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What's my scheme?

A solution for complex litigation

Over the last two years, the Scheme of Arrangement has emerged as the only restructuring mechanism suitable for facilitating large-scale legal settlements dependent on the binding of all creditor claims against third parties.

In Australia, we can expect to see an increase in the number of settlements dependent on the scheme's ability to bind creditors and guarantee settling parties a single, manageable payout and an end to hostilities rather than an ongoing stream of small-scale litigation. It is this binding characteristic of Schemes of Arrangement that is driving their revival and will give them an increasingly prominent role in our restructuring landscape.

The recent High Court decision in *Lehman Brothers Holdings Inc v City of Swan & Ors* [2010] HCA 11, set aside the more common deed of company arrangement (DOCA) on the basis that the underlying provisions of the Corporations Act could not be used where settlements with third parties were required. In doing so, the High Court distinguished a key difference between the underlying legislative regimes under which a DOCA and scheme operate.

In this article, we examine key aspects of schemes of arrangement and look at two examples where Ferrier Hodgson has utilised schemes to bring significant benefit to stakeholders.

The process for putting a scheme of arrangement in place is regulated by Part 5.1 of the Corporations Act. A scheme is an agreement between a corporation and its creditors which modifies those creditors' rights. Generally, schemes are used to pool assets of related entities or provide for a moratorium period on creditor claims against the company or party. Historically, schemes have not often been used in insolvency scenarios because of their relatively high cost compared with alternatives such as a DOCA.

Schemes are expensive because they require court approval prior to and subsequent to the requisite meeting seeking creditor approval of the scheme. They also require a detailed explanatory statement –

similar to a prospectus – enabling creditors to make an informed decision on whether to approve the scheme.

Generally, there is less chance of a scheme being approved than, say, a DOCA, on the basis that:

- The general body of creditors is required to be split into classes based upon similar interests in the company (eg: in obtaining approval for the Sons of Gwalia [SOG] scheme, the creditor pool was split between shareholders and ordinary creditors).
- Approval of a scheme requires 75% of votes by value and 50% of votes by number from each class. In contrast, approval of a DOCA requires only 50% of votes by value and 50% by number from the general creditor pool.



- Even if the creditors vote overwhelmingly in favour of the scheme, the court is not obliged to approve the scheme, although the outcome of voting is persuasive.

In determining whether to approve a scheme, the creditors of the company will consider the likely timing and value of any return for themselves personally and how the scheme compares with any alternatives that may exist.

Conversely, a Court determining whether to approve a scheme will have regard to the fairness and public interest as well as the interests of the company and its creditors, both generally and class-by-class.



Sons of Gwalia

SOG was a gold, lithium and tantalum miner when it entered voluntary administration in August 2004 and subsequently a DOCA in August 2005. Early in the administration, Ferrier Hodgson (the administrators) identified that SOG had a number of potential causes of action against its former directors and auditors. These included:

- A claim against the auditors regarding negligent accounting over the disclosure of certain derivative contracts.
- A claim against the auditors and certain former directors relating to inadequate internal controls.
- A claim against the auditors over negligent accounting.

A writ was issued against the auditors and the former directors in February 2005 and the statement of claim and particulars were served on the parties in February 2007. During the administration, it became clear some shareholders may also have a

claim against the auditors. The shareholders sought to participate as creditors in the administration and claim they had been misled as to SOG's worth by inaccurate and incomplete statements made in the 1999 annual report and the failure to make disclosures about unauthorised trading in mid-2000. As the cost of testing each claim for sufficient evidence would have been substantially more than the actual claims, the DOCA was amended to allow us to undertake an informal assessment of claims. In early 2008, Ferrier Hodgson offered to fund claims by shareholders with claims in excess of \$50,000 against the auditors on the basis that:

- Any proceeds from the litigation be pooled for the benefit of all shareholders.
- No shareholders would take individual action against the former directors or auditors of SOG.
- The administrators (with approval from creditors) were empowered to enter into a settlement with the relevant parties.

Ultimately, shareholders with claims totalling \$286m agreed to participate in a shareholder action against the former SOG auditors. As a result, any settlement would need to bind creditors' claims against SOG and their personal claims against the former directors and auditors. In September 2008 a proposed settlement was reached between SOG, the former directors and their insurers which resulted in the creditors receiving \$53m. A key condition was the adoption of a scheme to extinguish all creditors' rights against the directors and their insurers.

A scheme proved to be the appropriate vehicle through which to compromise creditor rights, not only against the company but also against the directors and auditors. This was so whether they voted in favour of the scheme or not, as a creditor- and court-sanctioned scheme binds creditors and also those parties that may become creditors at a later point in time. The creditors overwhelmingly approved the scheme and the court subsequently approved it.



Opes Prime

Opes Prime primarily provided stock broking services to institutional and private clients, mostly in the form of securities lending and equity financing.

In March 2008, Opes Prime appointed Ferrier Hodgson as voluntary administrators. Receivers were subsequently appointed by one of Opes Prime's financiers. The creditors of Opes Prime placed the company in liquidation in October 2008. Subsequently, as liquidators, Ferrier Hodgson foreshadowed potential claims against the company's main financiers relating to a \$95m loan agreement entered into with Opes Prime a few days prior to the appointment of administrators and the validity of security held by the financiers.

The liquidators identified claims relating to:

- 1 Breaches of statutory and fiduciary duties to the company.
- 2 Unconscionable conduct in breach of the Trade Practices Act.
- 3 An unfair loan and uncommercial transaction under the Act.
- 4 The floating charges granted by the Opes Prime entities were void except to the extent further monies were provided under the loan agreement.

Separately, certain clients of Opes Prime had initiated proceedings against the financiers for a number of reasons including claims that Opes had engaged in false and misleading conduct in relation to the beneficial ownership of their shares under a margin lending agreement.

In March 2009, through mediation between the financiers, ASIC and the Opes Prime administrators,

a \$253m settlement was reached which required the establishment of a scheme that would:

- Give effect to the settlement.
- Pool the assets and liabilities of certain Opes Prime entities.
- Bar any creditors of Opes Prime from proceeding with any claims against the financiers.

Similar to the SOG matter, the financiers would only settle the litigation threatened against them by the liquidators if all existing litigation initiated by creditors, and any future litigation they might agitate, came to an end. This provided the financiers and creditors with a meaningful alternative to what would be costly and lengthy litigation; with the financiers able to fix their total liability to Opes Prime at a point in time and creditors offered a more certain financial outcome.

Certain creditors opposed the scheme on the grounds that (like the SOG scheme), it sought to bind creditors not only as to their claims against the company, but also against third parties (in the case of SOG, the directors and auditors; in the case of Opes Prime, the financiers). But creditors overwhelmingly approved the scheme by the requisite majority of creditors (75% by value and 50% by number), and the court approved the scheme in August 2009.

Conclusion

The revival of the scheme of arrangement in the tool kit of the insolvency practitioner arises from its importance in:

- Dealing with a creditor body where interests may not be completely aligned (and where there are trade-offs between creditor groups).
- Bringing about "global" settlements, where claims of creditors against a company and third parties outside the company are settled with creditor and Court approval.

Such settlements are likely to arise more frequently given:

- The High Court's decision in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1; [2007] 231 CLR160

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which found that shareholders who had been misled would rank equally with other unsecured creditors (legislative changes to the Act are now before the Parliament).

- The appeal court's upholding of the decision to approve the Opes Prime scheme.
- The High Court's decision in *Lehman Brothers Holdings Inc v City of Swan & Ors [2010] HCA 11* wherein the court found that a DOCA could not bind creditors' rights against third parties.

These complex settlements are also being fuelled by the continued emergence of litigation funders (which enable class actions through the aggregation of creditors to pursue claims against parties outside the company) and the increasing complexity of commercial arrangements involving multiple advisors, parties and transactions. We are also likely to see more examples of the cost of large-scale commercial litigation forcing insolvency practitioners, defendants and plaintiffs to find alternatives.

In the absence of schemes dealing with third-party rights, the creditor participants in any settlement face the "free-rider problem." That is, they may settle now, only to find that someone else has settled on more favourable terms later. This creates a disincentive for anyone to settle. Further, defendants associated with the company will not want to settle for large sums with a willing majority, whilst they face the risk of continued litigation by a vigorous minority.

In the absence of a global settlement, defendants may leave value on the table to provide for the unknown risk of future litigation, depriving the defendant of certainty and the creditors of the fullest possible recovery.

Schemes provide a solution to that problem. As long as the law permits them to deal with rights of creditors not only against the company, but also against persons associated with the company, the revival in their use is likely to find increasing favour.

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