
MEMORANDUM

TO: The Treasury

FROM: Evan Flaschen and Renée Dailey

DATE: 11 May 2010

RE: Comments on Exposure Draft of Corporations
Amendment (No. 2) Act 2010

We appreciate this opportunity to submit our comments on the Exposure Draft relating to Corporations Act amendments intended to reverse the effect of the High Court's decision in *Sons of Gwalia Ltd v Margaretic*. We welcome any questions you may have on our comments and we would be pleased to provide written and oral testimony if considered desirable.

Our Background

We are partners in the US-based law firm of Bracewell & Giuliani LLP. Our CVs are attached as **Annexure A**. Our experience relates to matters we have worked at our prior firms as well.

We have been representing US-based and international investors in Australian transactions for many years. Our primary experience is with informal workouts and formal administrations of Australia-based corporates. Workouts and administrations we have been involved in over the years include Australian Education Trust, Burns Philp, Cedenco, Henry Walker Eltin, Newmont Yandal, NRG Energy's Australian affiliate, Pasminco (now part of OZ Minerals), Rubicon, Singer Sewing Company's Australian affiliate, and Western Metals.

We are currently representing US investors in the informal workouts involving Centro and Elders and in the administration proceedings involving Griffin Coal.

Of particular relevance here, we have been representing US-based and international investors in Sons of Gwalia since it entered administration in 2004, including serving together with Arnold Bloch Leibler as ING Investment Management's counsel in connection with ING's participation as creditor-intervenor in the *Sons of Gwalia* litigation.

We typically represent groups of creditors rather than individual entities. The groups typically include institutional investors, such as insurance companies, mutual funds and

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pension fund managers, as well as secondary purchasers, such as hedge funds and other distressed debt investors. In Sons of Gwalia we originally represented a group of insurance companies but, over time, the insurance companies sold their debts to various US and international distressed debt investors who now form our client group.

Due to our substantial experience in Australia and our representation of numerous US-based investors, we have written extensively on the *Sons of Gwalia* decision and its aftermath.

- In July 2007, we wrote "Australia: The Sins of the Sons (of Gwalia) Are Visited on Creditors Yet Again," which is reprinted at **Annexure B**.
- In January 2009, we wrote "US Investors in Australia Beware: New Advisory Report Supports the Sons of Gwalia Decision," which is reprinted at **Annexure C**.
- In January 2010, we wrote "The Rights of Creditors in Australia Restored: Sons of Gwalia To Be Reversed Through Legislation," which is reprinted at **Annexure D**.

The US Private Placement Market

The debt claims held by our clients typically consist of private placement notes or public debt securities. For example, Sons of Gwalia issued private placement notes while Griffin Coal issued public debt securities. The rest of this section focuses solely on private placement notes rather than on public debt securities.

Generally speaking, all issuances of debt securities to US investors are subject to the US securities laws. Private placement notes are debt securities that are issued pursuant to a provision of the US securities laws that exempts the issuer from certain public disclosure and reporting requirements. In general, only "qualified institutional buyers" are eligible to purchase private placement notes. These include insurance companies, institutional fund managers, pension funds and other large financial institutions.

There are a number of characteristics of private placement notes that make them an attractive capital markets option for Australian and other international companies.

- First, as noted above, private placement notes are exempted from many of the US securities laws' disclosure requirements that otherwise apply to publicly-issued debt and equity securities. This results in a considerable cost savings for the issuer.
- Second, private placement notes carry a fixed rate of interest. This provides an issuer with the certainty of its debt service requirements over the life of the notes and also

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serves as a natural hedge against the floating rate loans the issuer typically obtains from its bank lenders.

- Third, private placement notes are typically long-term obligations, such as 7-year notes, 10-year notes, and so forth. This provides an issuer with the ability to plan its long-term capital needs with greater certainty than with bank loans, which typically mature in 1 to 3 years.
- Fourth, private placement note issuances are often unrated, meaning the issuer is not required to obtain a corporate or debt rating from Moody's or Standard & Poor's (or similar).
- Fifth, the private placement market is particularly well suited for issuers with a "story." By this is meant that there are complications in the issuer's financial history, or they do not have a proven track record of financial returns, or there are other factors that can be complicated for the public capital markets to digest. This is particularly common for international issuers who fall between smaller-sized companies who do not need to access the international capital markets and very large companies who have frequently accessed the international capital markets and are therefore already well known to US investors.
- Sixth, and perhaps most significantly, the ability to issue private placement notes provides issuers with access to the huge sector of the US capital markets that consists of institutional investors who are legally prohibited from making commercial loans.

These and other factors make the US private placement market particularly attractive to non-US companies and, in fact, non-US issuers typically account for approximately 50% in dollar amount of new private placement issuances in any given year. Furthermore, Australia has consistently been one of the largest international markets for private placement notes. For example, more than US\$32 billion in private placement notes were issued by Australian companies to US institutional investors between 2005 and 2009.

The Effect in the US of the *Sons of Gwalia* Decision

Under US bankruptcy law (in the US, the term **bankruptcy** applies to companies as well as individuals and to reconstructions as well as liquidations), the claims of persons for rescission of, or damages in connection with, the purchase or sale of a security are subordinated to other claims. For example, if an unsecured creditor seeks damages for fraudulent misrepresentations that induced it to purchase (or not to sell) a debt security, the damages claim would be subordinated to the claims of all other unsecured creditors.

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Similarly, the damages claim of a shareholder would be subordinated to all other claims against the debtor and, instead, would be treated as *pari passu* with the interests of other shareholders.

Prior to the *Sons of Gwalia* decision, it was assumed that Australian law operated in the same way in administrations and liquidations. As a result, when the decision of the trial court in *Sons of Gwalia* was announced, it shocked the US institutional market and led many private placement note investors to re-evaluate investing in Australia. There are five principal reasons this occurred.

- First, US investors were concerned that their unsecured note claims would now be substantially diluted by shareholder damages claims.
- Second, given the prevalence of Class Orders among the types of issuers that are typically large enough to access the US capital markets, US investors were concerned that shareholder damages claims against the parent holding company would also dilute the US investors' claims against the operating subsidiaries who had guaranteed the notes.
- Third, while presumably not all shareholder damages claims would succeed, the assertion of such claims would likely slow down substantially the administration of insolvent Australian companies, thereby substantially delaying the payment of creditor dividends on the notes.
- Fourth, the need for administrators to deal with shareholder damages claims would substantially increase the cost of administrations, thereby reducing further the creditor dividends to be paid on the notes.
- Fifth, shareholder litigation is very common in the US for a variety of reasons, which compounded the fear that shareholder damages claims could become a common occurrence in Australia rather than the rare exception.

Many of these concerns were discussed in an article entitled "Gwalia ruling leaves US lenders wary" in the 12 May 2008 issue of *The Australian*, reprinted at **Annexure E**.

A sixth concern was raised as a result of the implementation of the *Sons of Gwalia* decision in the Administration of Sons of Gwalia itself. As a result of the *Sons of Gwalia* decision, the Administrators of Sons of Gwalia felt compelled to admit shareholder claims for the purpose of voting on a proposed sale of the business. Given the hundreds of shareholder claims involved and the fact that the shareholders, being largely represented by class counsel,

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voted as a bloc, the shareholders substantially outvoted the financial creditors, including the private placement noteholders, in number. The shareholder claims were also admitted for voting purposes in their full asserted amount. Even so, the dollar amount of the vote was A\$320 million (mainly the shareholder claims) in favor of the sale and A\$600 million (mainly the private placement notes and other financial claims) against the sale. Given the split vote, the Administrators cast the deciding ballot and approved the sale. In other words, the votes of the shareholder "creditors" outweighed the votes of the financial creditors, even though the shareholder claims were disputed in liability and amount while the financial claims were undisputed. The message to the US investors was clear – their vote did not matter. The vote and its consequences are discussed in more detail in the article reprinted at **Annexure B**.

As a result of the *Sons of Gwalia* decision, US institutional investors became more cautious about investing in new-to-market Australian private placement note issuances. We can state categorically that this was the case for many of the largest insurance companies in the US and we understand that this caution directly affected the amount of private placement note issuances that Australian companies were able to achieve as well as the pricing (interest rate) of such issuances. Unfortunately, because US institutional investors are, by nature, very conservative and very averse to publicity of any nature, we were unable to persuade any US institutional investors to state their concerns "on the record." However, it is clear from the marketplace that they "spoke with their feet," meaning they decreased their overall investment in Australian private placement note issuances and increased their overall investment in other countries such as the UK. Similar consequences prevailed after some surprising and unfavorable treatment of US investors occurred in the Italian insolvency proceedings involving Parmalat.

The Effect of the *Sons of Gwalia* Decision on Out of Court Restructurings

In addition to stifling US market appetite for investment in medium-sized Australian companies, the *Sons of Gwalia* decision also had an adverse, or at least complicating, effect on out of court workouts. One of the distinctions between US and Australia out of court restructurings is the overlay of director liability for "trading while insolvent" in Australia. In the US a company can operate while in default and even while clearly insolvent so long as the proper disclosures are made. While operating in default is not optimal for the long term, it does provide the company with an opportunity to engage in restructuring discussions with its financiers on a private basis. In contrast, in Australian restructurings, the waiver and forbearance agreement is paramount. Following the *Sons of Gwalia* decision not only did directors need to consider financier debt in evaluating solvency, but also the contingent, unliquidated and contested claims of shareholders.

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As an aside we are in favor of some form of the "safe harbour" modifications to the director trading while insolvent provisions currently being considered. Such a revision would allow directors to continue productive restructuring discussions with financiers without the fear of liability, as well as accomplish many of the objectives set forth on page 14 of the Explanatory Memorandum.

Support for the New Legislation

The Government's decision to draft legislation to reverse the *Sons of Gwalia* decision was widely reported in the US (see the article reprinted at **Annexure D**) and we received many comments from US institutional investors to the effect that they were prepared to increase substantially their investment in Australian private placement note issuances. As a result, we can predict with confidence that, from the perspective of the US institutional investor market, the enactment of the Corporations Amendment (No. 2) Bill 2010 will achieve the Main Points set forth on page 6 of the Explanatory Memorandum.

Effect on Shareholders

While we do not presume to be experts in Australian domestic shareholder issues, we note that some shareholder advocates have argued against the proposed legislation on the basis that it is harmful to shareholder interests. With respect, we believe the opposite is true. For every instance in which shareholders are justly aggrieved by corporate fraud, there are hundreds of instances where no one has perceived even the possibility of fraud. The shareholders of most Australian companies, therefore, benefit substantially when their companies are able to obtain needed financing for operations, business growth and domestic and international expansion. US private placement note issuances help Australian companies with all of these needs and the proposed legislation will increase the ability of Australian companies to obtain US private placement note financing. In short, for every shareholder damaged by corporate fraud, hundreds if not thousands of shareholders will be benefited from greater access to the US capital markets.

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Suggested Adjustments to the New Legislation

With respect to the particular terms of the new legislation, we have a suggestion based on the US experience. In the US, it is not just existing shareholders who assert damages claims in connection with the purchase or sale of a security, but also purchasers of debt securities, convertible debt securities, preferred shares, options and warrants. Holders of such “securities” can also assert damage claims, and often do. Consistent with the purpose of subordinating shareholder damages claims, US bankruptcy law also subordinates debt security holder damages claims and we respectfully request that the new legislation consider including similar treatment. Two examples will illustrate why this makes sense.

- Assume a company that issued unsecured public debt securities in 2007. In 2008, the company became aware of adverse financial information that, if disclosed, would depress the trading price of securities held at the time. In 2009, the company finally disclosed the adverse financial information. In 2010, the company commences bankruptcy proceedings. This creates two classes of holders of the securities. The first class consists of the holders who purchased their securities in 2008 when the company should have disclosed the adverse financial information but failed to do so. The second class consists of the holders who purchased their securities in 2009 after the adverse financial information had been disclosed.

The first class would have a claim for damages as a result of the company's failure to make timely disclosure of the adverse financial information. The second class would not have a claim for damages because the adverse financial information was known to them when they purchased their securities. If the first class of holders was entitled to assert its damages claims *pari passu* with the claims on the debt securities, it would increase the recoveries of the first class and dilute the recoveries of the second class. To address this inequity, US bankruptcy law provides that the damages claims of the first class are subordinated to all claims for repayment of the debt securities, including the claims of the second class.

- Assume a company that has issued both unsecured senior debt securities and unsecured subordinated debt securities. To avoid inequity, US bankruptcy law provides that any damages claims arising under the subordinated debt securities are subordinated to the regular claims of the holders of the senior debt securities and the subordinated debt securities.

Note that, under both of these scenarios, the damages claims are also subordinated to all other claims that are "senior or equal" to the claims on the securities themselves. For example, the damages claims in both scenarios above are subordinated not only to the claims

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on the debt securities but also to all other unsecured claims such as the claims of trade creditors.

We appreciate that Australia has not yet experienced this type of litigation from holders of senior, subordinated or convertible debt securities or from holders of preferred shares, options or warrants. However, our experience has been that international corporate markets often expand to include categories of securities and financial instruments that have become commonplace in the US. Our experience also indicates that US-style litigation (for better or for worse) has also expanded to other countries over the years (most recently the UK and parts of Continental Europe), so even though this may not be an issue in Australia today, prudence suggests that the new legislation also anticipate such possibilities in the future.

In order to cover both the potential damage claims of purchasers of various types of debt securities as well as preferred shares, options and warrants, we would recommend use of the term "securities" as defined in Corporations Act 2001 (and as used in Chapters 6 to 6CA) rather than the term "shares". Consideration should also be given to ensure that the term "securities" is sufficiently broad to encompass the types of debt and convertible securities that are now commonplace elsewhere.

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We thank you again for the opportunity to make this submission.

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ANNEXURE A

People



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Related Practices

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Private Investment Funds

Evan Flaschen is the chair of the Financial Restructuring Group at Bracewell & Giuliani LLP. His practice includes representation of many of the world's largest institutional investors, hedge funds, Wall Street proprietary desks, fund managers, leveraged finance participants and financial services companies in out-of-court restructurings, in-court proceedings and distressed M&A transactions, both domestically and internationally.

Mr. Flaschen has represented noteholder and bondholder groups, first and second lien lender groups, official creditors' committees or bank agents and syndicates in numerous high profile U.S. and international restructurings, including Washington Mutual Bank TOUSA, Centro Properties, Cemex S.A.B., American Media, BearingPoint, Australian Educational Trust, Parmalat, U.S. Shipping Partners, Abitibi, DURA Automotive, Tembec Industries, Scotia Pacific, Pliant, Remy International, Interstate Bakeries, Sons of Gwalia, Intermet, Star Gas, Kaiser Aluminum, NRG Energy, Liberty Electric, AT&T Canada, Asia Global Crossing, Loewen Group, Boston Chicken, Telex Chile, Burns Philp, Pasmenco, Global TeleSystems, Metromedia Fiber, Teleglobe, Consumers Packaging, Chilesat, Henry Walker Eltin, and Western Metals.

Mr. Flaschen has also served as lead counsel, special international counsel or "foreign representative" (a role he pioneered) for a number of multinational Chapter 11 debtors, including Owens Corning, Polaroid, Nextel International, Comdisco, Montgomery Ward, Singer Sewing and Exodus Communications. Mr. Flaschen has appeared in courts in four continents and has published over 85 articles and book chapters in several different countries on workout, restructuring and international insolvency topics. He has also been a lecturer or panelist at more than 140 restructuring, insolvency and distressed debt programs around the world and his legal writings have been cited by courts around the country and in more than 100 scholarly journals and treatises globally, including Australia, Brazil, Canada, Cayman Islands, China, England, Germany, Israel, Japan, Malaysia, The Netherlands, New Zealand, Norway, Peru, Slovenia, South Africa, Spain and Sweden. They have also been required reading in a number of graduate school courses.

Publications and Speeches

Author of "Expert Committee's Report on Cross-Border Insolvency Access and Recognition," which led to the formation of the working group that drafted the UNCITRAL Model Law on Cross-Border Insolvencies.

"How to Best the Mess of Distress," Debtwire Distressed Debt 09 Forum, Wednesday, March 25, 2009, Harvard Club of New York City.

Education

J.D., University of Connecticut School of Law, 1982
B.A., Wesleyan University, 1979

Bar Admissions

Connecticut
Registered Foreign Lawyer, The Law Society of England and Wales

Court Admissions

U.S. District Court Connecticut
U.S. District Court for the Southern District of New York
U.S. Courts of Appeals for the 1st, 2nd, 3rd and 5th Circuits

Affiliations

Elected fellow of American College of Bankruptcy, American College of Investment Counsel, American Law Institute, International Insolvency Institute and James W. Cooper Fellowship
Chair or member of advisory groups concerning the creation or updating of insolvency legislation for Canada, Estonia, Latvia, Lithuania and Russia

Noteworthy

US Legal 500, Corporate Restructuring, Leading Lawyer, 2008-2009
Named three times on Euromoney's list of the Top 25 "Best of the Best" insolvency lawyers in the world
Selected four times as one of the 20 lawyers on Who's Who Legal list of the "Most Highly Regarded" insolvency lawyers in the world
Named to Legal 500's list of the top 10 "Leading Lawyers" in the US for corporate restructurings
Named twice as the only US restructuring lawyer on Asialaw Legal's list of "Leading Lawyers"
Adjunct Professor, University of Connecticut School of Law, teaching an annual seminar entitled "International and Comparative Corporate Insolvency Law" since 1994 (www.evanflaschen.net)

People



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Related Practices

Finance

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Litigation

Private Investment Funds

Renée Dailey is a member of the firm's Financial Restructuring team. Ms. Dailey's practice focuses on representation of hedge funds and institutional investors in complex out-of-court restructurings and in-court proceedings both in the U.S. and internationally. Ms. Dailey's practice also involves the representation of debtor-in-possession lenders in chapter 11 cases and strategic purchasers in 363 acquisitions.

Representative Matters

Counsel to noteholder group of Washington Mutual Bank.

Counsel to noteholder group in restructuring discussions with Centro Properties Group.

Counsel to noteholder group in restructuring discussions with CEMEX.

Counsel to noteholder group in restructuring discussions with YRC Worldwide Inc.

Counsel to the ad hoc committee of subordinated bondholders in Pliant Corp.

Counsel to ad hoc committee of second lienholders in Remy International.

Counsel to ad hoc committee of second lienholders in J.L. French.

Counsel to DIP Agent in Kullman Industries and Heating Oil Partners.

Counsel to Official Committee of Unsecured Creditors in NRG Energy, Inc.

Counsel to ad hoc committee of certificateholders in their restructuring discussions with Atlas Air, Inc.

Counsel to noteholder group in Australian voluntary administration of Sons of Gwalia Ltd.

Counsel to noteholder group in Australian voluntary administration of Henry Walker Eltin, Ltd.

Counsel to noteholder group in Australian voluntary administration of Pasmenco Ltd.

Counsel to noteholders in their restructuring discussions involving Dixon Ticonderoga Company.

Counsel to ad hoc committee of bondholders of Cenargo International, Plc.

International bankruptcy counsel to Owens Corning.

Special appellate bankruptcy counsel to Nextwave Personal Communications, Inc. et al. and E. Pierce Marshall.

Publications and Speeches

"FDIC Stands Between J.P. Morgan and a Tax Windfall," Wall Street Journal, March 29, 2010.

"Tax-Break Battle Flares," Wall Street Journal, March 24, 2010.

Panelist, "Legal Careers in a Time of Scarcity," International Law in a Time of Scarcity, University of Connecticut, School of Law, 2010.

Education

J.D., University of Connecticut School of Law, 1999

B.A., magna cum laude, University of Connecticut, 1996

B.A., magna cum laude, University of Connecticut, 1995

Bar Admissions

Connecticut

District of Columbia

Court Admissions

U.S. District Court Connecticut

U.S. District Court for the Southern District of New York

Affiliations

American College of Investment Counsel

Connecticut Bar Association

American Bar Association

Noteworthy

Lecturer, University of Connecticut School of Law, teaching an annual seminar entitled "International and Comparative Corporate Insolvency Law"

Named by Connecticut Law Tribune as a "Woman in the Law - High Achiever"

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ANNEXURE B

News & Publications

**UPDATE**

Australia: The Sins of the Sons (of Gwalia) Are Visited on Creditors Yet Again

July 27, 2007

Australia is sometimes referred to as "down under" for obvious geographic reasons. In the investment community, however, Australia is becoming known as "upside down" due to the Sons of Gwalia (SOG) insolvency proceedings, in which the alleged fraud claims of shareholders have been elevated to *pari passu* status with legitimate unsecured claims. Now, the sins of SOG's fraud have been visited on SOG's creditors again, this time by permitting shareholders to outvote A\$600 million in real creditors in deciding on the sale of SOG's operating businesses.

When Is A Shareholder Not A Shareholder?

Section 510(b) of the United States Bankruptcy Code provides that, generally speaking, a claim by a shareholder for damages arising from the purchase or sale of its shares should be subordinated to the claims of unsecured creditors in bankruptcy proceedings. The thinking is that shareholders, in exchange for the ability to reap upside benefits, should also assume the possibility of downside risks, even if those risks arose as a result of an issuer's fraudulent misrepresentations. Simply stated, "once a shareholder, always a shareholder."

In Australia, Section 563A of the Corporations Act provides that, in an insolvency proceeding, the claim of a shareholder "in its capacity as such" is similarly subordinated to unsecured claims. As many US investors are now aware, the High (i.e., Supreme) Court of Australia recently issued a decision concluding that a shareholder's claim against an issuer for damages caused by defective disclosure practices should not be subordinated to the claims of legitimate unsecured creditors. *Sons of Gwalia Ltd. v. Margaretic* [2007] HCA 1. The Court's rationale was that, when a shareholder is defrauded by an issuer's public statements, the shareholder is in the same position as any other victim of fraud and, accordingly, should have a general unsecured claim the same as any other fraud victim. Stated differently, the shareholder's claim arose in the shareholder's capacity as a fraud victim, not in its capacity as a shareholder.

The SOG administration will be familiar to many of you because of the substantial amount of claims against SOG held by US and other international investors (as represented by Bracewell & Giuliani). Also familiar to you will be the two biggest practical consequences so far of the *Sons of Gwalia* decision: the risk of substantial dilution from shareholder claims in fraud situations and the risk of substantial delay in distributions while shareholder claims are adjudicated by the insolvency administrators.

But Wait, It's Even More Upside Down

As troubling as the foregoing consequences may be, a new one has arisen that may be the most troubling of all. Generally speaking, creditor votes in Australia are decided on the basis of a majority in amount plus a majority in number, in each case of those actually voting. This is similar to the US, except that chapter 11 creditor votes normally require a majority in number and two-thirds in amount. Where Australia really parts company with the US, however, is if there is a split vote. In the US, a split vote means that the creditors have rejected the proposal. In Australia, a split vote means that the insolvency administrators *cast the deciding vote*. The theory is that

Australian administrators are independent professionals with a fiduciary duty to all creditors, so they can be trusted to exercise appropriate business judgment in casting their deciding vote.

In the SOG administration, the administrators proposed to sell the business for an amount that would yield a dividend to creditors of only 12 cents on the dollar. A group of US creditors holding approximately A\$300 million in undisputed claims against SOG believed that the sale price was far too low and they put together a competing bid that featured the upside potential of an equity distribution. Without getting into unnecessary detail, suffice it to say that SOG's administrators rejected the competing bid because they applied a heavy discount to the equity component and a high risk factor to the conditions to closing. Thus, when it came time to vote on the asset sale, a "yes" vote indicated support for the proposed sale recommended by the administrators, while a "no" vote implicitly indicated support for the highly-publicized competing proposal, even though the administrators refused to put it on the ballot.

As part of the vote, the "claims" of the shareholders were permitted to be voted, even though fraud had only been alleged, not proven, and there had not yet been any showing of reliance on the fraud by any of the shareholders. Equally disturbing, the shareholder "claims" were permitted to be voted at the full amount alleged by the shareholders, even when they alleged so-called "lost opportunity" damages, such as, "If I had known of the fraud, I would have purchased BHP shares instead of SOG shares and, therefore, my damages should be measured by the substantial increase in value of the BHP shares that I would have bought." As a result, shareholders were deemed for voting purposes to hold A\$250 million of the A\$1.1 billion of claims eligible to vote.

The substantial majority of the shareholders were individual investors, not institutions, so, as expected, they voted in favor of the administrators' proposal. This assured that a majority in number of creditors favored the cash sale. Even so, a full A\$600 million of claims were voted against the sale, while only A\$320 million were voted in favor.

As noted above, in the US, the voting results would have meant that the sale was rejected (and resoundingly so). Even in Australia, however, one would presume that the administrators would cast their deciding ballot in favor of the view of the holders of the overwhelming majority in amount of the undisputed claims. Not so. The administrators had repeatedly and publicly recommended the cash sale and were not about to let the vote of 65% in amount of the creditors stand in their way. As a result, the administrators sided with the vote of the shareholders, even though not one of them actually had a proven claim yet.

To put the final nail in the coffin, the US and international creditors opposing the cash sale were advised that a court challenge of the administrators' decision would be pointless, given that insolvency administrators are independent professionals and, therefore, there is an almost insurmountable legal presumption in favor of their exercise of their business judgment.

Lessons Learned When Upside Down

First, SOG does not alter the fact that the overwhelming number of Australian companies do not commence insolvency proceedings.

Second, SOG does not alter the fact that, of those Australian companies that do commence insolvency proceedings, only a small minority are likely to involve listed companies where shareholders have potentially been defrauded by false or misleading public disclosures.

Third, SOG does not alter the fact that, even in those few insolvency situations potentially involving false or misleading public disclosures, the shareholders still have to make a credible showing of the fraud and their reliance on it before they are entitled to receive a distribution.

But fourth, where fraud has been alleged and there are thousands of shareholders (as is the case with SOG), it may prove less costly and time-consuming simply to make distributions to the vast majority of shareholders rather than to pursue objections to their individual small claims, just as one often does with "convenience class" creditors in the US.

And fifth, the ability of allegedly defrauded shareholders in Australia to vote the full amount of their "claims" in insolvency proceedings and to override the views of undisputed creditors can dramatically affect recovery expectations.

So What's an Investor in Australia To Do?

The *Sons of Gwalia* High Court decision was front-page news and the Australian government has appointed several commissions to consider whether the law should be changed. Given the conflicting constituencies in Australia, however, we think there is an equal likelihood that the law will be changed to subordinate shareholder claims OR the law will be changed to strengthen shareholder claims (or no change at all will be made). In the absence of an assured legislative fix, it raises the questions of whether to continue to invest in Australian debt securities or other claims and, if so, whether there are structural precautions that an investor can take.

As to the first question, most Australian companies will not end up in insolvency proceedings and most insolvency proceedings will not involve the shareholder issues present in the SOG matter. Given the continuing robust Australian economy and very low percentage of corporate defaults, we see no reason to avoid original Australian investments. A tougher question is whether to invest in distressed Australian securities and claims if there is even a hint of potential securities fraud. In such circumstances, distressed debt investors may wish to consult with Australian counsel before plunging in or, at least, before finalizing pricing.

As to the second question, one seemingly obvious fix would be to obtain guarantees from operating subsidiaries, thus providing structural seniority to shareholder claims against the parent issuer. Unfortunately, this is not a fix at all. Listed Australian companies typically report their group financial results on a consolidated basis. For creditors who do business with only one member of the group, this raises a concern about the creditworthiness of the individual company in the absence of separate public financial statements. The Australian solution to this concern is to require the members of listed corporate groups to cross-guarantee each other's debts, with the result being that, in insolvency proceedings, all of the assets and liabilities of the corporate group, including any shareholder claims, are essentially pooled on a *pari passu* basis.

Another possibility would be to obtain security. This would seem unlikely for highly-rated public corporates, but might be more realistic with middle market "story" private placements. At the same time, a middle market issuer's bank lenders will also be more likely to seek security for the same reasons, thus making equal and ratable security interests a legitimate option.

In negotiated transactions, investors should also consider a more thorough investigation of internal controls and requiring more stringent reporting requirements signed off by two corporate officers. Investors should also pay particularly close attention to hedging policies and controls, which seem to be at the root of the majority of fraud situations in the Australian mining and minerals sector. Fraud can never be eliminated completely, of course, but greater scrutiny should help to reduce fraud opportunities (which is certainly one of the main theories of Sarbanes-Oxley).

In sum, the challenge for investors in new Australian middle market transactions will be negotiating where possible for creative protections and stricter controls (and note that the same likely holds true for New Zealand transactions). The challenge for distressed debt investors in unsecured claims against listed Australian companies will be to sniff out the potential for shareholder fraud claims before finalizing their purchase decisions. Otherwise, in those few situations where a listed Australian company may have issued false or misleading public statements before ending up in insolvency proceedings, the priority and voting power of shareholder claims can truly turn the bankruptcy world upside down.

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News & Publications



UPDATE

US Investors in Australia Beware: New Advisory Report Supports the Sons of Gwalia Decision

January 29, 2009

We have previously reported on the infamous *Sons of Gwalia* decision in which the High (i.e. Supreme) Court of Australia concluded that a shareholder's claim against an Australian issuer for damages caused by defective disclosure practices should *not* be subordinated to the claims of legitimate unsecured creditors in insolvency proceedings. For our prior update on the *Sons of Gwalia* situation, including its drastic implications for creditor votes and our discussion of "lessons learned" for investing in Australian debt, [click here](#).

Our prior update also reported that the *Sons of Gwalia* decision was so controversial that it drew numerous market commentaries and business editorials, resulting in the undertaking of a review by CAMAC (Corporations and Markets Advisory Committee, www.camac.gov.au). Specifically, CAMAC was asked "to consider whether the current position should be retained or changed to postpone [subordinate] claims by shareholders as aggrieved investors, and whether other changes should be made to ameliorate the consequences of either outcome.

"CAMAC's press release announcing the study on September 20, 2007 can be found [here](#), and CAMAC's lengthy discussion paper concerning the issues, including a discussion of relevant law from other jurisdictions, can be found [here](#). Bracewell & Giuliani provided input through our Australian friends at Arnold Bloch Leibler, urging that the decision be overturned due to its poor policy and its negative effect on US investment in Australian debt securities. A copy of the submission can be found [here](#).

At noon today in Canberra, CAMAC publicly issued its long-awaited report. For a copy of the 112-page report, [click here](#). In short, CAMAC is recommending no change to the law. To quote from CAMAC's press release accompanying the report:

"While recognising that the decision has significant implications, including for providers of corporate debt finance as well as the conduct of external administrations, CAMAC has not recommended action to overturn its effect.

The empowerment of shareholders to hold a company to account in damages reflects a significant shift in regulation. It has in effect turned shareholders into potential unsecured creditors as well. The views of respondents to CAMAC's earlier discussion paper were polarised on the question whether the current position should be maintained or changed.

The Committee as a whole is not persuaded of the need for change in the legal position. Any move to curtail the rights of recourse of aggrieved shareholders where a company is financially distressed could be seen as undermining legislative initiatives to provide shareholders with direct rights of action in respect of corporate misconduct."

While this is only a recommendation to the Australian Government and it is clear that the members of CAMAC were not unanimous in their views, our sources tell us that the Government is likely to accept the recommendation. We do not intend to go down without a fight, however, and we and ABL will now focus our

lobbying efforts directly on the Australian Government, urging that a more pragmatic approach is required, particularly in these extraordinary times.

We repeat our comments from our prior update that the *Sons of Gwalia* decision should not prevent US investors from purchasing Australian debt securities or making loans to Australian corporates. At the same time, we have been involved in other restructuring and insolvency situations since the *Sons of Gwalia* decision was issued and the shadow of pari passu shareholder claims has loomed large in each of those situations, repeatedly frustrating swift restructuring efforts. The concerns have been further heightened by the explosion of third-party funded litigation in Australia, in which litigating shareholders are indemnified by the funders against the costs of the litigation, including any award of the other side's litigation fees under Australia's "loser pays" system. In fact, the largest litigation funder in Australia, IMF (Australia) Ltd. (www.imf.com.au), is now a public company listed on the Australian Stock Exchange.

The timing of the CAMAC report is particularly critical given the flood of Australian private place note offerings that are currently being shown to US investors as Australian corporates are seeking to refinance their borrowings from foreign banks who are exiting their positions due to the credit crisis. This raises once again the question of whether US investors should increase their focus on higher pricing, tighter covenants, structural protections, and possibly even collateral security. While each situation will be different, of course, we can assure you that Australian banks who are still lending are also considering all of these issues and we encourage you to do the same. We would also be pleased to discuss with you our views of particular transactions and protections if you would find it helpful.

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ANNEXURE D

News & Publications



UPDATE

The Rights of Creditors in Australia Restored: Sons of Gwalia To Be Reversed Through Legislation

January 19, 2010

We have reported twice before on the infamous *Sons of Gwalia* decision in which the High (*i.e.* Supreme) Court in Australia concluded that a shareholder's claim against an Australian issuer for damages caused by defective disclosure practices should not be subordinated to the claims of legitimate unsecured creditors in insolvency proceedings. For our initial update on the *Sons of Gwalia* decision, in which we discuss the decision in detail including its potentially drastic implications for Australian corporate finance, [click here](#). After the decision came out, a number of interested parties, including Bracewell & Giuliani, lobbied for a change in the law to overrule the decision. Unfortunately, as our second update reported ([click here](#)), the influential Australian Corporations and Markets Committee (CAMAC) issued an Advisory Report supporting the *Sons of Gwalia* decision.

While matters appeared bleak, we and others continued our lobbying efforts directly with the Australian government. Now, much to our delight, the Rudd government has just announced a series of insolvency reforms that includes a legislative reversal of the *Sons of Gwalia* decision. In other words, once the legislation becomes effective, the claims of defrauded shareholders will return to being postponed (subordinated) to the claims of legitimate unsecured creditors, including the holders of private placement notes and public debt securities.

One of the issues we highlighted in our initial update and in our subsequent lobbying efforts was that the *Sons of Gwalia* decision could result in more demands for security and higher interest rates to compensate for the increased risk, both of which could harm the financing efforts of Australian corporate borrowers. In announcing the decision to reverse the *Sons of Gwalia* decision through legislation, Australia's Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, agreed with the concerns, indicating that, "[a]ny direct benefits to aggrieved shareholders arising from non-subordination are outweighed by the negative impacts on shareholders generally as a result of restrictions on access to, and increases in, the cost of debt financing for companies." Minister Bowen added that, "[t]he Government also remains concerned that the *Sons of Gwalia* decision has the potential to further increase uncertainty and costs associated with external administration [*i.e.* corporate insolvency proceedings]." For the full text of Minister Bowen's press release, which includes other beneficial changes to corporate insolvency laws that promote out-of-court work-outs, [click here](#).

While the actual effective date of the legislation is still months away, the legislation will presumably affect existing finance arrangements in addition to new financings and it should be very welcome news indeed, both in Australia and the US. In the past, Australia and the UK vied for the position as the number one international destination for US financing outside of North America, and this new legislation will not only assist Australian corporates with their financing needs but also restore Australia as a favored haven for billions of dollars of US capital on reasonable pricing terms.

The restructuring partners at Bracewell & Giuliani have been representing US noteholders and bondholders in Australia for close to 15 years, including four current Australian assignments. For further information about the new legislation or about Australian restructurings and insolvencies in general, please contact your Bracewell relationship partner or either of the authors listed on the top-right of this Update.

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ANNEXURE E

The Australian

Gwalia ruling leaves US lenders wary

- Richard Gluyas
- From: The Australian
- May 12, 2008 12:00AM

CORPORATES face a higher cost of capital in the US after last year's controversial High Court decision that elevates shareholder rights at the expense of creditors in company collapses, according to one of the world's foremost insolvency lawyers.

Evan Flaschen of Connecticut law firm Bracewell & Giuliani, who represented investors with a E12 billion exposure to collapsed Italian food giant Parmalat, said "numerous" US institutional investors had told him they had lowered their assessment of Australian credits after the judgment.

"As a result, they will require a higher return (interest rate) in order to lend to them," he told The Australian.

"They will also look more critically at the issue of whether they should require security in order to ensure that they come ahead of shareholder claims.

"Each issue -- higher interest rates and requirements for collateral -- makes it more expensive and more difficult for Australian companies to raise financing, which hurts far more shareholders in far more situations than the few instances where shareholders are harmed by fraud or improper disclosure."

The Corporations and Markets Advisory Committee is considering whether to recommend legislative change that would subordinate shareholder claims to those of creditors.

This follows the High Court's ruling in Sons of Gwalia that a shareholder misled by a company into acquiring its shares can claim as a creditor in any external administration.

Aside from flow-on implications for the cost of capital, concern has been expressed that the judgment disadvantages unsecured lenders as well as trade and other creditors, because their claims face new competition.

CMAC announced last September it was considering the Sons of Gwalia issue. By December 21, the closing date for input, it had 19 submissions.

Arnold Bloch Leibler partner Leon Zwier has been a vocal proponent of winding the law back and subordinating shareholder claims.

He argues in his own CMAC submission that the law impedes the recapitalisation of distressed companies, such as property group Centro, which last week got a further three weeks to convince all its lenders to extend long-term funding.

As in Sons of Gwalia, Centro faces a shareholder class action for allegedly misleading investors over the misclassification of near-term debt as long-term borrowings. "The obvious commercial solution to any company in Centro's current difficulty is an injection of capital," he argues in the submission.

"The prospects of successfully achieving a capital injection are materially lessened by the existence of the substantial unknown liability represented by the shareholder claims, which by reason of the Sons of Gwalia decision, rank with all other creditors and in priority to equity."

Mr Flaschen said problems associated with the Parmalat administration had resulted in many US institutions putting Italy on their "do not invest" list, because they had no faith that they would be treated fairly in an Italian insolvency.

With Australia not viewed as favourably as it was before the Sons of Gwalia decision, he said higher interest rates charged by investors would have "substantial knock-on effects to the borrower, to the borrower's shareholders and even to the economy if it repeatedly happens".

Litigation funder IMF Australia disputes in its CMAC submission that the cost of debt will increase a result of Sons of Gwalia.

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