



# MERITAS AUSTRALIA AND NEW ZEALAND INSOLVENCY MONITOR

## Sons of Gwalia Ltd v Margaretic - One Year On

by Czarek Czajka, Associate, Downings Legal

The most important decision on insolvency in the past year has been the decision of the High Court in *Sons of Gwalia Ltd v Margaretic*; *ING Investment Management LLC v Margaretic*<sup>1</sup> (Decision). This was a test case to resolve whether valid shareholder claims were provable as ordinary unsecured debts ranking equally with debts due to unsecured creditors. The Decision will have significant impact on the law of insolvency and in the year since it has been handed down there have emerged practical implications for administrators and other stakeholders in respect of shareholder claims. It is currently unknown whether there will be statutory reform to address issues resulting from the Decision. Luka Margaretic (Margaretic) bought 20,000 Sons of Gwalia Ltd (SOG) shares eleven days before administrators were appointed pursuant to a resolution of the directors of SOG.<sup>2</sup> Margaretic brought an action in his capacity as an "aggrieved investor" in the Federal Court alleging that SOG breached the Australian Stock Exchange Listing Rules by failing to notify the Australian Stock Exchange that it could not continue as a going concern. He further alleged that SOG engaged in misleading and deceptive conduct in breach of the consumer protection provisions in the Corporations Act 2001 (Act), the Trade Practices Act 1972 (Cth) and the Australian Securities and Investments Commission Act 2001 (Cth).<sup>3</sup> The Federal Court agreed with Margaretic and SOG appealed. The Full Court of the Federal Court and the High Court concurred with the Federal Court's decision.

The outcome of the Decision is that shareholders rank equally with unsecured creditors in a liquidation where they bring a claim in their capacity as aggrieved investors under consumer protection legislation.

The Decision raises difficult questions for administrators and their lawyers, as evidenced by the issues facing SOG's administrators Ferrier Hodgson (Administrators).

Shareholders of SOG allege that they were misled as to SOG's worth by inaccurate and incomplete statements in all annual reports since 1999 and in relation to unauthorised trading from 2000 onwards. As at 7 December 2007 shareholder claims totalled 5,239 equalling \$238.5 million.<sup>4</sup> Whether shareholders who retained their

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## Significant Amendments to Voluntary Administration

by Catherine Pierce, Senior Associate, Madgwicks

The Corporations Amendment (Insolvency) Act 2007 (Cth) introduced extensive amendments to the voluntary administration, deed of company arrangement and liquidation regimes of corporate insolvency. The amendments were developed with four goals in mind: strengthening protection for creditors; deterring misconduct by company officers; enhancing the regulation of insolvency practitioners; and fine-tuning the voluntary administration process. This article outlines some of the more significant amendments but it is not an exhaustive list of them.

### Voluntary administration

As part of the increased regulation of insolvency practitioners, administrators are subject to an obligation of continuous disclosure of "relevant relationships" and indemnities (section 436DA). Failure to comply with that obligation is an offence under the Act. The term "relevant relationships" is not defined and would therefore appear to be fruitful ground for judicial activity. Further, creditors voting at the second meeting of creditors are not obliged to accept the appointment of the administrator as liquidator as was

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# Sons of Gwalia Ltd v Margaretic - One Year On

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shares for longer as a result of misleading information fall within this category is still to be tested.

In their Creditors Report of 14 June 2007<sup>5</sup> the Administrators envisaged that, if the shareholder claims were dealt with under the ordinary adjudication process, it would result in an expensive and drawn-out liquidation which would not serve the best interests of the creditors as a whole.

In their Creditors Report of 7 December 2007<sup>6</sup> the Administrators outlined a proposal for amendments to the Deeds of Company Arrangement (DOCA) to be considered and, if appropriate, approved at the creditors meeting of 28 December 2007.

Under the amended DOCA, the Administrators and their lawyers would individually assess the quantum of each of the 5,239 shareholder claims on their merits based on the evidence provided by the shareholders and in accordance with legal concepts of causation and reliance.<sup>7</sup> All positively assessed shareholders would receive a pro-rata distribution out of a pool of assets.

The alternative to the amended DOCA would be for the Administrators to apply to the court for directions on how to deal with the shareholder claims. Further time delays and legal costs associated with a court application does not make this avenue ideal.

We understand from an article in *The West Australian* on 4 January 2008 that the amended DOCA was approved.

In light of the Decision and as evidenced by the Administrators' issues to date, future implications are that, firstly, administrators will be faced with the complex task of assessing each shareholder claim on its merits similar to the manner suggested by the Administrators or applying to the court for directions, both leading to time delays and higher costs in the ultimate winding up of the company.

Secondly and more generally, within 28 days of appointment an administrator must put to creditors a statement of the best outcome for the company in their opinion.<sup>8</sup> Creditors make the ultimate decision whether

to end the administration, enter into a Deed of Company Arrangement or liquidate the company,<sup>9</sup> but rely on administrators to keep them fully informed. Quantifying potential shareholder claims could take longer than the 28-day period; the risk is that the administrator may not be able to put to the creditors a statement adequately dealing with all claims.

Another implication is that being a shareholder now carries less risk - shareholders not only benefit when the company is a going concern but also, in relevant circumstances, participate as an unsecured creditor in the winding up of a company.

These are some of the practical issues that the Administrators and stakeholders have faced as a result of the Decision and insolvency lawyers will be watching the liquidation process of SOG with special interest.

1 (2007) 232 ALR 232

2 Section 436A of the Act

3 Section 52 Trade Practices Act 1972 (Cth), s1041H of the Act and s12D of the Australian Securities and Investments Commission Act 2001 (Cth).

4 The quantum is subject to change as claims are still being received

5 Deed Administrators' Report Pursuant to Section 445F of the Act, 14 June 2007

6 Deed Administrators' Report Pursuant to Section 445F of the Act, 7 December 2007

7 A duly executed proof of debt, documentation proving the share transaction giving rise to the cause of action and dividends received, duly signed witness statement by the shareholder and any information which the shareholder relies upon in relation to the question of causation and reliance: pages 22 and 23, Deed Administrators' Report Pursuant to Section 445F of the Act, 7 December 2007

8 Sections 439A(3) and 439(4)(b) of the Act

9 Section 439C of the Act

## Removal of a Liquidator

by Catherine Watt, Senior Associate, Madgwicks

A recent Court of Appeal case demonstrates that the Courts are prepared to replace a liquidator if there are allegations of bias, even in circumstances where no bias or misconduct has been found.

Justice Mandie heard the case of *Malhotra v Tiwari & Ors* [2005] VSC 496 at first instance in a 17 day trial in the Supreme Court. The proceeding was about the affairs of an Indian grocery business in West Footscray. A company named S & D International Pty Ltd ("the Company") ran the business as trustee for the S & D International Unit Trust ("the Unit Trust"). The Supreme Court proceedings were brought by Dinesh Malhotra (the beneficial owner of one half of the units in the Unit Trust) against the other Unit Trust holders, and the liquidators of the Company. Dinesh Malhotra

alleged misconduct by the liquidators and also bias towards the other Units holders who were also directors of the Company. Dinesh Malhotra sought (amongst many orders) a declaration that the company was solvent, the removal of the liquidators and the liquidators to pay back to the Company their fees as liquidators and administrators.

The Supreme Court at first instance held that the allegations of bias were unfounded, that the liquidators were entitled to their remuneration and that they should remain as liquidators of the Company. The Court also found that the Company was hopelessly insolvent. Dinesh Malhotra appealed the decision to the Supreme Court of Appeal and was self represented at the hearing. He alleged that the Court at first instance

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# Recent substantial changes to New Zealand Companies Act

by Tony Johnson, Partner, Martelli McKegg Wells & Cormack

Recent changes to the Act have brought New Zealand more in line with the Australian legislation. Four particular areas of change are: Insolvent Transactions, Voluntary Administration, Phoenix Companies and Voluntary Appointment of Liquidators

## Insolvent Transactions

Previously New Zealand applied the "ordinary course of business test" as a defence to an Insolvent Transaction claim. This defence has been replaced with the "running account" defence. As with Australian cases it is anticipated that once a running account is found to exist, the extent of the preference will be a question of fact depending on whether the "ultimate effect approach" or the "peak indebtedness approach" is applied.

The substance of this change is liquidator friendly. Creditors need to be aware that recoveries from companies where there is an existing indication of insolvency, are more likely to be the subject of claw backs than previously.

## Voluntary Administration

The new regime came into effect on 1 November 2007. The amendments largely adopt the relevant provisions in the Australian legislation. There is, however, a major difference in that (despite the introduction of the new regime) the IRD has retained its preferential creditor status. Given this situation, concern has been expressed that the IRD is unlikely to vote in favour of a DOCA. The IRD have indicated that it will keep an open mind in respect to Voluntary Administration. The proof will be in its actions over the next twelve months.

## Phoenix Companies

These provisions have been enacted as a result of public concern over trading entities closing up one day and reopening under a similar name the next. The new provisions prevent the director of a failed

company being a director or a person directly involved in the management of a Phoenix company for a five year period.

Doubts have been expressed as to the effectiveness of the new provisions. The reason for this is the narrowness of the definition of a Phoenix company. The provisions effectively prevent the use of goodwill associated with the name rather than with goodwill associated with the individual that ran or operated the previous company.

## Voluntary Appointment of Liquidators

These provisions have also been enacted as a result of public concern over the appointment of "friendly liquidators" after proceedings have been issued for the appointment of a Liquidator.

The new provisions prevent the voluntary appointment of a liquidator from the time period ten working days after service of the Court application to have a liquidator appointed.

Commentators have suggested the new legislation addresses public perception rather than substance. The majority of voluntary liquidations have been carried out by independent experienced insolvency practitioners. Liquidators are in any event subject to statutory duties. Further, the ten working day period means any abuse of the system can still occur (the shareholders just need to move more quickly). Perhaps the more important issue the law makers should have addressed is the registration and qualification of those able to undertake liquidations. Those provisions have not been changed. The major requirements for a Liquidator in New Zealand are that he is over 18 years old, has not been involved in the management or auditing of the company's affairs, is not a creditor and is not insane. This can be compared with stricter requirements in Australia.

## Removal of a Liquidator (continued from page 2)

erred in finding that there was no bias or misconduct by the liquidators.

Interestingly, the Court of Appeal upheld Justice Mandie's decision by stating that there was no evidence of bias or misconduct, however the Court made the unusual move of removing the liquidators anyway. The Court of Appeal stated at paragraph 54 of the judgment:

"We do not accept that the judge erred in relation to the issue of bias or apprehended bias. In point of fact his Honour referred implicitly and, in some cases, specifically to most of the matters mentioned and he explained in considerable detail why he was not persuaded by those matters that the administrators were biased or that there was a reasonable

apprehension that the administrators were biased." The Court justified this by stating there was the possibility of a perceived bias (even though there was no actual or apprehended bias found) and that a new liquidator should be appointed. The Court said that the liquidators could not investigate their own conduct, and the new liquidator could make these investigations if they felt it necessary. The Court however did not direct the new liquidator to investigate the conduct of the previous liquidators, it was purely at his discretion.

The Court of Appeal decision is *Malhotra v Tiwari & Ors* [2007] VSCA 101 and has ramifications for all liquidators dealing with interested parties with different interests.

# Significant Amendments to Voluntary Administration *(continued from page 1)*

previously the case. Creditors can appoint a different insolvency practitioner (section 499). The role of the committee of creditors has been enhanced: the committee now has power to approve the remuneration of the administrator (section 449E); and the membership of the committee can now include a company (section 436G).

The time within which the first and second meetings of creditors must be held has been extended (sections 436E, 439A and 439B). Throughout Part 5.3A of the Act, time is now to be measured in "business days". For instance, whereas a chargee previously had ten days within which to decide whether or not to enforce a charge, that "decision period" has been extended to thirteen business days.

New procedures have been introduced to govern security interests such as liens or pledges over property of a company. For instance, a person who holds property of a company pursuant to a lien or a pledge may retain possession of the property but may not dispose of it without the consent of the administrator or leave of the Court (section 440BA). The new regime governing the sale of property subject to a lien or pledge requires that in exercising a power of sale, an administrator must act reasonably. The same obligation is imposed on an administrator who deals with property subject to a retention of title clause (sections 442CA and 442CB).

## Deeds of Company Arrangement

The recent amendments have mandated a practice which was commonly adopted in deeds of company arrangement prior to 31 December 2007. Practitioners previously tended as a matter of course and of good practice to preserve the priority of employee entitlements within the regime for the proving and payment of claims in the deed. It is now mandatory to preserve the priority of employee entitlements unless employee credits otherwise agree or the Court approves an alteration to the priority (section 444DA). Prior to the recent amendments, the administrator of a deed of company arrangement which was terminated automatically became the company's liquidator. Creditors may now appoint a different insolvency practitioner as liquidator (section 499). Creditors cannot, however, terminate a deed of company arrangement unless its provisions have been breached and that breach has not been remedied (section 445 CA).

Certain clarifications of the law relating to deeds of company arrangement have been supplied by the recent amendments. For instance, a debt for equity swap under a deed of company arrangement need not comply with the takeover provisions of the Corporations Act (section 708(17)). A creditor does not release a guarantee given in respect of the debt owed to the creditor merely by voting in favour of the execution of the deed of company arrangement.

## Liquidation

In a creditors' voluntary winding up the first meeting of creditors may now be convened by the liquidator and held within 11 days after the passage of a special resolution by shareholders to place the company into liquidation, rather than having to be held within one day (section 497). Importantly, however, creditors are still entitled to seven days' notice of the meeting. Section 497 allows creditors to replace one liquidator with another practitioner approved by them.

The value of claims which may be settled or compromised by a liquidator without approval of a court or of creditors has increased from \$20,000 to \$100,000 (section 477(2A)). Court approval is not required for a liquidator to appoint him or herself administrator of a company so long as the creditors' approval has been obtained.

Claims available to a liquidator under Division 2 of Part 5.7 (the claw-back provisions) are preserved where liquidation is preceded by a long period of voluntary administration or a long period subject to a deed of company arrangement (section 588FF(3)(a)).

The recent amendments have to some extent streamlined the liquidation process, in addition to streamlining and clarifying other aspects of the insolvency regimes. In addition to familiarising themselves with the raft of recent amendments to the insolvency regimes, lawyers and insolvency practitioners alike should also be aware of the transitional provisions which apply to the amendments.

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