dividend claims. Further discussions with the LCA indicate that the LCA holds concerns whether there is a risk that the section may be read to the contrary.

We note for completeness that if non-provable claims for the return for capital were not a claim for the purpose of subsection 563A(2)(b), then they would likewise not be read as a claim for the purpose of subsection 563A(1). This would result in the section not applying to them at all – as is currently the case with the section. All in all, it is Treasury's view that, under either interpretation, the status quo is retained in respect of the ranking of claims for the return of capital. This is the intended effect.

In respect of the concern raised in item 9 of the LCA supplementary submission, the policy intention is not that paragraph 563A(2)(b) claims will rank below 563A(2)(a) claims by operation of the section. The section therefore operates as intended in this respect.

While doing so may improve consistency with other provisions in the Corporations Act, the inclusion of "debts" in addition to "claims" in subsection 563A(1) is unnecessary. Claims made against a company will include all debts owed by the company.

As noted in item 8 of the LCA supplementary submission, there is a possible ambiguity due to the inclusion of the text "a person" in paragraph 563A(2)(b). We thank the LCA for raising this issue. Treasury will examine whether the paragraph as stated will give effect to the Government's policy intention. We note that any possible ambiguity could be addressed by the simple removal of the offending words.

*Interest claims*

Items 10 to 14 refer to the interaction of:

- the provisions that provide that post commencement interest on non-subordinated debts are paid after payment in full of those debts; and

- the new section 563A.

Section 563B(2) provides that interest accruing after the commencement of a winding up is payable only after all other claims are met, other than "debts owed to members of the company as members of the company (whether by way of dividends, profits or otherwise)".

The existing rule is that those claims covered by the current 563A are ranked after payment of non-subordinated claims and after payment of interest on those non-subordinated claims.

The current rules do not provide for different rankings for subordinated claims and interest on those subordinated claims – both pre- and post-commencement interest claims on subordinated claims and the principal subordinated claims themselves rank equally.

The Bill is not intended to alter this approach. The issue of the relative ranking of subordinated claims and interest on such claims was not subject to examination by the Corporations and Markets Advisory Committee (CAMAC) or public consultation. Prior to the LCA supplementary submission, no concerns were raised in submissions regarding the current law.

In practice, the payment of subordinated claims occurs extremely rarely.

The LCA supplementary submission does highlight a possible issue regarding whether the current cross referencing in section 563B will be read as referring to all subordinated claims (as intended) in subsection 563A(2) or only to paragraph 563A(2)(a) claims. We note that this concern has not previously been raised by stakeholders.

We thank the LCA for raising this issue. Treasury will examine whether the paragraph as stated will give effect to the Government's policy intention.

*Section 600H – no definition of 'external administration'*

As noted in items 15 to 17, "external administration" is not currently defined, either for the purpose of section 600H specifically or the Corporations Act generally.

The term is used in section 283BG and 283CD of the Corporations Act in a way that infers that it does not include receiverships. This implied exclusion is non-problematic as section 600H refers to rights of unsecured creditors that do not in any event exist in respect of receiverships (or any controllerships).

A definition for "external administration matter" is provided in section 580 for the purpose of sections 580 and 581 only. These sections deal with cross-border insolvency arrangements and the definition extends to certain foreign proceedings and excludes many domestic administrations which on their face fall within the ordinary meaning of the term (e.g. voluntary administrations).

Chapter 5 is headed "External Administration". With the exception of specialised windings up of Managed Investment Schemes, all kinds of corporate insolvency proceeding are included in that Chapter.

Treasury is of the view that the term will be read in line with the intended policy underlying the Bill and in accordance with the ordinary meaning of the term as all kinds of corporate insolvency administration under the Corporations Act. Depending upon the kind of administration, section 600H will have no effect due to creditors lacking certain rights in any event.

*Schemes of Arrangement*

The balance of the items in the LCA supplementary submission refers to concerns regarding schemes of arrangement.

In recent years, there have been nil to four insolvency related schemes of arrangement per year. Overwhelmingly, reorganisations occur through the non-court based process afforded by voluntary administrations. In recent years, there have been approximately 1500 to 2100 voluntary administrations per year. Given the low incidence of shareholder compensation claims in insolvency administrations, a Scheme with shareholder compensation claims would be expected to occur very rarely.

Section 411 provides that a creditors' scheme of arrangement is binding on a class of creditors only if a majority by number and more than 75% by value of creditors in that class vote for the scheme. There are separate requirements for votes by members (in that capacity) in a members' scheme of arrangement.

Approval by the Court is also required before a scheme can bind a class of creditors or members. This provides protection against abusive schemes.

The LCA raises concerns that an "external administration" will not include the process for establishing a Scheme. The LCA also raises concerns regarding how the regime will operate if it does apply to Schemes.

As stated above, Treasury is of the view that the Bill is effective in applying section 600H to the processes for establishing a scheme of arrangement (which are set out in Chapter 5 - External Administrations of the Corporations Act).

As noted at item 22 of the LCA supplementary submission, the Bill will have the effect that subordinated creditors will not be able to vote in a voluntary administration (without leave of the Court) but will be bound by a deed of company arrangement (DoCA) by operation of section 444D.

This is in accordance with the policy behind section 600H – if subordinated creditors are so far 'out of the money' that they cannot demonstrate to a Court that they have a legitimate interest in voting, they should not be able to frustrate any reorganisation/rescue plan by remaining free to take action against the company otherwise than in accordance with the plan.

For DoCAs, subordinated creditors are protected from possible abusive arrangements by the ability of the Court to set aside improper deeds.

In contrast, as drafted, the Bill will have the following effect in respect to schemes of arrangement:

- If the Court grants subordinated shareholder compensation claimants leave to vote (ie. the Court determines that it is appropriate that they should have a say, in light of factors such as whether they have a financial interest in the company) then they can be bound if the class collectively votes 'yes' and will not be bound if they collectively vote 'no'.
    - This outcome is consistent with the effects of the Bill in respect of deeds of company arrangement (although, there is only one class of creditors for voting purposes in voluntary administrations — putting to one side requirements for special votes by employees if a deed seeks to afford them a lower priority than in liquidation).
- If the Court does not grant subordinated shareholder compensation claimants leave to vote, then the scheme cannot bind them.
    - They will effectively remain free to frustrate deals in relation to matters in which they may have no demonstrated interest (or to use their ability to frustrate deals to extract from other stakeholders a financial interest which they would not otherwise be entitled to).
    - This effect could be avoided by the Court granting leave to vote. Schemes are a Court based process, affording an opportunity for this to occur. By granting leave to vote, effectively the Court would preserve the status quo in relation to the rights of subordinated creditors in respect of schemes of arrangement.

For schemes, Court approval of the scheme is required up front before a scheme becomes effective, providing an even greater level of protection for subordinated claimants against abusive schemes than exists in respect of deeds of company arrangement.

Treasury is examining whether, in respect of any schemes of arrangement that might arise in respect of companies subject to shareholder compensation claims, the Bill is effective in achieving its policy objectives.

We note that in addition to the option of not amending the Bill, the LCA have suggested two options:

- exclude schemes from the definition of "external administration"; or
    - This would preserve the status quo in respect of voting, without there being the need for the Court to give leave for subordinated creditors to vote.

- provide that, except where a scheme provides for payment of non-subordinated claims in full, subordinated claims are extinguished.

  – This would insert into statute the most likely way in which a scheme might seek to bind subordinated claims.

By way of information, further discussions have taken place between Treasury and the LCA in respect of a further option: to align the effects in respect of schemes with those that apply in respect of deeds. Schemes might be made capable of binding a class comprised of subordinated claims even if that class was not given leave to vote. Court approval would still be required, which would provide protection against inappropriate schemes. If this approach was adopted then, if the Court granted the class leave to vote then whether they were bound would depend upon the outcome of their voting behaviour.

It is noted that any possible amendments to section 411 that might be required would, by referring to section 600H, resolve any possible ambiguity as to whether section 600H applies to Schemes (and therefore whether "external administration" includes such matters).

**Allens Arthur Robinson**

The AAR submissions relate solely to questions of policy rather than drafting issues. The effects of the Bill observed by the AAR are in accordance with the intended effects of the Bill.

*Applications to pre-existing claims*

The Bill applies to claims arising after commencement.

This reflects an underlying policy decision that the Bill should not reduce the value of existing property rights of some claimants with a corresponding increase in the value of property rights of other claimants.

Legal advice has been obtained that indicates that doing so without providing adequate compensation to the persons whose property rights are adversely affected may amount to a constitutionally impermissible acquisition of property. The disclosure of the existence of this advice is not a waiver of legal professional privilege in respect of it.

*Nominees and custodians*

The Bill reflects the intention that subordination will not extend to claims arising from dealings in non-shareholder equity interests, e.g. transactions in derivatives. Such claims were not understood to be subordinated by section 563A prior to the Sons of Gwalia decision. CAMAC recommended that, if the Government chose to 'reverse' the effects of the decision, subordination of claims arising from shareholder interests should not extend to claims arising from other kinds of equity interests.

In the case of nominees or custodians, claims arising from their buying, selling, holding or dealing in shares will be subordinated by the provision. The provision does not require the buying etc of shares to have been carried out by the person making the claim.

*Subsidiary claims*

It is noted that where a shareholder made a claim against a subsidiary and the subsidiary then sought contribution or indemnity from a parent company, the later claim is not considered to have been subordinated under the current section 563A. Sons of Gwalia did not alter the generally accepted understanding of the law in this regard.

The Bill does not purport to alter the status quo in respect of this issue.

**Chartered Secretaries Australia**

The CSA is supportive of the Bill and has not raised any concerns with the text of the Bill.

**Recoveries and Litigation Support**

RLS's submission is in opposition to the underlying decision to subordinate shareholder compensation claims.

The Bill is intended to implement the decision of the Government that shareholder compensation claims should be subordinated.

Yours sincerely

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