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Bulletin No. 203

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1. Recent Corporate Law and Corporate Governance Developments

1.1 Financial System Inquiry interim report released

On 15 July 2014, the Australian Financial System Inquiry (FSI) released its interim report.

The report sets out the Committee's views on the objectives of the financial system and the principles that should guide its development. It discusses the financial system from nine perspectives, including competition, funding, superannuation, stability, consumer outcomes, regulatory architecture, retirement income, technology and international integration. The interim report makes 28 observations on how the system is currently working. For each of these observations, it sets out a range of options for change, including the option of no change.

The Inquiry is seeking feedback on these observations and options to inform the recommendations in its final report in November 2014.

The interim report is available on the FSI website.

1.2 FSB consultative document: Foreign exchange benchmarks

On 15 July 2014, the Financial Stability Board (FSB) released a consultative document on foreign exchange (FX) benchmarks.

In February 2014 the Foreign Exchange Benchmarks Group (the Group) was established by the FSB to undertake a review of FX benchmarks and analyse market practices in relation to their use and the functioning of the FX market. In particular, the Group was mandated to undertake analysis of the FX market structure and incentives that may promote particular types of trading activity around the benchmark fixings. The Group was also asked to propose possible remedies to address these incentives as well as to examine the construction of the benchmarks themselves.

The Group is proposing possible recommendations for reform in the FX market in the following broad categories:

- the calculation methodology of the WM/Reuters (WMR) benchmark rates;
- the publication of reference rates by central banks;
- market infrastructure in relation to the execution of fix trades;
- the behaviour of market participants around the time of the major FX benchmarks (primarily the WMR 4pm London fix); and
- recommendations from a forthcoming IOSCO review of the WMR fixes.

The consultative document is available on the FSB website.

1.3 UK report on executive remuneration

On 14 July 2014, the UK High Pay Centre released a report outlining policies to deal with excessive executive pay.

According to the report, the UK Government should consider requiring companies to cap executive pay at a fixed multiple of their lowest-paid employee. The report notes that since the late 1990s executive pay has grown from 60 times that of the average UK worker to nearly 180 times and that more radical action is needed if the gap between top executives and everyone else is to return to more proportionate levels.

In 2013, pay received by the average FTSE 100 Chief Executive increased to £4.7 million, up from £4.1 million in 2012.

Though a vote in Switzerland proposing a maximum pay ratio of 12:1 between the highest and lowest earners was defeated last year, UK companies John Lewis and TSB have already adopted a less radical ratio of 75:1. The High Pay Centre report notes that different ratios could be applied to different sectors, based on the advice of businesses, employees and academic experts.

The report also proposes:

- representation for workers on company boards and the "remuneration committees" that set executive pay, as well as on city pay regulators;
- a national "inequality target" based on previous legally-binding commitments to reduce child poverty and carbon emissions; and

- compulsory profit-sharing, so that if a company does well and the CEO receives a large bonus payment, ordinary workers also receive a windfall.

The report is available on the High Pay Centre website.

1.4 Central clearing of OTC AUD interest rate derivatives

On 8 July 2014, the Australian Treasury released a proposals paper based on the findings of an earlier report and proposals paper.

In February 2014 the Australian Government released a proposals paper seeking stakeholder views on a requirement for internationally active dealers to centrally clear interest rate derivatives denominated in four global currencies (US dollars, euros, Japanese yen and British pounds). The paper also sought preliminary views on a similar requirement for interest rate derivatives denominated in Australian dollars.

In April 2014 the Australian Prudential Regulatory Authority, the Australian Securities and Investments Commission and the Reserve Bank of Australia published a Report on the Australian OTC Derivatives Market. In the report the three regulators recommended the introduction of a central clearing mandate for interest rate derivatives denominated in Australian dollars, also limited to internationally active dealers.

Given the recommendation by the regulators, the Government is now consulting stakeholders on a proposal to combine the requirements to centrally clear interest rate derivatives denominated in four global currencies and in Australian dollars.

The proposals paper is available on the Treasury website.

1.5 EBA proposes potential regulatory regime for virtual currencies

On 4 July 2014, the European Banking Authority (EBA) published an Opinion addressed to the EU Council, European Commission and European Parliament setting out the requirements that would be needed to regulate "virtual currencies". The Opinion discourages financial institutions from buying, holding or selling virtual currencies while no regulatory regime is in place.

Following a thorough assessment of virtual currencies carried out jointly with other

European authorities, including the European Central Bank (ECB) and the European Securities and Markets Authority (ESMA), the EBA has concluded that, while there are some potential benefits from virtual currencies, such as faster and cheaper transactions, as well as financial inclusion, the risks outweigh the benefits.

The EBA identified in particular more than 70 risks across several categories, including risks for users, market participants, risks related to financial integrity, such as money laundering and other financial crimes, and risks for existing payments in conventional (so-called fiat) currencies.

The causes of these risks were also investigated by the EBA. These include that a virtual currency scheme can be created - and its function subsequently changed - by anyone, and in the case of decentralised schemes, such as Bitcoins, by anyone with a sufficient share of computational power, and anonymously so. The EBA also added that individuals validating transactions (so-called miners) can also remain anonymous, and so can payers and payees; IT security cannot be guaranteed; and the financial viability of some market participants remains uncertain.

Based on this assessment, the EBA is of the view that a regulatory approach to address these risks would require a substantial body of regulation, some components of which would need to be developed in more detail. In particular, a regulatory approach would need to cover governance requirements for several market participants, the segregation of client accounts, capital requirements and, most importantly, the creation of "scheme governing authorities" accountable for the integrity of a particular virtual currency scheme and its key components, including its protocol and transaction ledger.

However, considering that no such regime is currently in place, some of the more pressing risks will need to be mitigated in other ways. As an immediate response, the EBA therefore advises national supervisory authorities to discourage credit institutions, payment institutions and e-money institutions from buying, holding, or selling virtual currencies. While this response will mitigate risks arising from the interaction between virtual currency schemes and regulated financial services, it will not address risks arising within, or between, virtual currencies schemes themselves.

This two-pronged approach will allow virtual currencies schemes to develop outside the financial services sector and will also allow financial institutions to maintain a current account relationship with businesses active in the field of virtual currencies.

The Opinion is available on the EBA website.

1.6 Sustainability disclosure by Australian companies

On 3 July 2014, the Australian Council of Superannuation Investors (ACSI) released a report on sustainability. Forty per cent of S&P/ASX200 companies still rate in the two lowest categories of ACSI's annual review of sustainability disclosure.

ACSI's sustainability reporting research, now in its seventh year with the 2014 report, assesses the level of public reporting by Australia's largest listed companies with the goal of promoting continuous improvement in reporting standards and practices across the market.

2014 Report Highlights

- 85% of ASX200 companies provide some level of reporting on sustainability factors;
- 75 companies have been reviewed in all seven of ACSI's research projects since 2008; of these, almost 70% report to a level of "Comprehensive" or "Detailed", and there are none rated "No" reporting;
- a company's annual report continues to be the most likely place for a company to provide its sustainability reporting (153 companies), followed by the corporate website (132 companies); and
- larger companies continue to be more proficient sustainability reporters, with 62% of ASX50 companies reporting to a level of Comprehensive.

Further information is available on the ACSI website.

1.7 Research shows value of company secretaries

On 3 July 2014, the UK Institute of Chartered Secretaries and Administrators published research showing that company secretaries, or those fulfilling a similar role, make a significant contribution to board performance, share the same qualities as good chairpersons and enable effective decision-making.

The highlights of the research are as follows:

- the role is much more than dealing with administration. Top performers deliver strategic leadership. The company secretary is the third member of the top team and as such is a vital, independent bridge linking the board and the executive;
- company secretaries align the interests of different parties around a boardroom table, facilitate dialogue, gather and assimilate relevant information, and enable effective decision-making; and

- the skills and attributes of the best company secretaries are closest to those of the chairperson: humanity, humility, high intelligence, negotiation and resilience.

Other key findings include:

- it is vital that company secretaries have both direct and informal access to board members;
- the role is changing and is increasingly outward-focussed;
- there is a conflict of interest in the combined "Head of Legal" (or General Counsel) and "Company Secretary" role. The roles should be separate, as they can be incompatible;
- company secretaries, often the longest-serving members present at board meetings, are a vital repository of company history and culture, and a guarantor of continuity;
- company secretaries are embedded in the process of making boards more effective; they contribute by observing boards in action and advising on any skills gaps that need filling;
- the breadth of the role means that it must retain independence to rebalance power as required and demonstrate accountability; and
- a company secretary's direct reporting line should be to the chairperson, but a good working relationship between chairperson, CEO and company secretary is crucial and there should be equal esteem.

The research is available on the Institute of Chartered Secretaries and Administrators website.

1.8 New framework for good governance in the public sector

On 2 July 2014, the International Federation of Accountants (IFAC) and the Chartered Institute of Public Finance and Accountancy (CIPFA) released "International Framework: Good Governance in the Public Sector", which was developed together, to encourage more effective public sector governance.

The Framework encourages better governance and management of public sector entities by improving how they set and achieve their intended outcomes. Enhanced stakeholder engagement, robust scrutiny and oversight of those charged with primary responsibility for determining an entity's strategic direction, operations, and accountability lead to more effective interventions and better outcomes for the public at large.

The Framework establishes good practice principles for the fundamental aspects of public sector governance. The Framework also facilitates the review and update of national governance codes for the public sector and, where specific principles and guidance do not already exist, stimulates improvement.

The report is available on the IFAC and CIPFA websites.

1.9 Report on the fiduciary duties of investment intermediaries

On 1 July 2014, the Law Commission for England and Wales published the report "Fiduciary Duties of Investment Intermediaries". The report follows work undertaken in relation to the Kay Review of UK equity markets and long-term decision making.

The Commission concludes that the law of fiduciary duties should not be reformed by statute. It recommends that it is for the government to decide if investors should have greater rights to sue intermediaries. A possible option, based on s. 138D of the *Financial Services and Markets Act 2000*, is highlighted.

The Law Commission also advises that there is no impediment to trustees taking account of environmental, social or governance factors where these are, or may be, financially material. It advises that when trustees invest in equities over the long-term they should consider, in discussion with their advisers and investment managers, how to assess risks (including risks to a company's long-term sustainability).

The Commission accepts that trustees need more guidance but it does not advocate codification of the law; instead, it hopes that its report and accompanying guidance for trustees in respects of their duties when setting and investment strategy will prove useful.

The report and accompanying guidance are available on the Law Commission website.

1.10 Senate Economics References Committee report on ASIC's performance

On 26 June 2014, Senate Economics References Committee tabled its report on the performance of ASIC.

The report examines the regulation of consumer credit since 2002 and also examines the serious misconduct engaged in between 2006 and 2010 by financial advisers at Commonwealth Financial Planning Limited (CFPL), part of the Commonwealth Bank of Australia Group (CBA).

The report includes 61 recommendations that aim to bolster ASIC's ability to fulfil its responsibilities more effectively and also promote greater public confidence in the corporate regulator. Key recommendations include building analytical and investigative skills within ASIC, changing the internal culture to promote a receptive culture regarding complaints so that they are elevated where appropriate, and improving the whistleblowing regime. The Committee also recommended greater transparency of ASIC's processes as well as a reconsideration of how regulatory mechanisms are used and how compliance is monitored. Further, funding by industry levies was recommended to encourage better self-regulation.

On 26 June 2014, ASIC responded to the report noting that some recommendations are directed at ASIC's procedures and on those ASIC has already made several changes, including:

- ASIC's handling of whistleblowers;
- increased transparency of ASIC's processes;
- mechanisms to identify emerging risks; and
- the way ASIC ensures enforceable undertakings deliver good results for consumers.

On CFPL, ASIC has acknowledged that its actions in 2008 could have been improved in three ways:

- ASIC should have acted faster to remedy the misconduct at CFPL when it became apparent the firm was not dealing adequately with its own poor advice problems;
- ASIC's action against CFPL should have been more transparent; and
- ASIC should have communicated more effectively with the whistleblowers who contacted ASICs concerning poor practices at CFPL.

ASIC has also taken steps to remedy the inconsistent treatment of customers in the compensation process. It is imposing licence conditions that will ensure equal treatment of customers and will result in over 4,000 customers having the chance to reopen the question of compensation and be provided with $5,000 to obtain independent advice to assist them consider their options.

The report is available on the Parliament of Australia's website.

1.11 Revised principles for supervisory colleges published by the Basel Committee

On 26 June 2014, the Basel Committee on Banking Supervision issued revised "Principles for effective supervisory colleges".

Supervisory colleges are working groups of regulators (or supervisors) of the parent company and key branches or subsidiaries of an international banking group. The overarching objective of a supervisory college is to assist its members in developing a better understanding of the risk profile and vulnerabilities of a cross-border banking group and to provide a framework for addressing key topics that are relevant to the supervision of the group.

Key revisions include:

- greater emphasis on ongoing collaboration and information-sharing, as well as the expectation that home and host supervisors will put in place appropriate mechanisms and sufficient resources for effective and timely information exchange;
- differentiation between colleges and crisis management groups (CMGs) for banks that are subject to both structures, e.g. systemically important banks, and guidance on possible communication and coordination between the college and the CMG on crisis preparedness; and
- alignment across the principles on how macroprudential information is shared and used.

The revised principles and further information are available on the BIS website.

1.12 IOSCO report on risk identification and assessment methodologies for securities regulators

On 26 June 2014, the International Organization of Securities Commissions (IOSCO) published a report on "Risk Identification and Assessment Methodologies for Securities Regulators", which provides a practical overview of the methods, approaches and tools that IOSCO and securities regulators have developed to identify and assess emerging and potential systemic risks.

The paper is organised around the following themes:

- Definition of Risk;
- IOSCO Risk Identification Methods;
- Risk Identification Methods used by Securities Regulators; and
- An Analytical Framework for Assessing Systemic Risks.

The report is available on the IOSCO website.

1.13 Proposed revisions to Pillar 3 disclosure requirements published by the Basel Committee

On 24 June 2014, the Basel Committee on Banking Supervision published for consultation its "Review of the Pillar 3 disclosure requirements".

The proposed revisions aim to enhance comparability across banks by ensuring greater consistency in the way they disclose information about risk exposures. The review was prompted by concerns that the Basel framework's existing Pillar 3 disclosure regime failed to promote the early identification of a bank's material risks and did not provide sufficient information to enable market participants to assess a bank's overall capital adequacy. A particular goal of the proposed revisions is to improve the transparency of the internal model-based approaches that banks use to calculate minimum regulatory capital requirements. Under the revised regime, for example, banks would be required to disclose the drivers of changes in risk-weighted assets and the actual versus forecast performance of certain modelling parameters.

The consultative document and further information are available on the BIS website.

1.14 Cross-border bank resolution - Recent developments

In June 2014, the International Monetary Fund (IMF) released a report "Cross-Border Resolution - Recent Developments".

Developing an effective framework for cross-border resolution is a key priority in international regulatory reform. Large bank failures during the global financial crisis brought home the lack of adequate tools for resolving "too-big-to-fail" institutions. In cross-border cases, misaligned incentives and lack of robust mechanisms for resolution and cross-border cooperation left some country authorities with little choice but to take unilateral actions, which contributed to the high fiscal costs of the crisis and resulted in disorderly resolution in some cases.

The report is available on the IMF website.

1.15 State of CSR in Australia and New Zealand: Report

In July 2014, the Australian Centre for Corporate Social Responsibility (ACCSR) released "State of CSR in Australia and New Zealand Annual Review 2014".

The Annual Review suggests that future progress in corporate social responsibility will be closely tied to innovation in the arenas of supply chain, environment, reporting and collaboration with stakeholders, as well as leadership support.

Despite a general lack of integrated CSR practice, the 2014 survey highlights examples of good CSR leadership within Australian organisations.

The Annual Review is available on the ACCSR website.

1.16 Financial Hardship - The Legal Frameworks: Research Report

The Financial Hardship Project at Melbourne Law School is the first in-depth study of the practical operation of Australia's financial hardship laws, which are designed to protect consumers from suffering financial hardship, facilitate the performance of monetary obligations, and thus forestall default and bankruptcy. The project has published its first research report. The report outlines all of the legal frameworks that have been implemented to provide consumers with financial hardship protections in the last two decades. In the consumer credit and finance sectors, there is a national framework of financial hardship protections comprising the provisions of the National Consumer Credit Protection Act 2009 (Cth) and the National Credit Code; related case law; and self-regulatory initiatives by particular industries. In the essential services sector, financial hardship protections remain state-based, although the energy industry has also seen a move towards a national approach to consumer protection. In the telecommunications sector, a national framework of protections has also been put in place. This report provides an overview of all of these frameworks, focusing upon their history and objectives, and laying a foundation for later empirical research.

The report is available on the Melbourne Law School website.

2. Recent ASIC Developments

2.1 Australian students PISA financial literacy test results

On 9 July 2014, ASIC welcomed the results of the first international study of students' financial literacy but says there is more to be done to prepare young Australians for the challenges of financial decision-making beyond school.

Released by the OECD as part of its Programme for International Student Assessment (PISA) 2012, the study assessed the extent to which 15-year-olds across 18 countries have the financial literacy knowledge and skills to successfully transition from school into higher education, employment or entrepreneurship.

Australian students scored significantly higher than the OECD average, ranking equal third (fourth highest) out of the 18 participating countries and economies.

The release of the PISA study coincides with ASIC's release of an independent evaluation by the Australian Council of Educational Research (ACER) of its implementation of the Australian Government's Helping Our Kids Understand Finances (HOKUF) initiative - now known as ASIC's MoneySmart Teaching program. The evaluation found that ASIC's implementation met the criteria of appropriateness, effectiveness and efficiency.

ASIC's MoneySmart Teaching program is the only national financial literacy program for schools supported by states and territories and endorsed by Education Ministers through a National Partnership Project Agreement. The program aims to promote and support consumer and financial literacy in schools through teacher professional development and quality teaching resources aligned to the Australian Curriculum.

ASIC's MoneySmart Teaching resources are freely available at moneysmart.gov.au/teaching

Further information about the PISA study as well as the Australian National Report produced by the Australian Council for Educational Research (ACER), "Financing the Future: Australian students' results" in the PISA 2012 Financial Literacy assessment are available on the ACER website.

2.2 ACCC and ASIC revise guidelines for businesses and consumers on debt collection activities

On 8 July 2014, the Australian Competition and Consumer Commission (ACCC) and ASIC launched an updated version of their "Debt collection guideline: for collectors and creditors" (ASIC reference: Regulatory Guide 96).

The revised guideline will further assist creditors, collectors and debtors to understand their rights and obligations, and ensure that collection activity is undertaken in a way that is consistent with the important Commonwealth consumer protection laws that the ACCC and ASIC administer.

The regulatory guide is available on the ASIC website.

2.3 ASIC report on fee disclosure practices for super and managed investments

On 8 July 2014, ASIC released a report on its review of fee and cost disclosure practices in the superannuation and managed investment industry.

The report identifies:

- key issues where inconsistent disclosure of fees and costs occur, including non-disclosure of fees and costs relating to investment in underlying investment vehicles, incorrectly disclosing fees net of tax and inconsistent disclosure of performance fees;
- ASIC's view on proper disclosure with regard to the key issues identified; and
- further work that ASIC will undertake to assist industry in meeting its fee and cost disclosure obligation.

This work will include providing industry further guidance, modifying the requirements in the law to make it clearer and less costly to comply with and encouraging industry to develop standards that build on the guidance.

The report is available on the ASIC website.

2.4 ASIC provides interim relief on key management personnel equity

On 1 July 2014, ASIC announced the release of a new Class Order [CO 14/632] "Key management personnel equity instrument disclosures", to assist in the preparation of directors' reports for financial years ending on or before 30 September 2014.

The class order has been issued to address drafting anomalies in key management personnel disclosure requirements that were moved from accounting standard AASB 124 Related Party Disclosures (AASB 124) into the Corporations Regulations 2001

(Cth) for financial years starting on or after 1 July 2013. The relevant disclosures relate to:

- equity instruments held by members of key management personnel or their close family members;
- certain transactions involving equity instruments between the disclosing entity and members of key management personnel or their close family members; and
- options or rights over equity instruments held by key management personnel or their close family members.

The class order narrows the disclosure required by entities about equity instruments held by directors, other key management personnel and their close family members. Consistent with AASB 124, ASIC's relief means that disclosures only need to be about equity instruments in the disclosing entity or its subsidiaries rather than every company they have an investment in. Entities that adopt the relief will be required to make the disclosures by class of the equity instrument, consistent with AASB 124.

The relief has been granted on an interim basis (applying to reports for financial years ending on or before 30 September 2014) in anticipation of law reform correcting the drafting anomalies.

The class order is available on the ComLaw website.

2.5 ASIC findings from 31 December 2013 financial reports

On 27 June 2014, ASIC announced the results from a review of the 31 December 2013 financial reports of 135 listed and other public interest entities.

The review saw ASIC contact 23 companies about their reports. Matters ASIC looked at included inadequate impairment of assets and inappropriate accounting treatments.

Inquiries of a company will not necessarily lead to material restatements. Matters involving six of the entities ended without any changes to their financial reporting.

While the results from ASIC's review of 31 December 2013 are incomplete, risk-based surveillance led to material changes to 4% of the financial reports previously reviewed for reporting periods ended 30 June 2010 to 30 June 2013.

Further information is available on the ASIC website.

2.6 ASICs audit inspection findings for 2012-13

On 27 June 2014, ASIC released the results of its risk-based inspections of audit firms for the 18 months to 31 December 2013.

(a) Findings

In ASIC's view, in 20% of the total 454 key audit areas that were reviewed across 107 audit files at firms of different sizes, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 18% for ASIC's report covering the previous 18-month period ending in June 2012. While overall levels of findings have not yet improved, the largest six audit firms only finalised their action plans on audit quality for 30 June 2013 year-ends, and these plans are yet to have full effect.

ASIC's inspections suggest that the following three broad areas continue to require improvement by audit firms:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- ensuring appropriate reliance on the work of experts and other auditors.

Many of ASIC's findings related to accounting estimates (including impairment of assets) and accounting policy choices.

(b) Initiatives to improve audit quality

ASIC's report outlines areas that auditors should consider in order to improve audit quality and the consistency of audit execution, as well as future focus areas for audit inspections. ASIC also discuss actions that audit firms, directors and audit committees, standard setters, accounting bodies and others can take to support audit quality.

The report is available on the ASIC website.

3. Recent ASX Developments

3.1 OTC clearing amendments

On 7 July 2014, ASX made amendments to the OTC Clearing Rules to:

- extend the OTC product eligibility criteria to cover 1 month floating rate products and increase the eligible product maturity to ten years; and
- extend the OTC Client Clearing service to institutional clients based in Singapore and Hong Kong.

A Consultation Paper seeking feedback from OTC Participants and their clients was published in April 2014.

The Consultation Paper and ASX's response to consultation feedback are available on the ASX website.

3.2 ASX Listing Rules - Corporate governance amendments

On 1 July 2014, ASX made some amendments to the ASX Listing Rules. The changes complement the third edition of the ASX Corporate Governance Council's Principles and Recommendations and afford listed entities greater flexibility to make their corporate governance disclosures on their website rather than in their annual report. This includes their "if not, why not" corporate governance statement under Listing Rule 4.10.3. If they publish that statement on their website rather than in their annual report, they simply have to include in their annual report the URL of the web page where it appears.

Listing Rule 4.10.3 has been amended to require an entity's corporate governance statement to specify the date at which it is current, which must be the entity's balance date or a later date specified by the entity, and to state that it has been approved by the entity's board. The amendments also clarify what an entity should disclose if it has not followed a particular Council recommendation.

Listing Rule 4.7 has been amended to require a listed entity to lodge with ASX at the same time as it lodges its annual report with ASX:

- a completed Appendix 4G; and
- if the entity has chosen to include its "if not, why not" corporate governance statement on its website rather than in its annual report, a copy of that statement.

Appendix 4G serves a dual purpose - it is a verification tool that entities and ASX can use to verify that an entity has made the various disclosures called for under the third edition and the Listing Rules, and a key that investors can use to find those disclosures. The requirement to lodge a copy of the corporate governance statement recognises that an entity will likely update the information on its website from time to time and ensures there is a snapshot of its corporate governance statement at a point in time available on the Market Announcements Platform for stakeholders to review.

Numerous other Listing Rule changes came into effect on 1 July 2014. ASX's Supplementary Consultation Response, published on 6 May, provides an outline of those changes.

There are, however, three important changes that ASX highlights for attention:

- new Listing Rule 4.10.22, requiring a listed entity to disclose in its annual report any on-market purchases of securities over the course of the reporting period under or for the purposes of an employee incentive scheme or to satisfy the entitlements of the holders of options or other rights to acquire securities granted under an employee incentive scheme. This replaces the proposed Listing Rule 3.19B ASX consulted upon that would have required such purchases to be disclosed on a continuous basis. This new rule came into effect on 1 July 2014 for the first full financial year of a listed entity occurring on or after that date; and
- the changes to Listing Rule 10.17, clarifying a number of issues concerning non-executive director fees, which came into effect on 1 July 2014.

The changes to the proxy form requirements in Listing Rule 14.2, which also came into effect on 1 July 2014.

These include removing the requirement for the so-called "chairman's box" but adding new requirements:

- that a proxy form give security holders the ability to direct their proxy to abstain from voting on a resolution, as well as to vote for or against the resolution; and
- if the proxy form specifies that the chair of the meeting is appointed as proxy if a security holder does not appoint a proxy, or if the chair is appointed proxy by default, that the proxy form include a statement as to how the chair intends to vote undirected proxies.

The Supplementary Consultation Response is available on the ASX website.

3.3 Enhanced service levels and information handling standards

On 1 July 2014, ASX released its response to feedback on its consultation on enhancements to its service level commitments and Information Handling Standards for the Trade Acceptance Service and the Settlement Facilitation Service. In response to the Consultation Paper, ASX received written submissions from Chi X Australia and Asia Pacific Stock Exchange.

The response and the submissions from Chi X Australia and Asia Pacific Stock Exchange are available on the ASX website. The Consultation Paper is also available.

3.4 ASX Submission to the Competition Policy Review

On 24 June 2014, ASX lodged its submission to the Government's Competition Policy Review. The submission notes that a modern competition policy needs to look outward, supporting market structures and incentives for businesses to compete globally from Australia, as well as delivering efficiencies to, and protecting, consumers and small business within Australia. The policy now needs to balance the focus on competition within Australia with a greater focus on the competitiveness of Australia.

The submission is available on the ASX website.

3.5 Introduction of close-out netting for ASX Clear

On 23 June 2014, the ASX Clear Operating Rules were amended to give Clearing Participants the right to terminate novated contracts in the event of ASX Clear's default. The amendment has been introduced in response to feedback from Clearing Participants and delivers capital efficiencies to Clearing Participants that are part of banking groups.

The notice announcing the change is available on the ASX website.

3.6 Oxera global cost benchmarking of ASX's post-trade equity services

On 23 June 2014, ASX released the Oxera Global cost benchmarking of cash equity clearing and settlement services report. ASX Clear and ASX Settlement commissioned Oxera, a leading independent European economics consultancy, to benchmark the costs of using ASX's cash equity post-trading (clearing and settlement) services against the costs of using the services provided by financial market infrastructure providers (FMIs) in other financial centres. The annual costs to the Australian economy of cash equities clearing is $42 million and for settlement $40 million, based on ASX's FY13 financials.

The global cost benchmarking is part of ASX's commitment under its Code of Practice. ASX's other commitments under the Code of Practice include providing transparent and non-discriminatory access to and pricing of its cash equities clearing and settlement services, and the creation of an advisory Forum comprising senior customer and industry stakeholders. All commitments have been put in place.

The Oxera report concludes that "the costs of post-trading services in Australia are in line with the costs of similar services provided in financial centres of comparable size".

Further information is available on the International Cost Comparisons page on the ASX website. The media release and Oxera's report are also available.

3.7 Use of Twitter during market wide operational or technical incidents

Following recent enhancements to ASX Notices, ASX will extend its communications reach through its Twitter account (@ASX) to communicate market wide operational or technical incidents should they occur.

In the event of an incident occurring that impacts the production environment for any of ASX's key systems, or is significant enough that all of the market and its users should be aware, a message (tweet) will be sent via Twitter.

The tweet (an update broadcast by @ASX over Twitter) will include a link to the system status page on ASX.com.au where additional information, previous communications and a status of the incident can be viewed. During an incident the system status pages are regularly updated by ASX.

Please note that the use of Twitter to communicate incidents does not replace any of the existing communication mechanisms.

The notice announcing the change is available on the ASX website.

3.8 Reports

On 3 July 2014, ASX released:

- the ASX Group Monthly Activity Report;
- the ASX 24 Monthly Volume and Open Interest Report; and
- the ASX Compliance Monthly Activity Report

for June 2014.

4. Recent Takeovers Panel Developments

4.1 Envestra Limited - Panel declines to conduct proceedings

On 9 July 2014, the Panel declined to conduct proceedings on an application dated 1 July 2014 from Envestra Limited (Envestra) in relation to its affairs (see TP14/53).

Envestra is the subject of a conditional off-market takeover bid by CK ENV Investments Pty Ltd (CK ENV), a member of the CK Consortium. The bid was announced by Envestra and CK ENV on 30 May 2014 and both announcements, which were agreed by the parties, also stated:

> Envestra shareholders will be entitled to receive a final dividend of up to $0.035 per Envestra share in respect of the financial year ending 30 June 2014, provided that such dividend is declared (or determined to be paid) on or prior to 21 August 2014 (Final Dividend) without any reduction to the [Consortium] Offer price of $1.32 per [Envestra] share.

CK ENV's offer will close on 8 August 2014, unless extended.

In an announcement made on 20 June 2014, Envestra stated that it proposed declaring a final dividend of $0.035 per share with accelerated ex-dividend and record dates around mid-July 2014 but that the CK Consortium objected to the declaration of a dividend in those circumstances. In a media release later that day, the CK Consortium stated that it had no objection to the declaration of a final dividend but did object to the accelerated timetable for declaration and payment.

Envestra applied to the Panel for a declaration of unacceptable circumstances on the basis (among others) that the objection was designed to deter early declaration of the final dividend and deprive shareholders of the benefit of the final dividend. Envestra sought final orders including to the effect that Envestra shareholders who accept the offer also receive the final dividend in addition to the offer amount of $1.32 per share.

The Panel noted that Envestra had not yet declared its final divided and that the CK Consortium has not advised whether, if necessary, it would extend the offer period so that the record date for the final dividend would be before the offer closed or would decline to do so. In the circumstances, the Panel considers that no unacceptable circumstances have arisen yet. Accordingly, the Panel declined to conduct proceedings.

It appears to the Panel, without the benefit of submissions from the parties, that the statement in the 30 May 2014 announcements may be a statement to which truth in takeovers policy applies. If, in future, the statement was departed from, the Panel considers that a fresh application could be made.

The reasons for the decision are available on the Takeovers Panel website.

4.2 Sherwin Iron Limited - Panel declines to conduct proceedings

On 3 July 2014, the Panel declined to conduct proceedings on an application dated 19 June 2014 from Jerry Ren and his related parties Citizen International Investment Pte Ltd and Citizen International Investment Limited (together, Citizen Parties) in relation to the affairs of Sherwin Iron Limited (Sherwin).

The application concerned a 1 for 1 non-renounceable rights issue and a share purchase plan by Sherwin to raise up to approximately $41 million and the potential effect on control arising from the Citizen Parties, who hold 78.17% of Sherwin, not participating (see TP14/43). At the request of the Citizen Parties, pursuant to s. 249D of the Corporations Act 2001 (Cth), Sherwin has convened a meeting of shareholders to consider removing three of the existing directors and replacing them with three directors nominated by the Citizen Parties, including Mr Ren.

The Panel questions the Sherwin board's decision to delay holding the shareholders meeting until after the close of the rights issue. Despite some concerns with aspects of the structure of the rights issue, including its size and the discretion to place shortfall shares, the Panel largely considered that, among other things, Sherwin had a very considerable need for funds and, given this, it was unlikely that it would make orders as requested, namely not to proceed with the right issue.

Accordingly, the Panel declined to conduct proceedings.

The Panel noted the likely shortfall from the rights issue and considered that a fresh application could be made by the Citizen Parties, or a person interested, if events arising from Sherwin's placement of shortfall shares warranted it.

The reasons for the decision are available on the Takeovers Panel website.

4.3 Panel publishes Revised Guidance Note 18

On 21 July 2014, the Takeovers Panel published a revised version of Guidance Note 18: Takeover Documents.

On 10 January 2014, the Panel issued a consultation paper in relation to proposed changes to Guidance Note 18. The Panel received four submissions in response.

The main change proposed to Guidance Note 18 in the consultation paper related to the accessibility of takeover documents. The proposals encouraged the use of a summary section in takeover documents, primarily for retail shareholders.

Following consultation, the Panel has amended Guidance Note 18 to ensure that the proposals were not interpreted as unduly prescriptive. The Panel has also made it clear that the contents of a summary will depend on the particular transaction.

The revised Guidance Note 18 is available on the Takeovers Panel website.

5. Recent Research Papers

5.1 Influence of public opinion on investor voting and proxy advisors

The authors examine the evolution in voting patterns across firms over time. They find that investors have become more independent in their voting decisions, voting less with the recommendations of management or proxy advisors. Even when the proxy advisor recommends voting against a proposal, they find that over time investors are more likely to ignore the recommendation. Moreover, they also find that proxy advisory recommendations have become more supportive of shareholder proposals. The authors' main contribution is to examine the role of public opinion in influencing institutional voting. They show that public opinion on corporate governance issues, as reflected in media coverage and surveys, is strongly associated with investor voting, particularly mutual fund voting.

The paper is available on the SSRN website.

5.2 Independent directors and controlling shareholders around the world

The authors examine independent directors as a legal transplant from dispersed ownership systems to concentrated ownership ones. They focus on continental Europe, Japan, Brazil, Russia, India and China. The main thesis is that independent directors have a different and relatively narrower role to perform in controlled corporations. The authors also argue that in the law and practice of controlled corporations independent directors often play an even weaker role than economic theory would predict. In order to prove their thesis, the authors compare the legal regimes applicable to independent directors across countries. They find that the notion and functions of independent directors vary remarkably across their sample jurisdictions. First, the role of independent directors is not always specified. Second, independent directors often play a role in audit committees and, less frequently, in nomination and remuneration committees. However, they are rarely tasked with the vetting of related-party transactions and other conflicts of interest situations. Moreover, controlling shareholders often perform some of the functions that are typical of independent directors in diffuse ownership, such as the hiring and firing of managers and the setting of their remuneration. The authors conclude that the weak role of independent directors in several countries shows that they are often appointed mainly to accommodate investors' preference for Western-style corporate governance.

The paper is available on the SSRN website.

5.3 "Say-on-Pay" votes and compensation practices

The authors examine the causes and consequences of "say-on-pay" votes mandated by the US *Dodd-Frank Act of 2010*. They hypothesise and find that shareholder disapproval increases with the amount of total and abnormal compensation, decreases with the number of pay-restraining provisions, and decreases with the quality of compensation disclosures. Shareholder disapproval also correlates with contemporaneous director turnover. They also find that boards respond to shareholder disapproval by amending compensation policies to reduce that opposition. Such alterations do have the hypothesised effect of reducing the amount of shareholder dissent for the following year.

The paper is available on the [SSRN website](#).

5.4 Does mandatory shareholder voting prevent bad acquisitions?

Corporate acquisitions can be ruinous for acquirer shareholders. Can shareholder voting prevent such corporate disasters? Previous empirical studies based on US data are inconclusive because shareholder approval is discretionary. The authors study the UK setting where bids for relatively large targets are subject to mandatory shareholder approval. Their findings suggest that under the UK listing rules shareholder voting can deter bad acquisitions. The authors find that shareholders gain 8 cents per dollar at the announcement of a Class 1 deal or US$13.6 billion over 1992-2010 in aggregate. In the United States acquirers lost US$214 billion in matched deals during the same period. In the UK relatively smaller Class 2 transactions do not require a vote and shareholders lost US$3 billion. The results are robust to confounding effects and other controls. A Multidimensional Regression Discontinuity Design (MRDD) inspired test supports a causal interpretation of the findings. Class 1 deals just above the assignment threshold perform better than Class 2 deals just below. The evidence suggests that mandatory voting makes boards more likely to refrain from overpaying or from proposing deals that are not in the interest of shareholders.

The paper is available on the [SSRN website](#).

5.5 A defence of proxy advisors

Proxy advisors have dramatically transformed shareholder voting. Traditionally, even large institutional investors tended to follow the Wall Street Rule - vote with management or sell your stock - because the economics did not justify incurring any expense in deciding how to vote. The emergence of proxy advisors who perform proxy research for a modest fee paid by each of thousands of institutions now enables these investors to vote intelligently. New laws and rules have also expanded the range of matters on which shareholders vote. Because of these developments, business managements can no ignore but must cater to shareholder interests. However, corporate managers resent being dethroned. They are mounting a campaign to press the SEC to impose new regulations to hobble proxy advisors and, thereby, to neutralize institutional shareholders. This article reviews the charges levelled against proxy advisors and the new regulations proposed by their critics. It finds the complaints mostly unwarranted. Institutional investors are sophisticated and market forces minimise any problems with proxy advisors. With a few minor exceptions, new regulations are not needed and would be counterproductive.

The paper is available on the SSRN website.

5.6 Hedge fund activism coming to Europe? Lessons from the American experience

Hedge fund activists are the bright new hope of the shareholder empowerment movement. Free from conflicts of interest and with high-powered compensation incentives, activist hedge funds are shaking up corporate boardrooms. The recent surge in activism has provoked criticism against activist investors portrayed as short-term agitators seeking to obtain short-term profits at the expense of long-term value. Although the view of hedge fund activists as short-term speculators has been discredited by empirical evidence, innovative tactics employed by hedge funds allow them to secretly accumulate large stakes in target companies within a short-time period. In response to the adverse effects of activist tactics on market transparency and fairness, European regulators have tightened disclosure obligations for major blockholders with US regulators following suit. While calls for tightening disclosure obligations in the US have been accompanied by a lively debate between proponents and opponents of tighter disclosure rules, the amendment of disclosure rules in Europe was not preceded by any meaningful empirical analysis of the benefits and costs of tighter disclosure rules. The result is that current European disclosure rules tilt the balance heavily against activist investor seeking to operate in Europe. In line with the growing debate across the other side of the Atlantic which has highlighted the importance of empirical analysis before proceeding with a modification of disclosure rules, the present article urges European regulators to reconsider the current disclosure regime by conducting a careful empirical analysis of their benefits for market transparency and fairness and their costs on shareholders and companies as a result of a reduction in the incidence of activist shareholdings.

The paper is available on the SSRN website.

5.7 Regulating financial market infrastructures

This paper focuses on the impact of financial market infrastructures (FMIs) and of their regulation on the post-crisis transformation of securities and derivatives markets. It examines, in particular, the role that trading and post-trading FMIs, and their new regulatory regime, are playing in the expansion of 'public' securities and derivatives markets, and the progressive shrinkage of 'private' markets (which broadly coincide with the 'unregulated' or 'less regulated' over-the-counter (OTC) markets).

The paper provides an overview of the policy approaches underlying the international crisis-era reforms to FMIs, and focuses on the dichotomy between the "systemic risk" and "transaction costs" approaches to financial markets and FMIs regulation. By reviewing the current move from "private" markets to "public" markets internationally, and with respect to the EU and US regimes, the authors analyse the role of trading infrastructures as liquidity providers, both in the securities markets and in the derivatives markets. And, shifting the focus to post-trading infrastructures - central clearing houses (CCPs), central securities depositories (CSDs), and trade repositories (TRs) - the authors address their role in supporting financial stability and market transparency. They conclude by identifying how regulators are now more deeply involved in FMIs' governance and operation. They argue that such policy approach resulted in regulatory initiatives which move in the direction of increasing the systemic scope of FMIs, introducing elements of publicity in private markets, and calling for higher public supervision.

The paper is available on the SSRN website.

6. Recent Corporate Law Decisions

6.1 Secured creditors gain subrogation rights to s. 433 payments made by receivers to employees

(By Sally Milner, Mimosa Rizzo and Adam Purton, Corrs Chambers Westgarth)

Divitkos, in the matter of ExDVD Pty Ltd (in liquidation) [2014] FCA 696, Federal Court of Australia, White J, 30 June 2014

The full text of this judgment is available online.

(a) Summary

In this decision, White J confirmed the right of a secured creditor, whose security had been diminished by receivers' payments of entitlements to employee creditors pursuant to s. 433 of the Corporations Act 2001 (Cth) (the Corporations Act), to be subrogated to the entitlements of those creditors to the free funds in the later liquidation of the company. In doing so, White J recognised that he may have created a new class of equitable subrogation.

In late 2008, the Commonwealth Bank of Australia (CBA) appointed receivers to ExDVD Pty Ltd (ExDVD) and, on the same day, ExDVD was placed into voluntary administration. The creditors of ExDVD later resolved to have the company wound up.

The liquidator applied to the Federal Court for a determination in relation to payments that had been made by the receivers to employees in priority to other unsecured creditors.

The two questions that the Court was asked to address were:

- whether, upon liquidation, CBA was entitled to priority over unsecured creditors, either by subrogation or otherwise, for the amount of the payments made by the receivers; and
- if CBA did have such an entitlement, whether the liquidator was entitled to determine the issue of priority on the basis of the evidence provided by CBA, or whether proof of each of the underlying claims of the employees in respect of whom the payments were made was required.

White J concluded that, although the present circumstances did not fall into any of the established categories of subrogation, those categories should not be regarded as closed. In the circumstances, White J was satisfied that an equitable right of subrogation in favour of CBA should be recognised and held that CBA should be subrogated to the rights of employee priority creditors paid by the receivers.

With respect to the question of evidence, White J held that subrogation did not in itself affect the question of whether a proof of debt ought to be required from each employee or whether a single proof of debt from CBA would suffice. Instead, the sufficiency of the evidence provided by CBA in order to support a proof of debt remained a matter for the liquidator to determine in accordance with the Corporations Regulations 2001 (Cth).

(b) Facts

ExDVD sold DVDs through retail outlets and online. CBA held a fixed and floating charge (the Charge) over the present and future assets of ExDVD and, in late 2008, exercised its power to appoint receivers. Later, on the same day, ExDVD was placed into voluntary administration. In April 2009, the creditors of ExDVD resolved that the company should be wound up and the administrators were appointed as liquidators. After one of the liquidators resigned in November 2013, the plaintiff continued as ExDVD's sole liquidator.

The receivers traded the business of ExDVD until mid-2009, when a sale of the business was completed. During the period between December 2008 and August 2009, the receivers made payments to or on behalf of ExDVD's employees which amounted to $945,557.44. These payments included wages, superannuation contributions and interest, leave entitlements, retrenchment entitlements, bonuses and redundancy payments, and were made from the realisation of the assets secured by the Charge. CBA contended that the receivers were obliged to make the payments as the employees were afforded priority under s. 433 of the Corporations Act.

Section 433 of the Corporations Act requires a receiver taking control of company property following appointment by a debenture holder to pay certain employee entitlements, including wages, superannuation, leave entitlements and retrenchment payments, in priority to the claim of the debenture holder.

With the liquidation of ExDVD nearly concluded, the liquidator was in a position to make a distribution to unsecured creditors. CBA asserted that it was entitled to prove for $945,557.44 as a priority creditor on the basis that:

- its security was diminished by that amount because of the priority payments to employees; and
- it was entitled to be subrogated to the rights of the employees whose claims were given the statutory priority or, alternatively, it had a right of recoupment.

The liquidator sought a determination from the Federal Court on this issue, as well as on the secondary question whether, if CBA did have this entitlement, what evidence of the debt was required.

(c) Decision

(i) Characterisation of payments

White J reviewed the different payments made to, and on behalf of, employees and concluded that, subject to the liquidator being satisfied of the facts and assessing the quantum of CBA's proof of debt, the payments made by the receivers should be regarding as having been made pursuant to s. 433 of the Corporations Act.

White J held that the receivers were obliged to make those payments to employees out of the funds realised from the sale of assets secured by the circulating security interest in priority to any payment to CBA.

(ii) Right to recoupment

Although the right to recoupment of amounts paid under s. 433 as an alternative to subrogation was discussed, the Court found that recognising this right in the current situation would not benefit CBA. CBA sought priority over unsecured creditors which the recognition of the right to recoupment would not provide by itself.

(iii) Right to subrogation

White J was satisfied that a right of subrogation existed. Drawing on the judgment of Finkelstein J in *Cook v Italiano Family Fruit Company Pty Ltd (in liq)* [2010] FCA 1355, his Honour made the following observations:

- there is no all-embracing theory which explains where subrogation should be permitted;
- the situation of a secured creditor, or a receiver appointed to a company by a secured creditor, who makes payments to priority creditors is analogous to that of a person who, other than voluntarily, discharges the security of another. This is a well-recognised circumstance in which the right of subrogation arises;
- similarities can also be drawn between the present case and the classic case where subrogation arises, being the right of subrogation of a person who pays out a prior ranking secured creditor, as set out in *Ghana Commercial Bank v Chandiram* [1960] AC 732; and
- the Corporations Act does not evince an intention that the right of subrogation should be excluded. In fact, the Corporations Act is designed to facilitate early payments to priority creditors. For example, s. 560 provides priority to a person who advances money to a company for the purpose of making payments to employees.

A right of subrogation will not exist where a payment is made voluntarily. However, White J was satisfied that in the present case, the receivers and secured creditor were not strangers or volunteers and that it would be inappropriate to infer that they intended to forego their security by making payments which were required by law. Accordingly, White J was satisfied that the secured creditor was entitled to prove in the liquidation as a priority creditor.

(iv) Evidentiary requirements

The Court held that it was ultimately the responsibility of the liquidator to determine the evidence that CBA must provide to sufficiently support its right to subrogation, similar to the process of assessing all proofs of debt.

6.2 Refusal to grant an application to set aside or stay indefinitely examination summonses under s. 596B of the Corporations Act

(By Jason Choi, DLA Piper)

Equititrust Limited (In Liq) (Receiver Appointed) (Receivers and Managers Appointed) v Equititrust Limited (In Liq) (Receiver Appointed) (Receivers and

Managers Appointed) [2014] FCA 692, Federal Court of Australia, Foster J, 27 June 2014

The full text of this judgment is available online.

(a) Summary

Foster J of the Federal Court of Australia (the Court) considered an application to set aside or stay indefinitely examination summonses (Examination Summonses) under s. 596B of the Corporations Act 2001 (Cth) (the Corporations Act). Section 596B provides a court with discretionary power to summon a person for examination about a corporation's examinable affairs, if the court is satisfied that the person has been, or may have been, guilty of misconduct in relation to the examinable affairs, or the person may be able to give information about the examinable affairs.

The Court dismissed the application, and held that the fact that substantive proceedings had commenced did not warrant an order to set aside or stay the examination.

(b) Facts

The applicant in this case was Equititrust Limited (In Liquidation) (Receivers and Managers Appointed) (Equititrust) as responsible entity of the Equititrust Income Fund (EIF). The respondents were Equititrust Limited (In Liquidation) (Receivers and Managers Appointed) in its own capacity (EQL), three former directors of EQL, KPMG and Paul Steer, a former Partner of KPMG.

Equititrust was the responsible entity of three managed investment schemes, one of which was the EIF. From 2002 to 2010 auditors from KPMG, including Paul Steer (the Auditors), conducted various audits of Equititrust's activities. In 2011 the schemes collapsed, and liquidators were appointed to EQL (the Liquidators) by resolution of its creditors.

On 1 November 2012 the Liquidators successfully applied to the Queensland District Registrar of the Court for orders issuing Examination Summonses to the Auditors under s. 596B of the Corporations Act, as part of the Liquidators' investigations into whether the Auditors conducted the audits negligently.

On 27 September 2013 Equititrust commenced proceedings against EQL by filing an Originating Application and Statement of Claim. Equititrust however did not serve these documents on any of the respondents.

On 1 November 2013 KPMG and Paul Steer (the KPMG Respondents) sought interlocutory orders to set aside or stay indefinitely the Examination Summonses served upon the Auditors while the proceeding remained on foot.

The KPMG Respondents argued that the examinations were to be used for the improper purpose of obtaining a "tactical forensic advantage" through the pre-trial examination of potential witnesses because:

- the examinations were to occur after the commencement of the proceeding;
- Equititrust's Statement of Claim was lengthy and detailed, and had reached a stage of development such that a partner of Equititrust's law firm was confident enough to certify the pleading in accordance with the rules of the Court;
- Counsel's advice on Equititrust's prospects of success in the litigation enabled Equititrust to enter into a Litigation Funding Deed;
- the Auditors were external persons to Equititrust;
- Equititrust's solicitors were involved in the proceeding for a substantial period of time; and
- the Liquidators had concluded their investigation and report into the Auditors' conduct in Equititrust's activities.

(c) Decision

Foster J held that the KPMG Respondents failed to establish a case for setting aside or staying indefinitely any of the Examination Summonses served upon the Auditors. His Honour endorsed Barrett J's observations in *Re LED (South Coast) Pty Ltd* [2009] NSWSC 946 that:

- the mere fact that a substantive proceeding has commenced does not preclude examination, unless the predominant purpose for the examination is to carry out a dress rehearsal for cross-examination, to destroy the credit of potential witnesses or to obtain forensic advantages not otherwise legitimately available; and
- those who allege improper purpose bear the onus of establishing that purpose.

Foster J stated that, even if the KPMG Respondents' arguments were accepted, they did not support the contention that Equititrust's predominant purpose for conducting the examinations was improper. His Honour differentiated between a litigant being in possession of sufficient information to justify filing a pleading and a litigant being in possession of sufficient information to allow an adequate assessment of his or her prospects of succeeding in the action.

Foster J found that Equititrust's position was of the former category because:

- the Examination Summonses were served upon the Auditors long before the commencement of the proceeding and, but for the many adjournments of the Auditors' examinations, the Auditors would have been examined before the commencement of the proceeding;
- Equititrust's Originating Application and Statement of Claim had not been served on any of the respondents, which suggested that the Liquidators wished

to further test their views about Equititrust's prospects of success through the examination process;
- the facts suggested that Equititrust had commenced the proceeding in order to preserve the limitation period associated with its proposed causes of action against the KPMG Respondents;
- the Auditors' abilities to give evidence may still have assisted Equititrust's causes of action against the other respondents;
- the mere fact that the Liquidators possessed documents from KPMG, ASIC and other sources did not prevent them from proceeding with the proposed examinations;
- the fact that a litigation funder had agreed to provide funding to Equititrust did not necessarily mean that the proposed examinations were for an improper purpose; and
- it was a legitimate purpose for the Liquidators to examine the strength of Equititrust's case, the existence and strength of likely defences that may have been available to the KPMG Respondents and the KPMG Respondents' ability to meet any judgment.

Accordingly his Honour dismissed the KPMG Respondents' interlocutory application, and ordered them to pay Equititrust's and the Liquidator's costs.

6.3 Lead plaintiff who does not suffer loss and only seeks declaratory relief has no standing in securities class action

(By Katrina Sleiman and Diana Hu of Corrs Chambers Westgarth)

Melbourne City Investments Pty Ltd v WorleyParsons Limited [2014] VSC 303, Supreme Court of Victoria, Ferguson J, 27 June 2014

The full text of this judgment is available online.

(a) Summary

The case involved an application by a company (the Plaintiff) seeking leave to file a further amended statement of claim. The Plaintiff commenced group proceedings on behalf of itself and all persons who acquired ordinary shares in the defendant company (the Defendant) between 14 August 2013 and 20 November 2013. The application was opposed by the Defendant on the ground that the Plaintiff had no standing to bring the claim.

Importantly, the Plaintiff did not allege that it suffered any loss and only sought declaratory relief. In those circumstances, Ferguson J held that the Plaintiff had no standing to bring the claim as it had no real interest in the prosecution of the proceedings.

(b) Facts

On 1 November 2012, the Plaintiff acquired 28 ordinary shares in the Defendant for a little under $700. The Plaintiff alleged that between August and October 2013, the Defendant announced forecasts of increased earnings on four separate occasions, which it had no reasonable grounds for making and which were misleading or deceptive in breach of s. 1041H of the Corporations Act 2001 (Cth) (the Corporations Act). The Plaintiff further alleged that the Defendant corrected its prediction on 20 November 2013, resulting in a fall in the price of the Defendant's securities.

The Plaintiff alleged that group members suffered loss and are entitled to compensation pursuant to ss. 1041I and 1325 of the Corporations Act. The Plaintiff did not itself make any claim for compensation. Rather, it sought declarations that the Defendant contravened s. 1041H and that the group members are entitled to compensation and interest.

(c) Decision

Ferguson J accepted the Defendant's argument that the Plaintiff had no standing to bring the proceeding. Her Honour noted that a person has standing to enforce a public right provided that either some private right of that person has also been infringed or that the person has a real interest in doing so. The Court will not grant relief if a declaration will not produce any foreseeable consequences for the parties.

In contrast to other group members, the Plaintiff suffered no loss from the Defendant's conduct, as its shares were purchased before the alleged misleading or deceptive statements were made. While Ferguson J accepted that other class members may have standing, the Plaintiff was nonetheless required to show that it, as lead plaintiff, also had standing.

Ferguson J noted that under the Corporations Act, only the Australian Securities and Investments Commission (ASIC) has standing, via s. 1101B(1)(a)(i) of the Corporations Act, to seek a declaration that s. 1041H has been breached. Accordingly, the Plaintiff needed to establish that it had a "real interest" in seeking the declarative relief.

The Plaintiff submitted that the question of real interest, so far as it was concerned, is intimately linked with the foreseeable consequences of the relief sought.

It argued that there are foreseeable consequences associated with:

- the diminution in the value of its shares;

- a desire to avoid the Defendant engaging in further contraventions of s. 1041H due to the possibility of further diminution in the value of its shareholding; and
- a public interest in deterring the Defendant from further contravening the section.

(i) Diminution in the value of its shares

The Plaintiff submitted that group members who have suffered loss may proceed to seek to recover their loss from the Defendant. If there is an award of damages to be satisfied by the Defendant, the Plaintiff will suffer a reflective loss as a member, which it said is of real consequence to it.

The Plaintiff argued that because it and the group members are not outsiders, it is not prevented from bringing the action because of s. 124(2) of the Corporations Act, which provides that: "A company's legal capacity to do something is not affected by the fact that the company's interests are not, or would not be, served by doing it". Her Honour accepted that s. 124(2) did not prevent the claim that the Plaintiff sought to bring. But in her Honour's view, nor did it sanction it. It did not give the Plaintiff standing. Section 124(2) does not have anything to do with a claim by a shareholder against the company. Rather, it brings out the distinction between the company's capacity to perform an act and the abuse of powers by directors.

In the present case, Ferguson J noted there is no claim against the Defendant's directors in the proceeding. Her Honour held that it cannot be that the potential for such a claim at a later time, dependent, as it must be, on a myriad of unknown factors (including the outcome of the claim that the Plaintiff purports to bring) is sufficient to found standing in the Plaintiff to bring the current proceeding.

Her Honour relied on *Australian Agricultural Co v Oatmont Pty Ltd* (1992) 8 ACSR 255 (*Oatmont*). In that case, Mildren J held that in some instances, a shareholder may have standing to seek a declaration that the proposed activity is unlawful. His Honour gave as an example the situation where there is a derivative claim against the directors which the shareholder would bring in the name of the company. In that circumstance, his Honour was of the view that a shareholder might have a sufficient interest to bring an action for a declaration. However, his Honour held that a shareholder may not bring a claim against the company simply because the company has suffered damage which results in a diminution in the value of the shares. The diminution in share value is simply reflective of the loss suffered by the company.

Relying on *Oatmont*, the Plaintiff argued that it fell within the derivative action exception to which Mildren J referred. It argued that if the group members could recover their loss from the Defendant, the Defendant may sue its directors. If the Defendant failed to do so, then the Plaintiff and group members could each bring a derivative action. Ferguson J did not accept this argument. Her Honour held that a better interpretation of *Oatmont* was that where a derivative action has already been filed against the directors, then a shareholder may have standing to seek declaratory relief. This was not applicable to the present situation.

The Plaintiff also argued that *Oatmont* should be distinguished, as it was not a representative action and did not involve the public interest considerations that are engaged in proceedings such as the present case. However, her Honour saw no reason to depart from the principle espoused in *Oatmont* that where a shareholder could not bring a derivative action, a possible diminution in share price alone does not give the shareholder standing to restrain the company from breaching the law.

(ii) Deterrence

The Plaintiff placed more reliance on what it saw as the other foreseeable consequences that flow from the declarations sought, being generally deterring companies from breaching s. 1041H of the Corporations Act and in specifically deterring the Defendant from misleading its shareholders in the future.

The Plaintiff relied on *CSL Australia Pty Ltd v Minister for Infrastructure and Transport* (2012) 265 FLR 247 to argue that a "public interest" in deterring large listed companies from beaching s. 1041H of the Corporations Act was relevant to determine standing. While the public interest was considered in that case, Ferguson J did not accept that this factor alone would have given the applicant standing. On the facts, the applicant had an "obvious real interest" (as a licence holder who would be affected by decisions of the Minister) in seeking the declaration. In contrast, her Honour found that the Plaintiff had no comparable real interest.

Furthermore, Ferguson J noted there was no allegation that the Defendant is likely to breach s. 1041H of the Act in the future. Without this threatened contravention, a court cannot grant declarative relief "at the behest" of a private citizen for some kind of specific or general deterrence. There was no reason that the Plaintiff should be elevated above an ordinary member of the public, as it is not a regulator.

Ferguson J accepted that declaratory relief is commonly sought in class actions. However, her Honour observed that class actions are nonetheless a vehicle for the lead plaintiff to claim loss, which the Plaintiff does not seek in the present proceedings. Where only declaratory relief is sought, her Honour saw no reason to depart from the usual principles that apply to determine whether the lead plaintiff has standing simply because the proceeding is a representative one.

6.4 Debt for equity via a deed of company arrangement

(By Alissa Crittenden, Clayton Utz)

In the matter of Mirabela Nickel Ltd (subject to deed of company arrangement), [2014] NSWSC 836, Supreme Court of New South Wales, Black J, 23 June 2014

The full text of this judgment is available online.

(a) Summary

The Court approved the transfer of 98.2% of shares in Mirabela Nickel Ltd (subject to a deed of company arrangement) (Mirabela) through the vehicle of a deed of company arrangement, pursuant to s. 444GA of the Corporations Act 2001 (Cth) (the Corporations Act). Section 444GA of the Corporations Act permits a deed administrator to transfer shares in the company with either the written consent of shareholders or the leave of the Court, and the Court may only grant leave where the transfer would not result in "unfair prejudice" to the interests of the shareholders. The shares were proposed to be transferred to a related entity of Mirabela, namely Mirabela Investments Pty Ltd (subject to a deed of company arrangement) (Mirabela Investments), as part of a broader recapitalisation and restructuring of Mirabela. The Court found that, in circumstances including that the shares in Mirabela were of no value, the deed administrators' application satisfied the requirement that the members of Mirabela would not be unfairly prejudiced by the proposed transfer of shares.

(b) Facts

Mirabela was listed on the Australian Stock Exchange (ASX) on 14 July 2004. On 14 May 2014, 876,801,147 shares were on issue to approximately 3,700 shareholders. Mirabela is part of a broader corporate group (Mirabela Group), the principal asset of which is an open pit nickel sulphide mine in Santa Rita, Brazil. In mid-October 2013 the Mirabela Group encountered financial difficulty due to a declining spot nickel price and the loss of a major customer to whom nickel concentrate produced from the mine was sold.

On 7 October 2013, Mirabela's trading on the ASX was suspended.

At that time, it had several principal debt facilities in place, namely:

- a US$395 million of senior unsecured notes issued by Mirabela under an indenture, guaranteed by Mirabela Investments and the Mirabela Brazilian entity which held the interest in the nickel mine (Mirabela Brazil). Mirabela defaulted under the indenture by failing to make the requisite interest repayments;
- a US$55 million master funding and lease agreement with Caterpillar Financial Services Corporation (Caterpillar) to which Mirabela Brazil was party, guaranteed by Mirabela, of which US$5 million was outstanding at the relevant time;

- a US$50 million credit facility advanced by Banco Bradesco SA (Bradesco) to which Mirabela Brazil was party, secured against certain offtake contracts held by Mirabela Brazil and guaranteed by Mirabela, of which US$47.2 million was outstanding; and
- a US$4.42 million supplier credit agreement to which Mirabela Brazil was party, guaranteed by Mirabela, of which approximately US$1.5 million was outstanding.

In November 2013, Mirabela entered into standstill agreements with its financiers and a recapitalisation plan was developed. In December 2013, a group of the unsecured note holders advanced an interim loan of US$45 million via a syndicated note subscription deed.

Approximately 70 parties were approached between December 2013 and January 2014 to seek to elicit a sale or recapitalisation proposal, without success.

In February 2014, an ad-hoc group of unsecured note holders proffered the recapitalisation plan to which the s. 444GA application ultimately related (the Proposed Recapitalisation Plan).

In essence, the Proposed Recapitalisation Plan involved:

- the entry by Mirabela and Mirabela Investments into deeds of company arrangement under which the claims of unsecured note holders would be extinguished in exchange for the transfer to them of 98.2% of the existing shares in Mirabela. The claims of existing shareholders would be extinguished for no consideration;
- following the proposed transfer of shares to the unsecured note holders, Mirabela would offer to all unsecured note holders secured convertible notes to raise US$115 million, such notes to be convertible into shares that would equate to 42.3% of shares in Mirabela on a fully diluted basis;
- a subset of the ad-hoc group of unsecured note holders would subscribe up to $55 million for secured convertible notes not already subscribed by other unsecured note holders in return for receiving a fee of 10.25% of their respective commitment payable by the issue of shares in Mirabela;
- any amount over US$55 million would be applied to the interim loan of December 2013, with any residual outstanding amount under that loan to be extinguished in exchange for the issue of secured convertible notes;
- the Caterpillar and Bradesco facilities would remain in place on extended terms to be agreed; and
- Mirabela would remain listed on the ASX and trading would resume.

Following the voluntary administration of Mirabela and Mirabela Investments, deeds of company arrangement were put forward which sought to give effect to the Proposed Recapitalisation Plan. The creditors resolved to execute those deeds of company arrangement at the second creditors' meetings and, in doing so, engaged the process of transferring 98.2% of the issued shares in Mirabela to Mirabela Investments as bare trustee for each relevant unsecured note holder.

In order to give effect to that share transfer, the deed administrators needed to satisfy the requirements of s. 444GA of the Act by either obtaining the written consent of the shareholders or the Court's leave. Due to the number of shareholders, obtaining their approval was impractical, resulting in the deed administrators applying to the Court for leave.

To fulfil other requirements associated with the deeds of company arrangement, the deed administrators obtained approval under the Foreign Acquisitions and Takeovers Act 1975 (Cth), the necessary waivers from the ASX, and conditional relief from ASIC in respect of the prohibition on certain takeovers under s. 606 of the Corporations Act. Section 606 of the Corporations Act relevantly prohibits takeovers resulting in a person's shareholding increasing to more than 20%. As a requirement of the s. 606 relief provided by ASIC, the deed administrators issued an explanatory statement to the shareholders. The explanatory statement included an independent expert report prepared by the deed administrators with the assistance of a technical expert (a firm of engineers with mining expertise) which opined on the value of the relevant shares under the proposed deeds of company arrangement as well as the liquidation which would ensue if the deeds of company arrangement did not take effect.

(c) Decision

The matters on which the Court's decision to approve the s. 444GA application turned were:

- whether there was any "unfair prejudice" to the interests of shareholders by the proposed share transfer. Relevant to this was whether shareholders would have any residual equity in the company, which needed to be determined by a comparison to their position on a winding up as the only likely alternative to the Proposed Recapitalisation Plan. On the independent experts' report, the shares had no value because Mirabela's liabilities far exceeded its assets such that, in a liquidation, it was very likely that the shareholders would receive no return. On the other hand, the Proposed Recapitalisation Plan would result in the shareholders retaining some (even if minimal) equity in Mirabela, which was more favourable than a winding up outcome; and
- notice had been given to the shareholders of the application and an opportunity to voice their concerns. His Honour ultimately considered that those concerns were not fatal to the application because the alternative to the share transfer under the deeds of company arrangement was a liquidation which, on the evidence, would result in a return less favourable to shareholders (albeit marginally so).

6.5 Court refuses extension of time under the Corporations Act to bring proceedings to recover voidable transactions

(By Peter Motti, Minter Ellison)

In the matter of AAMAC Warehousing and Transport Pty Ltd (in liquidation) ACN 100 947 091 [2014] NSWSC 834, Supreme Court of New South Wales, Brereton J, 23 June 2014

The full text of this judgment is available online.

(a) Summary

The plaintiff liquidator sought an extension of time under s. 588FF(3)(b) of the Corporations Act 2001 (Cth) (the Corporations Act) to bring proceedings to recover voidable transactions.

Section 588FF(3)(b) provides that an application under s. 588FF(1) in respect of a voidable transaction may only be made during the period beginning on the relation-back day (in this case, 11 February 2011), and ending on the earlier of three years after the relation back day or 12 months after the first appointment of a liquidator in relation to the winding up of the company; or within such longer period as the Court orders on an application under s. 588FF(3)(b) made by the liquidator within that period. In this case the Court refused to grant an extension of time due to "the combination of absence of satisfactory explanation for why the proposed proceedings could not be commenced within the three-year period, coupled with the actual prejudice arising from the [delay]".

(b) Facts

AAMAC Warehousing and Transport Pty Ltd (the Company) was wound up in insolvency by order of the Court made on 20 April 2011. By originating process filed on 23 December 2013 and subsequently amended, its liquidator applied for an order pursuant to s. 588FF(3)(b) of the Corporations Act, extending until 10 December 2014, the time by which an application for orders under s. 588FF(1) would otherwise expire on 10 February 2014. The defendants were persons or companies against whom the liquidator was contemplating bringing proceedings. The liquidator stated that he wished to investigate potential claims against the defendants, and wished to undertake examinations of a number of persons whom he believed were likely to have relevant documents or information, and the possibility that other potential claims may emerge as a result of such investigations and examinations.

The first defendant, Warehouse Solutions International Pty Ltd (a related entity of the Company, which was alleged to have received unfair preferences of $5,123,322); the third defendant, Peter Panayi (a related person, who was alleged to be indebted to the Company for $697,233 and also to have received unfair preferences of $186,700); the fifth defendant, Peter Panayi Jnr; the sixth defendant Russell Panayi (a related person, who was alleged to have received an unfair preference of $10,000); the seventh defendant, Christopher Panayi (a related person, who was alleged to have received an unfair preference of $3,500); and the eighth defendant, Thomas James Panayi (a related person, who was alleged to have received an unfair preference of $6,000); appeared and opposed the relief sought by the liquidator.

Brereton J explained that the question to be answered on an application for an extension of time under s. 588FF(3) was:

> ... whether it was fair and just in all the circumstances to grant the extension, having regard to, inter alia, the liquidator's explanation for the delay, and the prejudice to the defendant from any extension. ... The relevant considerations are
>
> 1. the delay and the explanation for it;
> 2. the merits of the proposed proceedings (except, perhaps, where the liquidator's purpose is to investigate whether or not to bring proceedings); and
> 3. the prejudice occasioned by an extension.

(c) Decision

His Honour accepted the liquidator's evidence that there was "a strongly arguable case of insolvency during the relation-back period" and although some of the potential defendants potentially had "running account" defences, his Honour also accepted that on the presently available material the preference claims were "at least reasonably arguable".

(i) Delay

The liquidator had argued that as at the date of the application, he had not received all of the information he had requested, and had formed the view that the Company had not kept adequate books and records. On 31 August 2011 the liquidator lodged a report with ASIC pursuant to s. 533 of the Corporations Act, referring to possible offences and contraventions including the director's failure to deliver or maintain adequate books and records, insolvent trading, voidable transactions and potential phoenix operations. On 2 September 2011, ASIC advised that it had decided not to pursue an investigation into the matters referred to in the s. 533 report.

In discussing the liquidator's delay, his Honour noted that on 15 May 2012, the liquidator requested the Commonwealth Bank of Australia (the Bank) to provide traces of a number of transactions which the liquidator regarded as questionable. The Bank provided the information requested on 26 June 2012. On 12 November 2013 - 17 months after the Bank's response - the liquidator requested the Bank to conduct additional traces in respect of further transactions. As the Bank indicated that this would take two to three months, the liquidator in early December 2013 requested that the traces be expedited. Application for the extension was made on 20 December 2013, approximately six weeks before expiry of the three-year period.

(ii) Prejudice

His Honour emphasised that delay is presumptively prejudicial and that even in the absence of evidence of specific prejudice, there is still presumed to be prejudice through the deterioration in memories, the likelihood of which increases as the length of the delay increases. His Honour, referring to the decisions in *Brisbane South Regional Health Authority v Taylor* (1996) 186 CLR 541 and *Re Clarecastle Pty Ltd* [2011] NSWSC 857, [200]-[215], stated that "one does not approach an application for an extension of time by comparing the position of the defendants had proceedings been instituted the day before time expired with their position if an extension were granted".

In this case, his Honour believed that the defendants could point to actual prejudice, in the death of Mr Terry Panayi two years after the commencement of the liquidation, specifically noting Terry Panayi's role as the sole director of the Company. With the death of Terry Panayi, who was the principal person in charge of the financial affairs of the Company, his Honour found that the defendants were deprived of the evidence of the person who was most likely to be able to explain the transactions.

(iii) Consideration

His Honour explained that there was "undoubtedly a significant public interest in the recovery of unfair preferences for the benefit of creditors generally". His Honour noted however, that there was also a clear policy, reflected in s. 588FF, that "such claims should ordinarily be brought promptly", because an attempt to recover a payment received by a creditor involves disturbing and re-opening apparently settled transactions, and "a recipient of a payment ought not be at risk of having it set aside years after the event". In this case, almost at the expiry of the three-year period, the liquidator sought an extension, originally for six and then for ten months. His Honour believed that the extension was sought, not to enable any specific claims to be brought (even though potential claims had been identified), but to enable further investigation of those claims, in particular by way of examinations. His Honour noted that "no examinations have been applied for, let alone conducted, to date".

Accordingly, his Honour held that:

> ... [i]n circumstances where no effort has been made to conduct examinations within time, when there was no obstacle to doing so, and

> when in any event the liquidator had sufficient material to identify and frame the claims, the desire to conduct an examination does not justify an extension of time for commencing proceedings. Nor does the possibility that examinations might reveal further claims, when nothing has been done within the three-year period to commence examinations.

(iv) Conclusion

In considering the preference claims, his Honour took the view that the potential preference claims appeared to be "at least reasonably arguable". However, his Honour was not convinced that there was any good reason why proceedings could not have been commenced by February 2014, noting that: "the liquidator had sufficient information to identify and formulate the claims, strong indicia of insolvency during the relation-back period, and was in funds". His Honour held that the desire to conduct examinations was an insufficient reason for delaying commencing proceedings, where there was already sufficient information on which to do so, and sufficient funds available.

Furthermore, his Honour found that the delay had "resulted not only in the presumptive prejudice associated with delay, but actual prejudice through the loss of a material witness by the death of Mr Terry Panayi".

His Honour held that:

> ... the combination of absence of satisfactory explanation for why the proposed proceedings could not be commenced within the three-year period, coupled with the actual prejudice arising from the death of Mr Terry Panayi, require that the application for an extension be declined.

The Court ordered that the originating process be dismissed with costs.

6.6 Director's executive status determined by their managerial responsibilities

(By Sarah Naughton, Herbert Smith Freehills).

Jaques v AIG Australia Ltd [2014] VSC 269, Supreme Court of Victoria, Dixon J, 13 June 2014.

The full text of this judgment is available online.

(a) Summary

In these proceedings the Court considered:

- whether the plaintiff, Mr Jaques, was a non-executive director of Australian Property Custodian Holdings Ltd (Holdings) prior to 26 June 2007; and
- whether Mr Jaques fell within the meaning of "non-executive director" in the Investment Management Insurance policy held by Holdings.

Dixon J held Mr Jaques was a non-executive director entitled to indemnity under the policy and the special excess loss limit benefit of $1,000,000 for loss from 16 July 2010 to 16 July 2011.

The ruling turned on the factual issue of the delegation of executive functions and managerial responsibilities to a director. Dixon J relied on the fact that Mr Jaques was employed by and worked for Australian Property Custodians Pty Ltd (Custodians) in determining that he was an non-executive director rather than an executive director. Nothing in his employment contract or his agreement to provide services to properties owned by Holdings operated as a delegation of executive responsibility by Holdings to Mr Jaques.

(b) Facts

Mr Jaques became a non-executive director of Holdings in March 2001. Holdings was a passive investor landlord with an objective to make further acquisitions and appropriate investments. Mr Jaques had no role to play in this activity.

In 2004, Mr Jaques commenced employment with Custodians who paid him a salary, the only emolument he received for his labours as a manager and as a director. The Custodians board allocated duties to Mr Jacques and assessed his performance.

The defendant AIG Australia Ltd is an insurer that issued an Investment Management Insurance Policy to Holdings on 20 October 2010 operative for the period from 16 July 2010 to 16 July 2011. The insurer undertook to pay the loss of any insured person arising from a claim first made during the policy period for a wrongful managerial act.

Holdings was a defendant in recent Federal Court proceedings. Claims for defence costs by all five defendant directors exhausted the $5,000,000 liability limit under the policy. Under the policy terms, non-executive directors became entitled to a special excess limit of $1,000,000. When Mr Jacques sought that further indemnity, the defendant refused to provide the extended cover.

Mr Jacques sought a declaration that he is entitled to indemnity under the policy in respect of his loss including defence costs incurred in proceedings, where such loss relates to his conduct prior to 26 June 2007.

(c) Decision

Dixon J noted that it is well accepted that the office of managing director has powers of day to day management of a company that are exercisable without reference to the board as a delegated executive management function. In contrast, appointment as a director other than a managing director, carries no express or implied grant of executive power.

His Honour cited with approval the ratio of the decision in *Entwells Pty Ltd v National and General Insurance Co Ltd* [1991] 5 ACSR 424, 427 which provided that:

> ... it is a question of fact whether a person has assumed the powers of a managing director, or, I would add, an executive director, with the approval of the company. The critical aspect of that inquiry is whether the company approved, or perhaps acquiesced, in that assumption of power.

Dixon J held that:

> ... whether a director, other than the managing director, is an executive director is a question of fact. It may depend on whether there is some feature of the company's constitution, or conduct of the company in general meeting or of the board of directors that evidences the delegation of executive function, to that director to operate as an executive of the company. The classic example is board approval of a director's employment contract as an executive of the company.

His Honour found no explicit act of Holdings, either in general meeting or of the board, in the relevant period that evidences any delegation of power to Mr Jaques to operate as an executive director.

Dixon J ruled in favour of Mr Jaques who was entitled to indemnity under the Investment Management Insurance policy.

6.7 Prejudice to unsecured creditors and solvency of company relevant considerations in extending time for registration of PPSA security interest

(By James Siemon, Minter Ellison)

In the matter of Appleyard Capital Pty Ltd; 123 Sweden AB v Appleyard Capital Ltd [2014] NSWSC 782, Supreme Court of New South Wales, Brereton J, 12 June 2014

The full text of this judgment is available online.

(a) Summary

In certain circumstances described by s. 588FL of the Corporations Act 2001 (Cth) (the Corporations Act), a Personal Property Securities Act 2009 (Cth) (PPSA) security interest registered within six months prior to a company being wound up or going into liquidation may instead vest in the company. This case examines when the courts will exercise their discretion under s. 588FM to prevent this from occurring, to the detriment of unsecured creditors, and the factors that the courts will take into consideration in making such orders.

(b) Facts

The plaintiff, 123 Sweden AB, was a Swedish corporation whose principal was a Swedish national. The principal's son was a friend of the director of the defendant company, Appleyard Capital Pty Ltd. On 9 February 2013, the plaintiff agreed to lend $320,000 to the defendant and the agreement was recorded in a Binding Term Sheet which provided that, within 30 calendar days, a formal loan agreement would be signed and completed and the defendant would register a "full floating charge" with ASIC at its expense. On 7 May 2013, an executed copy of a loan agreement was delivered from the defendant to the plaintiff, under which the defendant agreed to grant the plaintiff a security interest over "all its present and future undertaking, [sic] assets and rights", however no security interest was registered.

On 19 February 2014, the defendant notified the plaintiff that it no longer had the capacity to pay interest, no longer had assets of any value, and would likely cease operation. It requested that the defendant, as an unsecured creditor, consider writing off its debt and any future interest. After seeking legal advice, the plaintiff became aware on about 21 April 2014 of the requirement that the security interest be registered and of the effects of s. 588FL of the Corporations Act. Registration subsequently took place on 29 April 2014, and the plaintiff sought an extension under s. 588FM. That application was made *ex parte*.

Section 588FL of the Corporations Act provides that where they are not registered within time, PPSA security interests may vest in the grantor company in certain circumstances.

Brereton J summarised the effect of the section at [8] as follows:

> Broadly, the effect of s 588FL(2) is that when a company is being wound up, an administrator has been appointed or a deed of company arrangement executed, any PPSA security interest which was perfected, registered, or enforceable against a third party after the latest of six months before the critical time or 20 days after the security agreement came into force or such later time as the Court may fix under [s.]

588FM, vests in the company, for the benefit of creditors generally, and the secured creditor loses the benefit of the security ...

In turn, s. 588FM provides that:

1. A company, or any person interested, may apply to the Court (within the meaning of s 58AA) for an order fixing a later time for the purposes of subparagraph 588FL(2)(b)(iv) ...
2. On an application under this section, the Court may make the order sought if it is satisfied that:
    a. the failure to register the collateral earlier:
        i. was accidental or due to inadvertence or some other sufficient cause; or
        ii. is not of such a nature as to prejudice the position of creditors or shareholders; or
    b. on other grounds, it is just and equitable to grant relief.
3. The Court may make the order sought on any terms and conditions that seem just and expedient to the Court.

(c) Decision

After concluding that s. 588FM(2)(a)(i) was satisfied on the facts, Brereton J therefore examined whether he should exercise the discretion to make the order sought and, if so, on what terms.

His Honour particularly discussed two related considerations relevant to the exercise of that discretion: the existence of evidence of the company's solvency and the impact the orders sought would have on unsecured creditors. In doing so, he noted that the English view that the interests of unsecured creditors were to be regarded as irrelevant had not prevailed in Australia, a position supported by decisions such as those of Long Innes J in *Re a Limited Company (1928) 28 SR* (NSW) 364 and of Walsh and Stephen JJ in *Commercial Banking Co of Sydney Ltd v George Hudson Pty Ltd* (1973) 2 ALR 1 (*CBC v Hudson*).

Instead, his Honour considered that the interests of unsecured creditors are relevant, and noted that the financial position of the company is a relevant consideration insofar as it affects the interests of unsecured creditors. Where the company is financially secure, the creditors are unlikely to be adversely affected. Where the court is not satisfied that there is no risk of an adverse outcome for unsecured creditors, unsecured creditors are entitled to be heard against the making of an order, although this can be achieved through inclusion of a "Guardian Securities" condition in the orders granted (*Re Guardian Securities Ltd* [1984] 1 NSWLR 95 (*Re Guardian Securities Ltd*)).

His Honour also queried the importance which the interests of the unsecured creditors are to be given in exercising the court's discretion. In particular, his Honour disagreed with the reasons of Mitchell and Walter JJ in *Re Flinders Trading Co Pty Ltd* (1978) 3

ACLR 218. In that case, in reliance on the decision in *CBC v Hudson*, their Honours concluded (at 233) that the argument for correction of an inadvertent failure to register a security interest should not prevail over the claims of unsecured creditors "where there is a danger that such claims will not be met in full owing to the insolvency or likely insolvency of the company".

His Honour dismissed this conclusion on two grounds: first, his Honour considered that to only make orders under s. 588FM where there was no such danger would leave the jurisdiction created by the s. devoid of practical utility and, secondly, his Honour noted that the existence of s. 588FM(2)(a)(ii) as an alternative ground of relief indicated against such a conclusion. His Honour also cited cases showing that, where relief was justified by the circumstances, orders under s. 588FM could be made even where liquidation or administration is imminent, including the decisions in *Re a Limited Company* and *Re Guardian Securities Ltd*.

Ultimately, his Honour found that, although prejudice to unsecured creditors from making an order under s. 588FM was inevitable, prejudice to unsecured creditors attributable to the delay in registration (such as where creditors had relied upon the absence of registered claims) might give grounds for objection to such an order.

His Honour noted the high degree of likelihood that the defendant was insolvent and would go into liquidation or insolvency within six months.

Nonetheless, in consideration of the factors outlined above, his Honour granted the orders under s. 588FM sought by the plaintiff, subject to two additional terms:

- first, as the application was made *ex parte*, his Honour reserved leave for the defendant to bring an application for the orders to be set aside; and
- secondly, his Honour imposed a "Guardian Securities" condition permitting an application to be brought to discharge or vary the orders in the event of the winding up or administration of the defendant company or the execution of a deed of company arrangement.

6.8 Consideration of a right of subrogation

(By Jason Choi, DLA Piper)

Bowesco Pty Ltd v Westpoint Management Ltd [No 2] [2014] WASC 207, Supreme Court of Western Australia, Chaney J, 12 June 2014

The full text of this judgment is available online.

(a) Summary

The plaintiff, Bowesco Pty Ltd (Bowesco) claimed that the defendant, Westpoint Management Ltd (Westpoint Management) held $550,000 in excess funds on a constructive trust for the benefit of Bowesco. Bowesco claimed the constructive trust arose because Bowesco's right to subrogation of Suncorp's rights under its securities required Suncorp to account to Bowesco for the surplus funds which it realised, it failed to account in breach of its fiduciary duty to do so, and Westpoint Management took the funds with knowledge of Bowesco's rights. Westpoint Management denied that any right of subrogation existed in relation to the $550,000 advanced by Bowesco to Lanepoint Enterprises Pty Ltd (Lanepoint) (who used the funds to purchase and develop property), and claimed that it was entitled to retain those funds in satisfaction of its loan to Bowesco secured by its second ranking charge.

(b) Facts

By letter dated 15 April 2005 Suncorp Metway Ltd (Suncorp) offered to lend Lanepoint Enterprises Pty Ltd (Lanepoint) up to $5,875,900 for the purchase and development of land (the Lanepoint Property) under a loan facility (the Suncorp-Lanepoint Facility). The letter provided that construction work was to commence by 30 June 2005 and was to be completed by 31 October 2005. The letter contained a provision for partial discharge of the security upon completion of contracts for the sale of individual lots, apartments or units. It contained certain conditions precedent to the construction funding, requiring the bank to be satisfied as to the form and substance of the proposed building contract, as to the receipt of a building approval, and that the development was proceeding with agreed cash flow and project feasibility statements. The loan was secured by a guarantee by Bowesco (Suncorp-Bowesco guarantee) to pay the secured money to Suncorp if Lanepoint defaulted. Suncorp subsequently advanced funds to Lanepoint under the Suncorp-Lanepoint Facility.

On 10 May 2005, a loan agreement was made between Westpoint Management as lender, Lanepoint as borrower, and Perpetual Nominees Ltd as custodian. Pursuant to that agreement, Wespoint Management agreed to provide financial accommodation to Lanepoint to a maximum sum of $4 million for the development (the WIF-Lanepoint Loan Agreement). The advances were secured by a second ranking charge granted by Lanepoint to Perpetual Nominees Ltd as custodian (the WIF-Lanepoint charge).

On 25 October 2005, ASIC placed an interim stop order on Westpoint Income Fund (WIF) from raising funds, and, on 23 November 2005, ASIC issued a final stop order pursuant to s. 1020E of the Corporations Act 2001 on WIF. As a result of those orders, WIF (and therefore Westpoint Management) was unable to make any advances to Lanepoint pursuant to the WIF-Lanepoint Loan Agreement.

A letter dated 15 January 2006, executed by Bowesco, Lanepoint and Westpoint Management, recorded an agreement that Bowesco as guarantor would provide funding required by Lanepoint to complete the development "so that the Suncorp loan facility is reduced by the amount of Bowesco's funding". Bowesco then provided $550,000 to Lanepoint.

On 3 March 2006, Suncorp appointed receivers and managers of Lanepoint (the Suncorp-Lanepoint Receivers), pursuant to the Suncorp-Lanepoint charge, who took possession of the development and Laneway's other assets. On 9 March 2006, Perpetual Nominees Ltd appointed receivers and managers of Lanepoint (the WIF-Lanepoint Receivers), pursuant to the WIF-Lanepoint charge.

On 15 March 2006, Suncorp issued a written notice of demand to Bowesco pursuant to the Suncorp-Bowesco guarantee for the amount of Suncorp's advances to Lanepoint pursuant to the Suncorp-Lanepoint Credit Facility Deed.

On 28 March 2006, Bowesco sold the Warnbro property (which Bowesco borrowed $1.5 million from Suncorp to refinance in 2004), and following, Suncorp appointed receivers and managers of Bowesco pursuant to the charge granted by Bowesco in relation to Suncorp's loan to assist in the purchase of the Warnbro property. The sale of the Warnbro property was completed by the Bowesco receivers, who were paid $2.75 million, which was used to pay out the balance of Bowesco's loan from Suncorp for the Wanbro property. The balance was used to reduce the Suncorp-Lanepoint facility.

On 27 March 2007, the Suncorp-Lanepoint loan was repaid to Suncorp.

On 4 April 2007, Lanepoint paid Bowesco $985,535 as reimbursement of the payment made by Bowesco in partial reduction of the Suncorp-Lanepoint loan.

During 2008, Wespoint Management was paid a total of $4,108,342 by Lanepoint pursuant to Wespoint Management's rights under the WIF-Lanepoint charge and in satisfaction of the amounts Lanepoint owed to Westpoint Management under the WIF-Lanepoint Loan Agreement. It was that amount against which Bowesco claimed that Westpoint Management held $550,000 by way of constructive trust.

(c) Decision

Chaney J held that Westpoint Management did not hold the $550,000 on constructive trust and dismissed Bowesco's claims.

Chaney J first assessed whether Bowesco guaranteed the performance of a covenant by Lanepoint to complete the development. Bowesco claimed that it guaranteed the obligations of Lanepoint, including the obligation to complete the development, and that it would be an event of default under the Suncorp-Lanepoint Credit Facility Deed if Lanepoint failed to complete the Development.

Chaney J extracted the comments of Brereton J in *Dalma No 1 Pty Ltd (in liquidation) (ACN 111 772 260); Application of Bruce Gleeson and David Shannon in their*

Capacity as Joint and Several Liquidators of Dalma No 1 Pty Ltd (in liquidation) and anor [2013] NSWSC 1335 (*Dalma*), which stated that there is no all-embracing theory that explains when subrogation will be permitted; the equity arises from the conduct of the parties on well settled principles and in defined circumstances which make it unconscionable for the defendant to deny the plaintiff's right. Brereton J continued that the doctrine is in general applied in favour of all persons who are required to pay the debt of another for the protection of their own interests. It is generally held that the right of subrogation will arise where the party claiming it has advanced money to pay a debt, which, in the event of default by the debtor, he would be bound to pay; or where the one making the payment has some interest to protect; or where the money advanced to pay the debt was under an agreement with the debtor, or the creditor, express or implied, that he should be subrogated to the rights and remedies of the creditor.

Bowesco claimed it paid to finish the units in the development to protect its interests as a guarantor liable to pay Suncorp. Chaney J, however, held that the condition precedent relating to construction being completed by a certain date was not a covenant by Bowesco to complete the Development, and rather, it was a condition affecting Suncorp's liability to commence or continue funding. In addition, Chaney J held that Bowesco's obligation under the Suncorp-Bowesco guarantee was only an obligation to pay damages in the event of breach, and it cannot be said that by advancing funds to Lanepoint, Bowesco performed an obligation under the Suncorp-Bowesco guarantee.

Chaney J next considered whether Bowesco was entitled to subrogation of Suncorp's securities in relation to the $550,000. His Honour referred to *Bofinger v Kingsway Group Ltd* (*Bofinger*), in which the court explained that when a guaranteed debt is paid by the surety he is entitled, unless the right is excluded by agreement or his conduct makes it inequitable to enforce it, in respect of the amount he has paid under his guarantee to the securities which the creditor holds for the debt guaranteed. *Bofinger* held that this right arises not from any agreement between the surety and the creditor, though it may be excluded by agreement between them, and that it rests on equitable principle.

Chaney J also noted that the entitlement to the securities was said to be "in respect of the amount he has paid under his guarantee". Similarly, in *Dalma*, the right to subrogation was said to be in relation to payment of a debt "which, in the event of default by the debtor, he would be bound to pay", or, where money was advanced "to pay the debt", there was an agreement that the payer should be subrogated to the rights and remedies of the creditor.

Chaney J then noted that in *Ulsta Bank Ltd v Lambe* the court stated that if a guarantor decides to make a payment on behalf of a debtor or to give to the debtor money in order that he may pay it to the creditor himself, then he can bring about a situation where the debt is reduced by the amount of the payment. The guarantor in such a case will not have paid on foot of the guarantee or acquired any right of ultimate reimbursement in respect of the money paid. Here, the $550,000 was paid to Lanepoint for the purposes of enabling Lanepoint to pay unsecured creditors. Because Suncorp was not the creditor which received the payment from Bowesco, and because Lanepoint's debt to Suncorp was unaffected by the advances to it by Bowesco, Chaney J held there was no basis upon which Bowesco could be subrogated to the rights of Suncorp under the securities in relation to Lanepoint's debt to Suncorp.

Finally, Chaney J considered whether Suncorp held surplus funds with the fiduciary obligation to account. His Honour stated the principle, on which the plaintiffs were attempting to rely, that a first mortgagee has a fiduciary obligation to account in relation to surplus funds to a surety who has made payments under a guarantee in reduction of debt to the first mortgagee. Here, the Suncorp-Lanepoint receivers obtained funds in excess of the amount necessary to discharge the Suncorp-Lanepoint facility as agents for Lanepoint, and accordingly, could not be said to have owed fiduciary duties in relation to those funds. Accordingly, Chaney J held that Westpoint Management could not be said to have received the surplus funds with knowledge of a failure by Suncorp to account, since that fiduciary obligation never existed.

6.9 Party found to have abused court process by "relitigating" an issue determined in an earlier proceeding to which it was not party

(By Annabel Humphreys, Minter Ellison)

In the matter of HIH Insurance Ltd (in liquidation); De Bortoli Wines (Superannuation) Pty Ltd v McGrath [2014] NSWSC 774, Supreme Court of New South Wales, Brereton J, 11 June 2014

The full text of this judgment is available online.

(a) Summary

This case provides an example of where the Court will find a party should be estopped from litigating an issue that was determined in an earlier proceeding to which it was not a party. The Court found that Aabrofay Pty Limited's (Aabrofay) claim should be dismissed because Aabrofay was sufficiently identifiable with De Bortoli Wines Pty Limited (DBWines) (who had previously unsuccessfully litigated the same issue) as it was a subsidiary of DBWines and it was unreasonable for Aabrofay to stand by and allow the earlier proceedings to be determined without intervening. The Court found that DBSuper on the other hand did not have a similar connection with DBWines and allowed its claim to proceed.

(b) Facts

This case concerns an interlocutory application brought by Anthony McGrath and Christopher Honey (Liquidators) in their capacity as liquidators of HIH Insurance Limited (in liquidation) (HIH) and the scheme administrators of HIH Casualty and General Insurance Limited, FAI General Insurance Company Ltd and CIC Insurance Limited (in liquidation) (collectively, the HIH Subsidiaries) to have proceedings brought by creditors of HIH and the HIH Subsidiaries dismissed.

The proceedings were brought by De Bortoli Wines (Superannuation) Pty Ltd (DBSuper) and Aabrofay to have the decision of the Liquidators not to admit their respective proofs of debt and claims reversed or modified pursuant to s. 1321 of the Corporations Act 2001 (Cth).

In 2008, DBSuper submitted a proof of debt with the Liquidators alleging it paid more for its shares in HIH than their true value because it relied on misleading and deceptive representations made by HIH and lodged with the ASX. The proof of debt was supported by a statutory declaration of Darren De Bortoli in his capacity as managing director of DBSuper. The Liquidators admitted DBSuper's proof of debt. In 2009, Aabrofay's parent company DBWines submitted a proof of debt in respect of a similar claim against HIH in relation to shares purchased by DBWines and Aabrofay (then deregistered) accompanied by a similar statutory declaration of Mr De Botoli in his capacity as managing director of DBWines. The Liquidators rejected DBWines proof of debt on the grounds that the cost of the shares purchased by Aabrofay was not a loss suffered by DBWines and there was insufficient evidence to establish DBWines relied on the representations made by HIH in purchasing the shares.

In 2010, DBWines applied to the Federal Court to have the Liquidators' decision in relation to DBWines (not Aabrofay) set aside and its proof of debt admitted (the DBWines Proceedings). DBWines' claim was dismissed by the Federal Court on the grounds that Mr De Bortoli did not rely on the alleged misrepresentations of HIH when purchasing the shares. Both the Full Federal Court and the High Court rejected appeals brought by DBWines.

While the DBWines Proceedings were still on foot, DBSuper lodged claims with the Liquidators against the HIH Subsidiaries. Aabrofay was eventually reinstated and lodged its own proof of debt against HIH. After the DBWines Proceedings were resolved, DBSuper and Aabrofay (who had since submitted claims against the HIH Subsidiaries) submitted to the Liquidators that they had suffered loss as a result of paying a price for shares that the market set whereas, but for the contravening conduct, the price so set would have been lower, also known as "indirect causation". The Liquidators rejected both claims against the HIH Subsidiaries. The Liquidators also rejected Aabrofay's proof of debt against HIH on the grounds that the findings in the DBWines Proceeding were applicable to the purchase of shares by Aabrofay. In response, DBSuper and Aabrofay brought the proceedings to which the Liquidators' interlocutory application relates.

The Liquidators sought to have the proceedings brought by DBSuper and Aabrofay dismissed pursuant to rll. 13.4(a) and/or (c) of the Uniform Civil Procedure Rules 2005 (NSW), and alternatively in the Court's inherent jurisdiction, on the basis that the proceedings amount to an abuse of process because they are an attempt to relitigate matters that have already been determined, or could and should have been determined, in prior proceedings.

(c) Decision

Brereton J identified the critical question for the court to determine was whether the decision in the DBWines Proceedings should be regarded as precluding DBSuper and Aabrofay, who were not parties to the DBWines Proceedings, from maintaining their indirect causation claims which were not litigated in the DBWines Proceedings. His Honour referred to several authorities for the proposition that abuse of process may only be established if the issue being litigated was resolved by a competent court in an earlier proceeding and the applicant in the new proceeding was the unsuccessful party in that proceeding.

(i) Identity of issue

Brereton J did not accept DBSuper and Aabrofay's argument that the issue in this case was sufficiently distinguishable from that of the DBWines Proceedings merely because the transactions the subject of the DBWines Proceedings were different to those the subject of the new proceedings. The relevant transactions were entered into during the same period, by the same agent and in circumstances that were relevantly indistinguishable. However, his Honour also rejected the Liquidators' submission that the findings in the DBWines Proceedings that Mr De Bortoli did not rely on any misleading representations by HIH were inconsistent with the "indirect causation" argument because the "indirect causation" argument does not depend on Mr De Bortoli's state of mind.

Brereton J further noted that a party will not be permitted to reopen the same subject of litigation in respect of a matter which could have been but was not brought forward in the earlier proceeding. In that regard, even where "indirect causation" was not litigated in the earlier proceeding, it would not be open to DBWines to mount a new case based on those arguments as such a case had to be raised, if at all, in the earlier proceeding.

(ii) Identity of party

As already noted, the critical question to be determined was whether the decision in the DBWines Proceedings should be regarded as precluding DBSuper and Aabrofay from bring the "indirect causation" claims, neither of which were litigated in the

DBWines Proceeding, but which DBWines itself could not now raise in later proceedings.

His Honour considered that a person who is not a party to an original proceeding may be precluded from maintaining new proceedings that involve relitigation of an issue decided in the earlier proceedings where:

- the non-party was a privy of the unsuccessful party to the earlier proceedings, that is, they claim under or through the unsuccessful party, seek to enforce any right or interest of the unsuccessful party, have a financial interest in the outcome of the earlier proceeding or their claims involve or depend on any right of the unsuccessful party; or
- the non-party is sufficiently identified with the unsuccessful party to the earlier proceedings and it was unreasonable for the non-party to stand by and allow the earlier proceedings to be determined without intervening. This is a form of *Anshun* estoppel.

Brereton J held that neither DBSuper nor Aabrofay were a privy of DBWines. Brereton J considered that DBSuper did not have a sufficient connection with DBWines as neither party controlled the other nor did they have any legal or financial interest in the success or failure of the other's claim. The presence of Mr De Bortoli as a common controlling mind was not sufficient to establish the necessary connection as he was no more than the relevant agent of both companies. His Honour further considered that it was not unreasonable for DBSuper to have refrained from intervening in the DBWines Proceedings because the accessorial liability of the HIH Subsidiaries was not an issue in the DBWines Proceedings. Accordingly, Brereton J held that DBSuper was not precluded from maintaining its claim in the new proceedings and it was not an abuse of process for it to do so.

Brereton J held that Aabrofay's proceedings on the other hand should be dismissed on the grounds that it was unreasonable for Aabrofay not to bring its claim in the DBWines Proceedings because:

- DBWines controlled Aabrofay and, as a shareholder in Aabrofay, DBWines had a financial interest in Abrofay's claim;
- Aabrofay's principal claim corresponded with DBWines' claim;
- evidence pertaining to Aabrofay's acquisition of shares in HIH was given in the DBWines Proceedings;
- unlike DBSuper, Aabrofay was not pushing for early adjudication prior to the determination of the DBWines Proceedings; and
- DBWines could have caused Aabrofay to seek leave to proceed against HIH in tandem with the DBWines Proceedings, but decided not to.

6.10 Payment of income tax on equitable compensation and the scope of a director's fiduciary duties

(By Elizabeth Park and Will Heath, King & Wood Mallesons)

Howard v Commissioner of Taxation [2014] HCA 21, High Court of Australia, French CJ, Hayne, Crennan, Gageler and Keane JJ, 11 June 2014.

The full text of this judgment is available online.

(a) Summary

Mr Howard did not include an award of equitable compensation in his 2005 income tax assessment. The award had been made in a separate matter, pursuant to a joint venture for the purchase, lease and on-sale of a golf course.

Mr Howard claimed that:

- the compensation was held on trust for Disctronics Ltd (Disctronics), a company of which he was director, on the basis of his fiduciary duty to the company; or
- the right to the compensation had been assigned to Disctronics under a litigation agreement; or
- he was entitled to tax deduct his share of the legal expenses.

The Commissioner of Taxation did not accept Mr Howard's contentions and issued him with an amended tax assessment. The High Court rejected a final appeal by Mr Howard. It held that Disctronics was not a party to the joint venture, nor did any fiduciary obligation prevent Mr Howard profiting from the joint venture on his own account. The compensation was therefore not held on trust for Disctronics. The assignment of compensation was of future property and therefore was still taxable in Mr Howard's hands. Furthermore, Mr Howard was not entitled to deduct legal expenses as these had been paid by Disctronics.

(b) Facts

In July 1999 a joint venture was formed for the purchase, lease and on-sale of a golf course. The intention was to make a "day-one profit" on the difference between the purchase price and sale price, and to split that sum between the six joint venturers. Some of the joint venturers, who were directors of Disctronics, thought that the golf course might prove a better investment for Disctronics than its current investment in insurance bonds. They suggested that Disctronics could provide the equity required of an investor in the golf course. However, Disctronics could not put up more than

$1,500,000 in equity and debt funding, which would put a limit on the potential "day-one profit" of the joint venture.

Two of the joint venturers, Edmonds and Cahill, were unhappy with this arrangement. While an offer was made to purchase the golf course with Disctronics as the equity investor, the golf course owner instead accepted an offer by Edmonds and Cahill which had been made without the other joint venturers' knowledge. In a separate case, diverting the opportunity to themselves was found to be in breach of their fiduciary duty as joint venturers to act honestly and in good faith.

A litigation agreement was entered into for Disctronics to pay all legal fees and indemnify the injured joint venturers for all costs incurred in that litigation, in exchange for the injured joint venturers "assign[ing] absolutely unto and to the sole use of [Disctronics], any award of damages (whether on revenue or capital account) ... arising out of the proceedings and the ultimate outcome thereof".

In the earlier separate case the injured joint venturers, including Mr Howard, were compensated for their lost opportunity. Disctronics was not compensated. It was held there was no agreement between the joint venturers to sell the golf course to Disctronics, and that Disctronics was not a member of the joint venture and so was not a beneficiary of the fiduciary duties which Edmonds and Cahill had breached.

Mr Howard did not include the award of equitable compensation in his 2005 income tax assessment. Instead Disctronics declared the award as assessable income. The Commissioner of Taxation believed that the award had been received by Mr Howard beneficially and so issued an amended tax assessment in 2009, which Mr Howard disputed.

At first instance the Federal Court found in favour of Mr Howard, but on appeal to the Full Court the decision was in favour of the Commissioner of Taxation. It was then appealed to the High Court.

(c) Decision

(i) No constructive trust over the award of equitable compensation

The joint venture was not pursued in Mr Howard's capacity as director of Disctronics, Disctronics was not a party to the joint venture nor was it pursuing a similar business venture. The compensation was calculated by reference to Mr Howard's loss, and was not compensation for any loss made by Disctronics.

There was no conflict between Mr Howard's interest as a member of the joint venture and his fiduciary duties as a director. To be an unauthorised gain or profit held on trust, it would need to be shown that Mr Howard obtained the profit by reason or by use of his position or any opportunity or knowledge resulting from his position as director. This was not the case.

Furthermore, if it had been Mr Howard's duty to try to introduce Disctronics to the venture, he performed that duty. Once Edmonds and Cahill made it clear they would not agree to Disctronics being the ultimate purchaser, or at least once they had diverted the project to their own use, the potential for Disctronics to benefit was at an end and Mr Howard's duty to pursue any benefit could not be further performed. It was not a failure on Mr Howard's part.

If the venture had not been diverted there may have been a conflict, but as it was Mr Howard's interests at all times aligned with Disctronics. Furthermore, Mr Howard's actions may be regarded as sanctioned by Disctronics who knew he was a party to the joint venture.

Mr Howard therefore received the compensation beneficially and not on trust for Disctronics.

(ii) Assignment of future income, not the right to compensation

If an assignment is of future income, the assignment only takes effect when the income has been acquired by the assignor. The income is therefore first derived by the assignor and forms a part of the assignor's assessable income.

The litigation agreement did not assign Mr Howard's interest in the joint venture or in the cause of action to Disctronics, that is, it did not assign Mr Howard's present rights. Hayne and Crennan JJ held that the references in the assignment clause of the litigation agreement to "revenue or capital account" and the "ultimate outcome" made more sense in the context of referring to sums received rather than to the right to receive those sums. This was an assignment of future property and as such was assessable in Mr Howard's hands.

(iii) No deduction for litigation costs

Mr Howard argued in the alternative that the amount of assessable income should be reduced by his share of the legal costs. The only evidence of expenditure on legal costs was by Disctronics, for which it was presumed to have claimed a deduction. Given that Disctronics was a party to the litigation and the terms of the litigation agreement, there was no basis on which to conclude that Mr Howard had incurred any liability to pay legal costs and therefore he was not entitled to have his assessable income reduced.

6.11 Statutory limitation periods apply to purely equitable claims by analogy

(By Elizabeth Goodman, Herbert Smith Freehills)

Gerace v Auzhair Supplies Pty Ltd [2014] NSWCA 181, NSW Court of Appeal, Beazley P, Meagher and Emmett JJA, 6 June 2014

The full text of this judgment is available online.

(a) Summary

This decision is an appeal from *In the Matter of Auzhair Supplies Pty Ltd (In liq)* [2013] NSWSC 1, where Brereton J ordered that the directors of Auzhair Supplies pay compensation to the plaintiff company for breach of their fiduciary duties. Brereton J refused to apply, by analogy, the six year limitation period set out in s. 1317K of the Corporations Act 2001 (Cth) (the Corporations Act), on the basis that to do so would be inequitable.

In this appeal, the NSW Court of Appeal unanimously overturned the decision of Brereton J, finding that the limitation period is applicable by analogy and, as a result, that Auzhair Supplies' claims regarding breach of directors' duties are barred.

The Court of Appeal distinguished between applying a statutory limitation period by analogising between a statutory and equitable claim, and the equitable doctrine of laches. The Court further found that the limitation period would only be denied if it would lead to an unconscionable or unjust result.

(b) Facts

The Gerace brothers were the directors and sole shareholders of Auzhair Supplies Pty Ltd. Between July 2002 and July 2003, Auzhair Supplies received an advance of $600,000 from Mr and Mrs Greenway. A written loan agreement between the parties was later recorded in July 2004, under which repayment was due by 1 July 2007.

The Gerace brothers then created a second company, Auzhair 1, which was incorporated in June 2003, with themselves, their wives, and the Greenways as shareholders. The assets and undertakings of Auzhair Supplies, including the business' goodwill, were transferred to Auzhair 1. No consideration was given for Auzhair Supplies' assets.

On 6 June 2005, Auzhair Supplies was deregistered under s. 601AA of the Corporations Act, on the premise that all assets and liabilities had been transferred to Auzhair 1. Deregulation under s. 601AA requires, among other things, that the company has no outstanding liabilities. However, the liability to repay the Greenway loan remained with Auzhair Supplies. The loan was not repaid by the agreed deadline, and the Greenways applied for the reinstatement of Auzhair Supplies under s. 601AH of the Corporations Act, and its winding up, so that they could recover the loan. Their application for reinstatement was successful (*In the matter of Auzhair Supplies Pty Ltd (a deregistered company) and Auzhair 1 Pty Ltd* [2010] NSWSC 1339; 80 ACSR 538).

Auzhair Supplies subsequently brought proceedings against Auzhair 1 and the Gerace brothers for breach of directors' duties in transferring the company's assets to Auzhair 1. Auzhair Supplies claimed that the directors were in breach of their duties under ss. 180 to 183 of the Corporations Act as well as their fiduciary duties under general law, which continue to exist under s. 185 of the Corporations Act. The breaches themselves were not disputed; the directors admitted to having acted "wrongly, but mistakenly". The defendants claimed, however, that the proceedings had been commenced too late as more than six years had passed, and that any equitable claim was now barred by Statute of Limitations. As the equitable claims were "essentially the same as" the contraventions of the statutory duties in ss. 180 to 183 of the Corporations Act, s. 1317K's six year limitation period for bringing proceedings for those contraventions was equally applicable, by analogy, to the equitable cause of action.

At first instance, Brereton J refused to apply the limitation period, despite finding that the statutory and equitable claims were "as close an analogy as one can conceive" (*In the Matter of Auzhair Supplies Pty Ltd (In liq)* [2013] NSWSC 1, [79]). Brereton J held that applying the limitation period would be "inequitable" and ordered that the Gerace brothers pay a sum of $749,447.32, the value of the assets and undertakings transferred to Auzhair 1 without consideration, plus costs, to Auzhair Supplies. The decision was appealed.

(c) Decision

Meagher and Emmett JJA, Beazley P concurring, held that the limitation period applied to the equitable claim in this case. In coming to this conclusion, the Court of Appeal reviewed the principles of law underlying when it is appropriate to apply a statutory limitation period to a purely equitable claim, and when such a bar will be denied. The principle was specifically distinguished from the equitable doctrine of laches.

(i) The relevant principle: limitation period applicable by analogy

Underlying the decision in this appeal is the longstanding principle that "where the remedy in Equity is correspondent to the remedy at Law, and the latter is subject to a limit in point of time by the Statute of Limitations, a Court of Equity acts by analogy to the statute, and imposes on the remedy it affords the same limitation", quoting the often cited statement concerning equity's treatment of limitation statutes in *Knox v Gye* (1872) 5 LR HL 656, 674, per Lord Westbury).

Thus, if the equitable and statutory rights are sufficiently similar, any relevant statutory limitation period will be applied by analogy to the equitable claim. This is true even if the claim arises in equity's exclusive jurisdiction, citing *In Cia de Seguros Imperio v Heath (REBX) Ltd* [2001] 1 WLR 112.

(ii) When will the analogy not apply?

The Court considered two lines of reasoning which have been relied on in past cases to deny the application of a statutory limitation period to an analogous equitable claim. In some cases it has been suggested that equity has a discretion not to apply the analogy. In other cases, the analogy has been denied on the basis that "the circumstances make its application unconscionable or unjust", or, in other words, where a "greater equity" exists. Such cases involved circumstances where the equitable cause of action was fraudulently or mistakenly concealed. The Court of Appeal favoured the second line of reasoning, Meaghar JA finding that if equity retained such a discretion, "it would not truly be acting by analogy and following the law".

Thus, a statutory limitation period will only be denied in the case of an analogous equitable claim where there has been fraudulent concealment. Unlike common law fraud or deceit, equity requires the defendant to be conscious of their wrongdoing.

(iii) Distinguishing the doctrine of laches

The Court of Appeal distinguished between denying a statutory limitation period in analogous cases on grounds of unconscionability to Equity's doctrine of laches. According to the Court, the distinction "is one of substance". A statutory limitation period can be overlooked where not doing so would allow a party to take advantage of his or her wrongdoing. The doctrine of laches, on the other hand, requires a broader inquiry, which looks at the length of the delay, and the knowledge and actions of the parties to determine whether it would be "practically unjust" to allow the claim.

(iv) Applying the principles to this case

The cause of action in this case arose from a breach of fiduciary duties, which sit in "equity's exclusive jurisdiction", but are almost indistinguishable from the statutory directors' duties set out in ss. 180 to 183 of the Corporations Act. The six year limitation period applicable to claims for breach of such statutory duties in s. 1317K is therefore equally applicable, by analogy, to the equitable claim.

Moreover, there is no basis on which to deny the limitation period. It was not established at trial that the directors were conscious of their wrongdoing in transferring Auzhair Supplies' assets to the new company, or that they did so with the specific intention of defeating the Greenways' claim as creditor of Auzhair Supplies. Rather, it could only be established that the directors mistakenly believed the liability for the loan had been transferred to Auzhair 1, along with all other assets and undertakings. No claims of concealed fraud on the part of the directors or other equitable ground which would make it unconscionable to enforce the statutory limitation period was put forward by Auzhair Supplies, either at trial or on appeal, and as such it was unnecessary for the Court of Appeal to consider when Auzhair Supplies acquired knowledge of the breaches.

(v) Outcome of the case

The Court of Appeal held that, as the six year limitation period set out in s. 1317K of the Corporations Act applied by analogy to the equitable breaches of fiduciary duties, and that there is no reason to deny the time bar on grounds of unconscionability, Auzhair Supplies' claims have been made too late and are barred.

6.12 Preliminary discovery: reasonably held belief in a breach of s. 283DA of the Corporations Act

(By David Bryant and Rebecca Williams, King & Wood Mallesons)

Clarke v Sandhurst Trustees Limited [2014] FCA 580, Federal Court of Australia, Greenwood J, 5 June 2014

The full text of this judgment is available online.

(a) Summary

The applicants were holders of debentures in a company now in liquidation, and sought preliminary discovery from the relevant trustee, Sandhurst Trustees Limited (Sandhurst), in relation to a potential action against Sandhurst for breach of its duties.

The case turned on whether the applicants' belief that they may have a claim against Sandhurst was, objectively, a reasonably held belief within the meaning of rl. 7.23 of the Federal Court Rules 2011 (Cth) (the Federal Court Rules).

Sandhurst contended that the applicants' belief could not be reasonable on the bases that:

- the statutory context entitled Sandhurst to rely on the certificates of the company's directors and negligent auditor, and the company's quarterly reports; and
- the trust deed, when properly construed, excluded Sandhurst's liability in full.

Greenwood J held that, in light of the relevant facts and the administrators' reports, there were reasonable grounds for the applicants' belief that they may have an action against Sandhurst.

(b) Facts

Wickham Securities Limited (Wickham) carried on a business of raising funds through the issue of debenture notes to investors, who subscribed via various prospectuses issued between June 2005 and December 2010. Such funds were then invested into "high yielding secured loans within a predetermined risk profile", funding property investments and property development projects. Section 283AA of the Corporations Act 2001 (Cth) (the Corporations Act) provides that before a corporation makes an offer of debentures, it must enter into a trust deed and appoint a trustee. Accordingly, Wickham entered into an Unsecured Note Trust Deed with Sandhurst in June 2005 (the Trust Deed).

Sandhurst raised concerns about Wickham's cash flow position in late 2012. In response, Wickham provided it with an Account Balance Confirmation Letter, purportedly from the Bank of Queensland and its fund manager DDH Graham Limited. It was later found that this letter overstated Wickham's account balance as approximately $10.7 million when it was in fact $264,892.00.

Administrators were appointed in December 2012, and issued a preliminary report to Wickham's creditors in January 2013. This report noted that the Board had not accurately reported the position and quality of its loan portfolio to Sandhurst since at least August 2010. Further, several directors claimed to the administrators that they knew nothing about Wickham's business operations or its loan book, and that these matters were handled by another director who had resigned two days before the administrators' appointment. In addition, Wickham's auditor had provided an unqualified audit opinion that the company's accounts as at 30 June 2012 represented a "true and fair view" of its position. The auditor was considered to have so totally failed to discharge his duties that he later undertook to the Australian Securities and Investments Commission to never act as an auditor again.

The administrators' preliminary report noted that they had commenced investigations into Sandhurst's compliance with its obligations under the Trust Deed. These investigations were continued after the administrators were appointed as liquidators.

The prospective applicants, Mr and Mrs Clarke, had invested a total of $220,000 in Wickham's unsecured deposit notes via their self-managed superannuation fund. They filed an application for preliminary discovery in order to ascertain whether they may have a right to obtain damages from Sandhurst, in respect of a breach of its duties as trustee under Chapter 2L of the Corporations Act and/or the Trust Deed.

(c) Decision

Rule 7.23 of the Federal Court Rules requires, among other elements, that the prospective applicant must reasonably believe that it may have the right to obtain relief in the Court from a prospective respondent.

The case therefore turned on whether there were, objectively, reasonable grounds for Mr and Mrs Clarke's belief that they may have a cause of action against Sandhurst, rather than a "mere belief" or a matter of speculation. This involved a preliminary examination of whether the facts could support such a reasonable belief (rather than a preliminary assessment of the merits of any such action) such that the requirements of rl. 7.23 were met.

(i) Reasonable belief in relation to statutory action

Part 2L.4 of the Corporations Act 2001 governs the duties of the trustee. Per s. 283DA, Sandhurst was obliged to:

- exercise reasonable diligence to ascertain whether Wickham's available property would be sufficient to repay the amount deposited or lent when due;
- exercise reasonable diligence to ascertain whether Wickham had breached the terms of the debentures, the Trust Deed or Chapter 2L of the Corporations Act; and
- do everything in its power to ensure that Wickham (or a guarantor) remedied any breach known to Sandhurst.

Sandhurst contended that there were no reasonable grounds for the Clarkes' belief because, although it was required to discharge these duties, the overall statutory regime entitled Sandhurst to rely on the certificates of Wickham's directors and auditor, and quarterly reports. This "statutory regime" included the requirements for annual financial reporting and statements to be prepared by Wickham and its directors under Chapter 2M of the Corporations Act. It also included the audit regime, including the obligation under s. 313 for the auditor to provide Sandhurst with a written report about any matter that is relevant to its powers or duties as trustee and which is likely to be prejudicial to the note holders' interests.

Sandhurst contended that at no time prior to the appointment of administrators did any quarterly report raise any cause for concern, that all auditors' reports had been unqualified, and that Sandhurst's reliance was therefore permissible in light of the broader statutory context.

Greenwood J had regard to the view of an investor lending money to Wickham within a statutory structure that necessitated the presence of a trustee acting for the benefit of note holders. He considered that such a note holder might reasonably form a view that a professional trustee, experienced in engaging with auditors and with the officers of borrowers such as Wickham, might well have developed a sophisticated "nose" - with the result that it would recognise that two of the directors knew nothing about the business. Further, such an investor might reasonably form the view that reliance upon directors' statements and an auditor's certificate was not sufficient to discharge the duties of the trustee to a note holder. Greenwood J also noted that a number of Wickham's quarterly reports were sloppily prepared in a way that might put a professional trustee on notice that independent enquiries should be made.

While Greenwood J did not need to decide whether Sandhurst was entitled to rely on these reports as contended, he found that the facts were sufficient to ground a reasonable belief that there might be a breach of duty.

In forming this view, Greenwood J noted that the administrators had initiated investigations into Sandhurst's compliance with its obligations, and that these investigations were continued by the liquidators. The applicant's belief was therefore not mere speculation but was reasonably supported by the objective facts.

(ii) Reasonable belief in relation to Trust Deed

Clause 12 of the Trust Deed imposed duties of reasonable diligence similar to those contained in s. 283DA of the Act. Clause 13 then set out a series of limitations on Sandhurst's liability. While cl. 13 acknowledged that this could not exempt liability arising from a breach of s. 283DA of the Corporations Act (consistent with s. 283DB, which voids any provision that purports to do so), Sandhurst contended that cl. 13 effectively excluded any liability arising under the Trust Deed.

In particular, Sandhurst contended that it had "absolute discretion" in the exercise of its powers and duties (as per cl. 13.3), was under no duty to keep itself informed as to Wickham's performance of its obligations, investigate any failures or inspect the books (clause 15.2), and was entitled to accept any certificate issued by Wickham's officers or auditor (cl. 18(b)).

Again, while Greenwood J did not decide the merits, he indicated that each of these clauses were unlikely to be construed so favourably at a final hearing. A prospective applicant might therefore objectively form a reasonable belief that these provisions would not be adequate to fully shield Sandhurst from liability.

Sandhurst has subsequently sought leave to appeal to the Full Federal Court.

6.13 The totality principle in sentencing in respect of civil penalties

(By Anthony Lau, Ashurst Australia)

Kerkhoffs v Registrar of Aboriginal and Torres Strait Islander Corporations [2014] FCAFC 66, Full Court of the Federal Court of Australia, Rares, Collier and Barker JJ, 23 May 2014

The full text of this judgment is available online.

(a) Summary

The Full Court of the Federal Court of Australia has held that the primary judge had regard to the totality principle when determining the overall penalty imposed on Leigh Kerkhoffs (the Appellant), notwithstanding the fact that the primary judge did not make a statement to that effect.

The Full Court found that the primary judge considered "as a whole" a pecuniary penalty of $50,000 and a disqualification from being a director of a corporation for a period of five years, when imposing penalties on the appellant for four contraventions of the Corporations (Aboriginal and Torres Strait Islander) Act 2006 (Cth) (the CATSI Act).

(b) Facts

The appellant was the chairperson of a charitable company known as the Aboriginal and Torres Strait Islanders Corporation for Welfare Services (the Company), which was incorporated under the predecessor of the CATSI Act.

The appellant was involved in four contraventions of the CATSI Act, namely she:

- deliberately received unauthorised payments totalling $8,220.17 after she had been made aware of the related party transactions provisions and prohibitions;
- was involved in the decision of the Company's board to forgive her arrears of rent totalling $23,194 that she owed in respect of her residential property that the Company owned;
- was involved in the decision of the Company's board to enter into a contract to sell her the property which she was renting for $248,000, being at an undervalue, to her knowledge, of $42,000; and
- failed to cause the Company to keep adequate books and records.

In the original hearing, the primary judge imposed a pecuniary penalty of $50,000 and a disqualification order from being a director of a corporation for a period of five years, having regard to the need for general deterrence, balanced with the appellant's particular financial and family circumstances and her ready and timely acknowledgement of the contraventions.

A second hearing was necessary because in the original hearing, there was a misapprehension as to the effect of the automatic disqualification provisions in s. 206B(5) of the Corporations Act 2001 (Cth) (the Corporations Act), which disqualifies a person from being a director of a corporation under the Corporations Act if the person was disqualified from being a director under the CATSI Act. In the second hearing, the primary judge did not vary the orders made in the original hearing.

The appellant appealed against the decision arguing that in both judgments, the primary judge failed to consider the combined effect of the two penalties imposed, particularly given the consequential disqualification under s. 206B(5) of the Corporations Act.

(c) Decision

The Full Court found that the primary judge took into account the totality principle when imposing the civil penalties on the appellant so that they are just and appropriate for the entirety of the contravening conduct. It was found that the primary judge considered the impact of the pecuniary and disqualification penalties he was imposing "as a whole", notwithstanding the fact that the primary judge did not make a statement to that effect.

The Full Court also noted that the primary judge, when imposing the penalties, took into account the need for courts to avoid excessive subtleties and refinement in sentencing. Therefore, the Full Court found that there was no error in the primary judge's sentencing approach and dismissed the appeal accordingly.

6.14 US Supreme Court decision on the need for reliance by plaintiffs in shareholder securities class actions

(By Ross McInnes, Nicholas Mavrakis and Shamus Toomey, Clayton Utz)

Halliburton Co. v Erica P. John Fund, Inc., No 13-317, 82 USLW. 3119, United States Supreme Court, Roberts, Ginsburg and Thomas JJ, 23 June 2014

The full text of this judgment is available online.

(a) Summary and background

By allowing the defendants to challenge the presumption of reliance at an early stage, the US Supreme Court in Halliburton took a small step forward in reducing the costs of shareholder claims.

In Australian shareholder class action litigation, the ultimate game of brinkmanship is being played out before the courts. While numerous cases have been commenced, and some have run to trial, all shareholder class actions to date have settled. This means that the question of how shareholders as a class prove causation - a necessary element for the award of damages - remains clouded in uncertainty. A final decision on this issue could throw fuel onto the shareholder class action fire, or destroy the viability of this kind of action.

In the United States there has been a greater degree of judicial direction. Since 1988 the Courts have accepted the "fraud-on-the-market" theory which establishes a presumption of reliance on an efficient market and that shareholders traded in reliance on the integrity of the market price for securities. This rebuttable presumption absolves United States claimants from having to establish that they personally relied on the impugned conduct in making purchasing decisions about their securities.

The recent decision of the United States Supreme Court in *Halliburton Co v Erica P John Fund* had the potential to overturn the "fraud-on-the-market" theory of causation. Even though it did not, what it did decide could influence how Australian courts consider the issue.

(i) The debate in Australia

Australian shareholder class actions are generally brought in respect of two causes of action:

- misleading or deceptive conduct in respect of inaccurate or incomplete statements and/or a failure to disclose or correct certain information; or
- breach of a listed company's continuous disclosure obligations.

For both causes of action, establishing causation is essential in a claim for damages. The question is, what must a claimant do to establish causation?

Is it necessary for each claimant to separately prove actual reliance on the contravening conduct (direct causation)? Or can the claimant establish causation by showing that the impugned conduct caused the market price of the shares to be inflated and that by purchasing shares at the inflated price, the shareholders have suffered loss (indirect causation)?

(ii) Fraud-on-the-market theory

Indirect causation has some similarities with the United States "fraud-on-the-market" theory, which was first endorsed in *Basic v Levinson* (485 US 224 (1988)) (*Basic*), in the context of securities class actions under the US Securities and Exchange Commission Rule 10b-5.

In *Basic* the US Supreme Court created a rebuttable presumption of shareholder reliance on a company's material public misrepresentations.

The Court based that presumption on the "fraud-on-the-market" theory, which holds that:

- well-developed capital markets efficiently incorporate all publicly available information into a company's market price - the so-called "efficient market hypothesis"; and
- investors buy or sell stock in reliance on the market price conveying the company's true value,

such that misleading, or improperly withheld, information will affect the market price of the security and can therefore be presumed to be the cause of loss to shareholders following a market correction, once the information is disclosed or corrected.

In a representative action, that means that proof of individual investor reliance on the conduct is unnecessary, instead allowing common proof of reliance.

The presumption of reliance in *Basic* was rebuttable, if the link between the alleged misrepresentation and either the price paid, or the decision to trade, could be severed.

The "fraud-on-the-market" theory had real resonance in the United States, because it has a "certification" requirement - a judicial endorsement that the claim can proceed as a class action. One of the necessary elements of certification is that "the questions of law or fact common to class members predominate over any questions affecting only individual members". This is a hurdle which would be insurmountable in shareholder class actions in the absence of the "fraud-on-the-market" theory.

While the presumption has not been adopted in Australia, it does have some similarities with the indirect causation approach, which means the recent decision in Halliburton was keenly awaited by the class action industry in Australia.

(b) Facts and issues

In deciding to hear the appeal, the US Supreme Court considered:

- whether it "should overrule or substantially modify" the holding in *Basic* to the "extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory"; or
- whether defendants may rebut that presumption at the class certification stage.

In Halliburton the claim alleges that Halliburton misrepresented its financial position regarding asbestos litigation, a merger, and costs-overruns on fixed price contracts. As those misrepresentations were discovered or were corrected, Halliburton's share price dropped. The Erica P. John Fund asserted that these misrepresentations defrauded Halliburton's investors and sought class certification to recover investors' losses from Halliburton.

Halliburton had urged the Supreme Court to overrule *Basic*'s presumption of reliance and to instead require every plaintiff to prove that he or she actually relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. Halliburton's primary argument was that there was no longer any justification for the "fraud-on-the-market" theory.

(c) Decision

The Supreme Court determined that Halliburton had not established the necessary "special justification" for the presumption of reliance established in *Basic* to be overruled. In particular, Halliburton "had not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities".

However, the Supreme Court agreed with one of Halliburton's alternative arguments, namely, that defendants must be afforded an opportunity to rebut with evidence of a lack of price impact the presumption of reliance before class certification.

In other words, the Court would permit defendants to lead direct evidence that an alleged misrepresentation did not actually affect the stock's price, and so the *Basic* presumption should not apply. Without the presumption, the claim would not be certified because the common issues would not "predominate" over individual ones.

(d) Implications for Australia: shareholder class actions dodge a bullet

The US Supreme Court, in declining to overrule *Basic*, has in effect affirmed the adoption of the "fraud-on-the-market" theory in establishing a rebuttable presumption of reliance. The viability of that theory of causation in the United States provides some support for proponents of indirect causation in Australian shareholder class actions.

By granting the defendants a procedural victory which enabled them to challenge the presumption at an early stage of the proceedings, the Supreme Court took a small step forward in reducing the costs of shareholder claims in the United States. This, in turn, is likely to reduce the attractiveness of the more speculative shareholder class action suits.

Australian courts have, to varying degree, previously looked to United States developments in class actions, and so this decision has been awaited in Australia with some eagerness. Although it has not been as decisive as some might have hoped, it will provide some guidance to the first Australian court to rule on the appropriate rule for causation in shareholder class actions.

Until a decision is made in Australia, and while the issue remains unresolved, however, the game of brinkmanship continues. Both plaintiffs and defendants take a risk in allowing a matter to proceed to judgment - a decision either way on an essential element in obtaining damages will have a major impact on these kinds of class actions in the future.