COMMONWEALTH OF AUSTRALIA

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SENATE

LEGAL AND CONSTITUTIONAL AFFAIRS LEGISLATION COMMITTEE

Reference: Corporations Amendment (Sons of Gwalia) Bill 2010

TUESDAY, 26 OCTOBER 2010

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SENATE LEGAL AND CONSTITUTIONAL AFFAIRS

LEGISLATION COMMITTEE

Tuesday, 26 October 2010

Members: Senator Crossin (*Chair*), Senator Barnett (*Deputy Chair*) and Senators Furner, Ludlam, Parry and Pratt

Participating members: Senators Abetz, Adams, Back, Bernardi, Bilyk, Birmingham, Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Bushby, Cameron, Cash, Colbeck, Coonan, Cormann, Eggleston, Faulkner, Ferguson, Fierravanti-Wells, Fielding, Fifield, Fisher, Forshaw, Hanson-Young, Heffernan, Humphries, Hurley, Hutchins, Johnston, Joyce, Kroger, Ian Macdonald, McEwen, McGauran, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Stephens, Sterle, Troeth, Trood, Williams, Wortley and Xenophon

Senators in attendance: Senators Barnett, Crossin, Furner and Pratt

Terms of reference for the inquiry:

To inquire into and report on:

Corporations Amendment (Sons of Gwalia) Bill 2010

WITNESSES

Committee met at 3.49 pm

GORDON, Ms Barbara, Member, Corporations Committee, Law Council of Australia; Member, Insolvency and Reconstruction Committee, Business Law Section, Law Council of Australia; Senior Consultant, McKenzie Moncrieff Lawyers; Assistant Professor, Law School, University of Western Australia

MCKENZIE, Mr Robert, Deputy Chair, Corporations Committee, Law Council of Australia; Member, Insolvency and Reconstruction Committee, Business Law Section, Law Council of Australia

Evidence was taken via teleconference—

CHAIR (Senator Crossin)—I declare open this public hearing of the Senate Legal and Constitutional Affairs Legislation Committee and our inquiry into the provisions of the Corporations Amendment (Sons of Gwalia) Bill 2010. This inquiry was re-referred by the Senate to this committee on 30 September 2010 for inquiry and to report by 18 November 2010. We have received three submissions for this inquiry. All of three have been authorised for publication and have been made available on the committee's web site.

I remind all witnesses that, in giving evidence to the committee, they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee and such action may be treated by the Senate as contempt. It is also contempt to give false or misleading evidence to the committee.

We prefer all evidence to be given in public, but if you would prefer to provide us with evidence in a private session then you can request to be heard in camera. If you object to answering a question, we ask that you state the ground upon which the objection is taken and the committee will determine whether or not it will insist on an answer, having regard to the ground which is claimed. If we determine to insist on an answer then of course you have the right to request that that answer be given in camera.

I welcome representatives from the Corporations Committee of the Law Council of Australia. The Law Council has lodged a submission with us, which is No. 3 for our purposes. Do you have any changes or amendments you wish to make to that submission?

Mr McKenzie—No, not at this stage.

CHAIR—I invite you to provide us with a brief opening statement and then we will go to questions.

Mr McKenzie—The submission is by both the Insolvency and Reconstruction Law Committee and the Corporations Committee. We are authorised by both of them to present it. I will make a brief general statement about our position—and I presume that the submission has been read—and Ms Gordon will take you through some of the detail.

There are obviously several issues and elements that need to be considered and dealt with here. The first is whether a certain shareholder claim should be allowed at all rather than being extinguished or released. Subject to some comments we will make later in relation to company reconstruction and context, consensus seems to indicate that they should be allowed rather than be extinguished. The principal issue, therefore, becomes whether shareholder claims should be subordinated or postponed to non-member unsecured creditor claims—that is, should some claims rank above others in an insolvency situation?

Another issue is: in what insolvent situations should the subordination be available? Different regimes can apply to an insolvent company, such as liquidation—that is where there is a winding up, and there can be different types of windings up; receiverships or where a controller is appointed—and again there can be different types of those; voluntary administration, which could lead to a deed of company arrangement or liquidation; or schemes of arrangement. Different rules may apply or be appropriate in those different situations.

On the issue of whether shareholders should be able to claim in competition with ordinary unsecured creditors, the view of our committees is not unanimous; however, a vast majority of members support a change in the law to restore what was generally thought to be the position in respect of shareholder claims prior to the Sons of Gwalia case. That view is, of course, consistent with the position taken in the draft legislation which we are presently considering and which we accordingly support.

The reason for this prevailing view is that dealing with shareholders claims causes delays, increased complexity, increased costs and increased court involvement, all of which prejudice the financial returns for other unsecured creditor claims. Dealing with the shareholder claims and other unsecured creditors equally is therefore contrary to the efficient and cost-effective administration of an insolvency regime in our submission.

More of the assets are lost in administration costs rather than being returned to creditors as dividends. Ordinary unsecured creditors like trade creditors are not in the same position as shareholders. Shareholders take risks in order to get capital appreciation and dividends paid out of profits. Unsecured creditors do not get that opportunity. Of course, not all shareholders claims are of the same type. For example, there may be claims where a dividend has been declared, where there is misleading or deceptive conduct or for a return of capital. It seems there is broad agreement that the return of capital class of claims should be subordinated to everything else. The next issue is whether the declared dividend type and misleading conduct type should rank together or one of those groups should be subordinated to the others.

Finally, debts and claims may be different sorts of liabilities, although debts are generally regarded as a subset of claims. Our submission is directed at clarifying and ensuring that the legislation considers and deals appropriately with those issues which I have outlined. We have suggested some amendments to lessen the scope of potential conflicting interpretation. I would like to thank Chris Pearce of McKenzie Moncrieff for his assistance with the submission. I will hand over to Mrs Barbara Gordon to discuss in more detail the amendments we propose and the reasons. If senators have any questions we will attempt to answer them.

Mrs Gordon—Would you like me to take you through the submission in a bit of detail or just hit the main points?

CHAIR—You have proposed five or six amendments, if I read your submission correctly. I think it would be useful if you explained to us the reasons behind your proposal for those amendments, because that would pre-empt a lot of questions.

Mrs Gordon—That is fine. The first amendment we were requesting was in relation to the proposed section 563A. At the moment, 563A(1) reads:

> The payment of a subordinate claim made against a company is to be postponed until all other claims made against the company are satisfied.

The concern we have there is that the reference purely to claims made against the company is not consistent with earlier sections in the legislation in relation to admission of debts and claims. We had made an initial request that the reference to claims be extended to refer to debts or claims admissible to proof against the company.

I can understand why the reference just to claims was included in the draft, because the deed of company arrangement provisions in section 444D of the Corporations Act 2001 simply refer to claims, but a court decision was required to interpret the meaning of that phrase. So it would help everyone and avoid further issues in terms of requiring interpretation if the reference was to 'debts or claims' rather than just to 'claims'. In the context of the definition of 'subordinate claim', paragraph (a) largely reflects the original drafting of section 563A as it exists at the moment. Paragraph (b), however, is expressed very broadly to refer to:

> any other claim that arises from a person buying, holding, selling or otherwise dealing in shares in the company.

The concern we have with that is that there is no qualification there in relation to ensuring that claims by creditors for a return of surplus do not get inadvertently caught by paragraph (b). So we have suggested that paragraph (1) makes it clear that subordinate claims are only postponed to the debts and claims that would otherwise be admissible against the company in a liquidation. Then we have got consequential amendments in paragraph (2) of that definition to make it consistent with that and to ensure that there is no inadvertent inclusion of members' claims to surplus. I could clarify that if you need me to.

Mr McKenzie—Effectively, the issue there is that the wording seems wide enough to catch what was previously excluded. In my earlier statement I mentioned that there are different types of claims: where shareholders are involved; where a dividend has been declared; and where there is misleading and deceptive conduct—or for a return of capital. Obviously we do not want the return of capital to be caught in this; it never has been and should not be. So, effectively, what we are asking there is just to make sure that that is the situation by essentially clarifying what sorts of claims to rank above the subordinated claims. Then, to make sure that they are also excluded from the subordinated claim definition, so they are in fact subordinated to the subordinated claims as well. I am happy to answer any questions if you need clarification of that.

CHAIR—We might get you to go through the list and we will—

Senator PRATT—Yes, what kinds of claims—

CHAIR—ask you questions when you finish.

Mr McKenzie—Right.

Mrs Gordon—We also asked for a small amendment clarifying paragraph (2)(b) of the definition of subordinate claim to ensure that it is not expressed too widely and so that it reads: 'any other claim by a person that arises from that person,' rather than potentially extending to a claim against the company from any other person dealing in the shares. That was just to tighten up the wording of it and to limit it to claims by a person and entities for their own individual claims.

Getting onto something a bit more substantive now, the legislation anticipates that both claims for debts owed to persons in their capacity as a member—so, claims for unpaid dividends, for instance—will rank equally to the Sons of Gwalia type claims. That is a presumption that we have made based on the drafting of the section, because both paragraphs (a) and (b), paragraph (b) being the Sons of Gwalia type claims, are subordinate and both rank in the same position.

However, in the existing section that follows that in the Corporations Act, which is 563B, there is provision for statutory interest to be paid on debts and claims in a winding up from the relevant date until the date of payment. The situation there is that in a winding up interest does not accrue in relation to debts pursuant to contracts et cetera from the relevant date. But should there be enough money to pay out all claims 100 cents in the dollar then, once those claims have been fully satisfied, the liquidator then pays interest on those claims for the period between the commencement of the winding up, for instance, and the date on which the debts have actually been repaid.

The existing section 563B, however, in subsection (2) says that payment of that interest is to be postponed until all of the debts and claims and the winding up have been satisfied, other than debts owed to members of the company as members of the company, whether by way of dividends, profits or otherwise. That has been expressed longhand because of the existing wording of 563A and it effects a postponement of interest payable in respect of all other claims to the subordinate claims that we have now listed in paragraph (a) of the definition of 'subordinate claim'. But no attention has been given to the ranking of interest in relation to the Sons of Gwalia type claims.

So, if I take it you to paragraph 10 of our submission, at present statutory interest is postponed on the claims enunciated under existing section 563A, and the proposed amendments do not contemplate any change to section 563B. But section 563B(2) specifically refers just to the existing types of claims which are now only part of the subordinate claims. So there are a few questions that have to be considered; in particular, where do we want this statutory interest to rank as against a subordinate claim? That is one question, and I will come back to that in a moment.

With regard to proposed section 563A(2)(a), looking at the definition of 'subordinate claim', are we going to distinguish between paragraph (a) and paragraph (b) for the purposes of statutory interest; and what is the relative ranking of statutory interest on subordinate claims? To present that in a different way, do we want our Sons of Gwalia claims to be paid out before any of the other creditors are paid interest on their debts? That is one question. If the answer to that is no, then what will happen is that the existing creditors will get their 100c in the dollar. They will then get interest on those debts. Then the Sons of Gwalia type claims and the other existing claims for dividends et cetera which fall within the definition of 'subordinate claim' would then presumably be payable, and we would be guessing—and that is all we are doing at the moment—from the draft of the legislation that interest should then be payable in relation to those claims once both paragraphs (a) and (b) have been paid. But this is a question that needs consideration, some sort of decision needs to be made and then the legislation needs to be tweaked to amend section 563B to reflect the outcome of that consideration. That is basically a quick summary of the points in paragraphs 10 to 14 of our submission.

Going to paragraph 15 and proposed section 600H, now we get to something a bit more substantial. There is an issue as to what will happen in the context of schemes of arrangement where the company has Sons of Gwalia type claims. We understand why this issue has not been considered to date, and that is largely because schemes of arrangement have not been used in a creditor context, or very, very infrequently, since the introduction of part 5.3A. However, the first draft of this legislation and the CAMAC report et cetera all predated some significant decisions, in particular the decision in Opes Prime and then the High Court decision in Lehman Brothers, which differentiated between schemes of arrangement and deed of company arrangements in so far as they could bind creditors to a release of third-party claims by those creditors. So there is some speculation that schemes of arrangement will regain popularity in the context of claims against the company where creditors will also have claims against third parties arising out of the same circumstances. Now, given that possibility, we need to make sure that this works in the context of schemes of arrangement as well, or that schemes of arrangement have been addressed in some way.

The problem with the drafting of proposed section 600H at the moment is that 600H(a) refers to administrators and liquidators, while 600H(b) prevents our subordinated creditors from voting in their capacity as a creditor during the 'external administration of the company'. The problem here is the use of the term 'external administration'. It is not a defined term. It is not clearly limited to administration or deeds of company arrangement and liquidation. Furthermore, chapter 5 of the act includes schemes of arrangement, receiverships, voluntary administration, deeds of company arrangement and liquidation, yet the heading of chapter 5 is simply 'External administration'. So, at a glance, the term 'external administration' refers to all forms of administration, but I am not sure that that was the intention of clause 600H. So that question needs to be asked and that needs to be clarified.

I will just talk about the schemes of arrangement problem at the moment. There is a difference between schemes of company arrangement and deeds of company arrangement in terms of the majority of creditors required to vote in favour of a deed or a scheme in order to bind the other creditors. In the context of a deed of company arrangement there is one vote by all creditors and a majority in number and value is required. There is no differentiation between creditors in terms of their interests or class of creditor. So, to the extent that a Sons of Gwalia subordinated creditor is a creditor, they would without this legislation be entitled to vote alongside everyone else.

With this legislation clause 600H(b) deprives them of their right to vote but the existing provisions in relation to a deed of company arrangement would have effect so that the deed would nevertheless bind them to the arrangements set out in the deed of company arrangement, which means that, if a deed of company arrangement is proposed so as to extinguish the Sons of Gwalia subordinated claims, then that deed of company arrangement will bind the subordinated creditors who are described in subclause (2)(b). It will bind them because they are creditors just like the others.

If they have a problem with that they then have the right to appeal to the court to have the deed set aside on the basis that it is unfairly prejudicial or discriminatory—and there are other grounds such as injustice et cetera. But for them to be able to establish that though they would have to be able to say that they would have got more on a winding up and, because of the subordination arrangement that has been put in place by the legislation, that would be difficult for them. So, from a deed of company arrangement perspective, the legislation works.

The problem with a scheme of company arrangement, however, is that a scheme will only bind a class of creditor who has voted in relation to the scheme. I think that is pretty much not an issue. Sons of Gwalia claimants with subordinated claims would be a separate class of creditors. So if a scheme of arrangement was being proposed in order to restructure the affairs of the company so as to deal with all of its debts and claims, including these claims, it would be necessary to convene a separate class of these creditors and have them voting on it in order for that scheme of arrangement to bind those claimants to the scheme of arrangement. So depriving them of their vote in that capacity does not help us at all. We would need to somehow amend section 411 to say that the votes of the other unsubordinated creditors could bind these creditors as well.

Mr McKenzie—The problem with them not being able to be bound is that you cannot really reconstruct the company so, therefore, with the current High Court authorities you would not be able to bind third parties to a reconstruction like was done in Opes Prime with ANZ. So it causes problems in terms of getting a reconstruction effected. In Australian law we do not have the flexibility that some other jurisdictions have to reconstruct companies like chapter 11 in the United States. We have to work with the provisions we have got.

One that has resurrected itself is schemes of arrangement. It was previously the way you effected a reconstruction of a company before part 5.3A and deeds of company arrangement came into effect. It is now going to be resurrected because of this requirement to use a scheme of arrangement rather than a deed of arrangement to reconstruct the company if you want to bind third parties. It is quite an important mechanism that we need to be able to utilise if we are going to try to reconstruct companies and get them and their assets back so that they can be usefully utilised in the economy. It is actually quite an important issue. This authority has really come about since we started talking about this, so it is really quite a new development in many respects caused by this authority.

Ms Gordon—I will just take you back one step with this that might help you understand what is happening. The legislation as it is proposed effects a postponement of the subordinate claims; it does not extinguish them. And, in particular, section 563A only applies in the context of a winding up. So, in a winding up, the subordinate claims will be postponed to payments. That simply means that they do not get paid until the other creditors are paid in full. It does not mean that those claims go away. So if we effect a reconstruction where the

other claims are dealt with in their entirety by way of compromise and release—usually it will be by way of compromise and release: they accept something less than 100c in the dollar and then they release the company from those claims—that leaves these subordinate claims there to be dealt with by the company at a later date.

That is the reason for the problem. You cannot reconstruct a company and come out clean on the other end if these subordinated claims survive the reconstruction, so there needs to be some mechanism for binding these claimants to the reconstruction, be it by way of deed of company arrangement or by scheme of arrangement. Deeds of company arrangement are addressed in the legislation in the way it is at the moment because those claimants will be creditors who will be bound by the deed under the existing legislation. That is not a problem. Schemes of company arrangement, however, are a residual problem because there is nothing in the legislation that enables these creditors to be caught by the scheme unless they vote in favour of it.

We have made a couple of suggestions there. The least contentious is that the government amends its current draft of section 600H to define external administration in paragraph (b) as only including voluntary administration, deeds of company arrangement or winding up of the company, and in the context of winding up that it be both winding up in insolvency, which is winding up by the court in insolvency, and creditors' voluntary winding up, which is also an insolvent type of winding up. If that happens then schemes are left outside of this for a later date, to some extent, which would mean that these creditors would have to be involved in the scheme of company arrangement and that meetings of them would have to be convened, but there is a process inherent in section 411(1) whereby the court orders the convening of the meetings, and facilitative orders could be given by the court in that context. I am saying there that the problems we are currently facing with deeds of company arrangement and the Sons of Gwalia type claims will continue to exist in the scheme of company arrangement context with the legislation as it exists at the moment.

CHAIR—Ms Gordon, we certainly appreciate your comprehensive analysis of your submission, and you have clarified quite a few questions I had, but we are probably ready to go to questions now.

Ms Gordon—Okay.

CHAIR—I think that might be useful now, just to drill down into some details. Senator Barnett, I will kick off with questions from you.

Senator BARNETT—Thanks very much, Mr McKenzie and Ms Gordon, for your presentation and your submission. Clearly this is quite a complex and technical reference that we have before us, and your expertise is appreciated. We are not commercial Pitt Street lawyers, so we will do the best we can to respond to your submission. It seems from where I sit at least that these deeds of company arrangement and the scheme of arrangement, as you have indicated, are a key point and a key concern. You have made the observation that it is unclear whether a company that is already subject to a scheme of arrangement with its creditors is in external administration. You are really making the point that this is a key area of concern. I will go back to clause 26 of your submission, where you say:

The Bill does not provide any mechanism to bind creditors with subordinate claims to a compromise under a creditors' scheme of arrangement—

and you go on. My understanding of the essence of your concern is that you cannot effectively consummate an arrangement, whether a deed of company arrangement or a scheme of arrangement, because subordinate claims cannot be properly taken care of in any such arrangement. If that is the case, can you respond to that. Secondly, have you considered a specific amendment to the bill to address this concern or is this now a matter that the government will need to respond to? Thirdly, have you raised these concerns with the department and, if so, what have they said about your concerns?

Ms Gordon—In the context of the deeds of company arrangement, I think this legislation works and those claims can be dealt with. The other creditors can vote to approve a deed that extinguishes these claims. The existing legislation, in section 444D, arguably binds those creditors to the deed of company arrangement if the deed goes that far. So, if we just want to allow that in the context of deeds of company arrangement, the specific amendment would simply be to clarify paragraph (b) so as to define external administration to be limited to liquidation and voluntary administration.

Senator BARNETT—So, if that were done, you would be satisfied.

Mr McKenzie—I think it is not necessarily the best solution. It is a solution, but then in each individual instance we would have to go to the court and get court orders by convincing the court to make orders that the subordinated creditors could be bound notwithstanding that they refused to vote in favour of a scheme of arrangement.

Ms Gordon—That was the deed of company arrangement context. The scheme of company arrangement context has not been dealt with at all. What Rob McKenzie is talking about now refers to the schemes.

Mr McKenzie—Yes. I think that if you exclude schemes from the whole regime then you have to rely on a court—court applications and individual judges—which I do not think is particularly the right solution. I think it is better that it is handled with a legislative solution. We have had to put this submission together reasonably quickly, so we have not yet dealt with the department and we have not really proposed wording that might fix the problem from a scheme of arrangement perspective. We think it works in a deed of company arrangement context because of the existing provisions, which enable one class of creditor to outvote another class of creditor. So, with these amendments, the subordinated creditors would not be entitled to vote but their claims would still be released if the other creditors voted to proceed with the deed of company arrangement.

Ms Gordon—And if the deed of company arrangement released those claims.

Mr McKenzie—Yes, which inevitably it would. So effectively it works in the deed of company arrangement context. What we are concerned about is whether or not it works in a scheme of arrangement context. We think that it does not cover the situation; it leaves it open. If the claims are subordinated under the legislation then it could cause some problems in terms of getting those subordinated claims released, because it would clearly be a separate class, so they would have to have a separate meeting, and under the schemes of arrangement regime each class has to vote in favour of the scheme. There is no mechanism to say that subordinated claims do not have to vote in that context. So I think the legislation needs to be amended so that there is a provision whereby subordinated creditors essentially lose their claims in a situation where they will not vote in favour of a scheme. They will lose their claim irrespective of how they vote, or you might even deny them a vote in that context. So you would extend the provisions that are currently proposed to include a scheme of arrangement whereby they are not entitled to vote. But you probably need one more clause in section 411, the section that deals with schemes of arrangement, to say that, notwithstanding that they do not vote, their claims are released if that is what the scheme provides for.

Senator BARNETT—I will come in there and try and cut to the quick. What you are saying is that you have identified a problem and there is considerable doubt. The subordinated claims need to be released and an amendment needs to be inserted into the bill so that there is a removal of any doubt regarding those claims and their access under the scheme of arrangement. My question is: are you in a position to draft an amendment in the not too distant future and would further consultation with the department and/or others assist in achieving a potentially mutually agreeable outcome and, if so, how long would it take?

Ms Gordon—There are two options here. The first one is the simple one where we confine the existing amendments to not extending to schemes of arrangement unless schemes, the way they are, are to be subject to further consultation later. That would be quite simple. If we are going to go along the route of trying to address how these claims will be dealt with in a scheme of arrangement context, that is potentially contentious.

Mr McKenzie—I think it is no more contentious than the existing position on the other types of insolvent external administrations. To answer your query, I believe it could be done quite readily. We would certainly be prepared to work with the department to formulate some sort of proposal, and I think it could be done very quickly. It would not be a major amendment. It would just be a similar amendment to the provision that is already in the deeds of company arrangement whereby those claims can be released. So it could be done.

Senator BARNETT—I have a final question: are you saying to the committee that you think this bill should be subject to further consultation before it is put to the Senate so that you can have further discussions with the department? You have indicated that you have not had those discussions. Is that something that you would appreciate or recommend?

Mr McKenzie—I do not think so. We want to get this dealt with as quickly as possible. It is not to act retrospectively, so it is important that it be dealt with very expeditiously. But I think we could liaise with the department quickly to agree or to propose a form of wording that might address this issue that we have found.

Senator PRATT—Dot point 10 on page 3 of your submission refers to, as we have discussed, the ranking issue in the treatment of statutory interest on claims. I am not a commercial lawyer. Can you take me through what kinds of interests are being ranked for the purposes of this legislation? I understand it in quite broad terms and in terms of unsecured creditors versus shareholders versus employee entitlements. Could you give me an example of who is accruing statutory interest and which parties are likely to be in that situation.

Ms Gordon—Some creditors, as you know, have arrangements whereby they can charge interest for late payments and others do not. So, rather than distinguishing between them when they all have to wait the same

amount of time, for those with the right to obtain interest under a contract, the interest stops accruing at the date of liquidation or at the relevant date as it is defined in the legislation. All claims from that point on are dealt with equally. So, if all debts and claims that are admissible to proof against the company are paid out 100 cents in the dollar and the liquidator has extra money before they make any payments to members in relation to dividends et cetera, the liquidator will make a payment of interest on all of those claims. Does that help you?

Senator PRATT—Yes, that does.

Ms Gordon—There is a statutory rate of eight per cent at the moment. It is a prescribed rate, and it changes according to the regulations. It is the interest payable on all debts and claims that are admissible to proof. The question is: will that interest be payable before the subordinated claims are payable, or should it be paid after the subordinated claims? At the moment it ranks ahead of the dividend payments et cetera, which are the payments in paragraph A in the definition of subordinate claims.

Mr McKenzie—It really only comes into effect where the creditors are going to be paid 100 cents in the dollar.

Senator PRATT—Yes.

Mr McKenzie—They then get their interest before any monies go back to the shareholders as the return of their capital.

Ms Gordon—Or by way of dividends before the return of capital.

Mr McKenzie—Or by way of dividends. Yes.

Ms Gordon—The problem is with some small claims and where we will put those in relation to the interest.

Senator PRATT—It would not strike me that it is all that common—that there would be that many funds available.

Mr McKenzie—It certainly is not very often that you see that, although having said that I have seen about three I would think in about 30 years of practice.

Senator PRATT—Yes. What is in the public interest as far as how you go about resolving those competing claims in order to decide what that hierarchy should look like?

Ms Gordon—The simplest solution, if we truly want to subordinate these claims to the claims of all other creditors, is to have interest payable before these subordinate claims. From a consumer protection perspective if we are going to allow these claims against companies at all, it may be that interest should rank after them. But are we now talking about differentiating between the two types of subordinate claims?

Senator PRATT—Yes. I am just trying to work out if there is anything in it either way if you were the liquidator in charge of this. In most instances there is not, but in some instances the way you manage payments is a source of your own revenue. I am just trying to look at other angles in that.

Mr McKenzie—That is a good point in the sense that if interest on these debts ranks after the Sons of Gwalia type claims you are going to have to determine the value and the quantum of all those Sons of Gwalia claims. You get back into all that costly and difficult determination of the value of those claims and who should be entitled to them, and therefore the cost blows out and it is a much more complicated and time-consuming exercise. As I say, it is not likely to occur that often so it is not necessarily a world-shattering thing. It is just that when it does occur, it is useful to have thought through a solution.

If the objection to the Sons of Gwalia type cases is that it adds to the complications, then it may be better to allow the calculation of interest before the Sons of Gwalia claims come in. Otherwise you would have to calculate all those before you have calculated interest, and the expense of that would be prohibitive and there would be nothing left.

Senator PRATT—I am also trying to work out in my head the extent to which any really great injustice is caused if you say, for example, 'Look, we're not going to give you that entitlement to interest post the wind-up point, and we are going to favour shareholders'. What does the actual significance of this financial interest look like?

Mr McKenzie—Historically, the situation has been that shareholders do not get the contribution back until the creditors have been paid and they have been paid interest. So Sons of Gwalia reversed what people previously thought the law was. What we thought the law was was that you got the interest first before any

moneys were returned to the shareholders. So if you were to take away the interest it certainly would be a change to a very longstanding practice, but that is not to say that it would be wrong. It certainly would be a change to existing practice, which is essentially that creditors should be paid, together with interest, before shareholders get a return on their capital.

Ms Gordon—I think in a nutshell the question is that if we have made a decision to subordinate these claims to the same status as dividends then interest needs to rank above them.

Senator PRATT—Thanks for that. You have made that very clear, so thank you.

CHAIR—Ms Gordon and Mr McKenzie, thanks for your time this afternoon. We are running over time now more because of our fault than anything else, given the Senate's attention to general business and general motions on a day like today. Thank you very much for your submission and the detailed explanation you have given to us today on your suggested changes. All that is most useful. Thank you once again for your time and your work in this area.

Mr McKenzie—Thank you very much for allowing us to make a submission.

[4.36 pm]

MILLER, Mr Geoffrey, General Manager, Corporations and Financial Services Division, Department of the Treasury

McAULIFFE, Mr Daniel, Acting Manager, Governance and Insolvency Unit, Department of the Treasury

CHAIR—I officially welcome the officers from Treasury. I am wondering if you have an opening statement that you want to present to us.

Mr Miller—I have a very brief opening statement.

CHAIR—Please proceed.

Mr Miller—Thanks very much for allowing us to appear before you today. The history of this you probably know. The High Court, in Sons of Gwalia v Margaretic, overturned a fairly longstanding and widespread view that all shareholder claims were subordinated below those of creditors. The case held that compensation claims by shareholders were not claims in their capacity as members for the purposes of section 563A of the Corporations Act. Such claims therefore rank equally with other creditors'. In February 2007 the previous government referred the High Court's decision to the Corporations and Markets Advisory Committee—CAMAC, for short—for its analysis and advice on this matter. CAMAC released its report in January 2009. CAMAC actually recommended against amending the law to reverse the effect of the High Court decision. But CAMAC did note at the time that its advice did not have the unanimous support of its members.

On 18 January 2010 the former Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, announced a package of reforms to Australia's corporate insolvency laws including this response to Sons of Gwalia. That announcement, that the shareholder compensation claims would be subordinated, was generally positively received. On 2 June 2010 the government introduced into parliament the Corporations Amendment (Sons of Gwalia) Bill 2010 and the intervening election resulted in it being reintroduced on 29 September 2010. I think you know the contents of the bill, so I will not go through that. I would say that in seeking to subordinate shareholder compensation claims Australia does seek to follow the position that is current in the United States and in Canada.

In regard to the rationale, the government's key reasoning for subordinating shareholder compensation claims was clearly set out in the second reading speech of the Parliamentary Secretary to the Treasurer, Mr David Bradbury MP. The reasons referred to included: restoring the traditional distinctions between debt versus equity in relation to the risks that they bear, addressing impacts on cost and access to credit, and addressing complexities and costs to insolvency administrations. We are very aware of this more recent submission on the bill from the Law Council of Australia. In particular we note that their submission has raised a number of matters which have not been previously referred to in submissions on the exposure draft of the bill or in submissions to the previous inquiry which commenced prior to the federal election.

I have to say that we have great respect for the Law Council and for their advice. There is never a time when any of the issues that they raise are not taken very seriously. We are very mindful that, as you are aware, the Sons of Gwalia issue arose in the first place because minor wording differences can make a really big difference to the meaning of the law. So even these minor differences that the Law Council are now raising are, in our view, very important to consider and consider in some detail. Unfortunately because that submission only came in I think last Wednesday night we are still in the process of considering those issues.

Some of the issues had been raised earlier but there were a fair few new issues that were brought up in that submission that came in on Wednesday night. But, as I said, they are valid points to raise and I think it is incumbent on us that we really do need to think about those in some detail. In the end we want this legislation to actually achieve what we have set out for it to achieve.

I am not sure what you would like us to do as far as helping the committee with this goes. We can talk about each of the five issues in a bit of detail or we can talk a bit about some pros and cons and the things we are thinking about at the moment, but we have not had the time on some of the issues to go into enough depth to even in our own minds be in a position to advise the government of what should be done in some of these areas.

Senator BARNETT—Thank you, Mr Miller and Mr McAuliffe, for your feedback. I understand where you are coming from. This is a very complex technical matter; and, as I said earlier, we are not the expert lawyers

around here—and hopefully there are some in your department who can assist. You have read the submission of last Wednesday from the Law Council. We all respect them and have an admiration for their skills. They have presented here today. I think you were sitting in and listening to their evidence. They have raised in particular concerns about the scheme of arrangement and the lower-ranking creditors. What is your response to their submission, particularly on that matter because that seems to be the major concern that they have or at least a substantial concern. They talked about the deed of company arrangement and they seemed to be okay on that. Do you have the view on the scheme of arrangement and the subordinate claims issue and whether an amendment needs to be inserted into the bill to address those concerns? If you do, could you share it with the committee, at least in principle.

Mr Miller—I can tell you what our gut feeling is at the moment but it still has to be developed.

Senator BARNETT—All right, away you go.

Mr Miller—Our gut feeling is that if there is an amendment to be made, and there might need to be and we are looking at that, in what we heard today I think the two different witnesses were actually presenting two different possible solutions to that. We have even thought of other solutions to that. This is part of our issue: there may be two, three or even four different ways of achieving what we need to achieve; we have to find the one that is going to work the best.

Mr McAuliffe—On the issue of the scheme of arrangement, I think it was stated by a previous witness that schemes are not used terribly often. I think we were down to having approximately one scheme of arrangement a year and in the last year or two it has increased to approximately three a year.

They are not terribly common, but they are very important in certain circumstances. If we have three a year you might ask yourself, 'How many of those might actually have shareholder compensation claims in them?' It might not occur very frequently, but it is important to ensure that where there is a role for schemes that the amendments address those. The issue really comes down to this question that schemes only bind classes which vote for the scheme, and 600H of the amendments takes away the voting rights of subordinated shareholders. So, if they cannot vote then they cannot be bound. And yet, still, there is a potential for them to frustrate schemes because if they are not bound there is nothing to stop them continuing litigation and enforcement activity against the company and a scheme may unravel.

We still need to look at how the amendments interact with those provisions. If there is an issue there which we need to address we still need to look at options. There are two in the paper and at least one or two other options. This is not an issue that has been raised before in consultation and the devil is in the detail, especially with Gwalia, so we really need to have a close look to see how that issue may need to be addressed.

Senator BARNETT—We are sort of between a rock and a hard place in the sense that we understand, and I think that everybody agrees, that the bill needs to be expedited. But on the other hand, it appears that the Law Council would like to have further discussions with you, and it sounds like it would be productive if you had discussions with them. Do you see that as possible, and can you work through some of these matters together to try and come up with an understanding as to a preferred option?

Mr Miller—Without a doubt. We have to get our advice up to government in a fairly short time to say what to do about these issues. We are always open to discussion, and the Law Council is good at talking to us too. The submission that came on Wednesday night did come out of the blue. It was a bit of a surprise to us, really. Normally we would know about these things beforehand. But I am sure, as you heard from the previous witnesses, that they are very happy to talk to us and we are very happy to talk to them. We will get in contact with them.

Senator BARNETT—Yes. I think the main point from our committee's point of view, or at least from where I sit, is that you acknowledge that they have raised the concerns and the concerns are legitimate and need to be addressed. Is that correct?

Mr Miller—They are legitimate concerns, but what I do not know is the best way of addressing them at this point.

Senator BARNETT—No. But you also agree that the bill needs to be amended to address the concerns—is that a fair assessment?

Mr Miller—I cannot say that. In the end it is the government who will decide what amendments are needed.

Senator BARNETT—Yes.

Mr Miller—We will put to the government what these issues are and what options are available. In the end the government will make a call on which way.

Senator BARNETT—But with those options that you will put to them, apart from saying, 'Status quo,' there will be a range of options for amendments?

Mr Miller—In some of them. There are some amendments there where even at this point in time we do not actually think that an amendment is needed. But that is not for all of them, that is just for some of them.

Mr McAuliffe—Because subordinate creditors can be granted leave to vote and if the court decides to do that—and schemes arrangements are a court based process, so a court is looking at it already—in effect the status quo is maintained. An option is to maintain the bill as it stands on this issue.

Senator BARNETT—In conclusion, from my point of view and perhaps the committee's, we would appreciate your feedback on the specific recommendations made by the Law Council so that we can take that into account in our report to the Senate. It is basically that simple, as far as I see it.

Mr Miller—Sure. Would you like something written on each of the five?

CHAIR—Yes, we need to write a report recommending whether the bill should be passed or not and whether it should be amended or not. Not that your submission influences our decision about whether it needs to be amended or not, but it would be useful if you could give us a response. The Law Council has gone into great detail, highlighting quite a range of recommendations which we could go through one by one here now, but I do not know that that is going to give either us or you any benefit. But it would not be efficient for us to finalise our report if we did not have a response from you.

For example, do you actually believe that the term 'external administrator' should be defined in the bill? Do you have a view about some of the contradictory evidence, like should this legislation be amended to say 'all other debts owed by or claims made against' so that there is consistency? You would need to get your view about that back to us and then we will decide as a committee whether or not we finally accept your view.

Mr Miller—To some degree we cannot set a view of what should be amended, because that is a government call, but we can discuss the pros and cons of what is being put forward.

Mr Miller—I think that is probably as much as we could do at this point.

CHAIR—All right, that in itself will assist. We need to report on 18 November.

Mr Miller—We need to get in contact. It would be better to have this to you after we talk to the Law Council.

CHAIR—We are going to have to ask you to give us this information by next Friday—the following week. That is generous—I was going to give you until Wednesday. We are going to go for Wednesday of next week, if you could do that, which is a week and seven hours because we need to finalise this report and then table it. When did you say you saw the Law Council submission? Last week?

Mr McAuliffe—Wednesday evening.

CHAIR—We will give you until Wednesday of next week then. If you could assist us, not just with the Law Council—I know that the Chartered Secretaries of Australia and the recovery and litigation support make comments, but I think their comments are replicated by the Law Council's recommendations anyway. But it would certainly be useful for us—maybe just a spreadsheet? It would be most useful if you could just go through the Law Council's proposed recommendation and your response to that.

Mr Miller—Yes.

CHAIR—Thank you very much, then, and we look forward to that piece of work. I now adjourn this hearing of the Senate Standing Committee on Legal and Constitutional Affairs.

Committee adjourned at 4.53 pm