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Implications of the Federal Court's decision
in the Lehman Brothers collapse

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Table of Contents

1.	Introduction	3
2.	Outline of Statutory Framework	3
2.1	Section 444D (Effect of deed on creditors)	3
2.2	Section 444E (Protection of company's property from person bound by deed)	4
2.3	Section 444H (Extent of release of company's debts)	4
2.4	Section 444J (Guarantees and indemnities)	4
2.5	Section 445G (When Court may void or validate deed)	4
3.	Pre-Lehman	5
4.	<i>Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited</i>	10
4.1	Background	10
4.2	The decision	11
5.	<i>City of Swan v Lehman Brothers Australia Ltd</i>	11
5.1	Background	11
5.2	The decision	13
(a)	Arrangements under Pt 5.1 differ significantly from the administration of a company under Pt 5.3A of the Act	13
(b)	Pt 5.3A does not confer upon the administrators, the company and the creditors an 'entirely free rein' in respect of what is included in a DOCA	14
(c)	Section 444D(1) refers only to 'claims' against the company under administration	15
(d)	'Getting around' the limitation in Pt 5.3A	16
(e)	Impugned provisions unseverable from deed	16
6.	Implications of the Full Federal Court decision	17
6.1	Third party releases are not permissible under Pt 5.3A of the <i>Corporations Act</i>	17
6.2	Not every DOCA that does release third parties will be void	17
6.3	Third party releases under Pt 5.3 of the <i>Corporations Act</i>	18
7.	Conclusion	20

1. Introduction

In *City of Swan v Lehman Brothers Australia Ltd (Lehman)*,¹ the Full Court of the Federal Court unanimously held that section 444D of the *Corporations Act 2001* (Cth) (the **Corporations Act**) does not authorise a deed of company arrangement (**DOCA**) that releases or compromises creditors' claims against third parties. The decision was handed down only weeks after another unanimous decision of the Full Federal Court in *Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited (Opes)*,² where it was held that third party releases are permissible in schemes of arrangement under section 411 of the Act. The decision in *Lehman* is significant not only because of the Full Court's findings on the scope of Pt 5.3A of the Act, but also because the Court made some observations on the decision in *Opes*. The High Court of Australia has granted special leave to appeal in *Lehman*. The findings in *Opes* are likely to be the subject of argument in the *Lehman* appeal.

2. Outline of Statutory Framework

The issues to be decided in *Lehman* arose out of Part 5.3A of the *Corporations Act*, and, in particular, the following sections.

2.1 Section 444D (Effect of deed on creditors)

444D Effect of deed on creditors

- (1) *A deed of company arrangement binds all creditors of the company, so far as concerns claims arising on or before the day specified in the deed under paragraph 444A(4)(i).*
- (2) *Subsection (1) does not prevent a secured creditor from realising or otherwise dealing with the security, except so far as:*
 - (a) *the deed so provides in relation to a secured creditor who voted in favour of the resolution of creditors because of which the company executed the deed; or*
 - (b) *the Court orders under subsection 444F(2).*
- (3) *Subsection (1) does not affect a right that an owner or lessor of property has in relation to that property, except so far as:*
 - (a) *the deed so provides in relation to an owner or lessor of property who voted in favour of the resolution of creditors because of which the company executed the deed; or*
 - (b) *the Court orders under subsection 444F(4).*
- (4) *Section 231 does not prevent a creditor of the company from becoming a member of the company as a result of the deed requiring the creditor to accept an offer of shares in the company.*

¹ [2009] FCAFC 130.

² [2009] FCAFC 125.

2.2 Section 444E (Protection of company's property from person bound by deed)

444E Protection of company's property from persons bound by deed

- (1) *Until a deed of company arrangement terminates, this section applies to a person bound by the deed.*
- (2) *The person cannot:*
 - (a) *make an application for an order to wind up the company; or*
 - (b) *proceed with such an application made before the deed became binding on the person.*
- (3) *The person cannot:*
 - (a) *begin or proceed with a proceeding against the company or in relation to any of its property; or*
 - (b) *begin or proceed with enforcement process in relation to property of the company;*

except:

 - (c) *with the leave of the Court; and*
 - (d) *in accordance with such terms (if any) as the Court imposes.*
- (4) *In subsection (3):*

property, in relation to the company, includes property used or occupied by, or in the possession of, the company.

2.3 Section 444H (Extent of release of company's debts)

444H Extent of release of company's debts

A deed of company arrangement releases the company from a debt only in so far as:

- (a) *the deed provides for the release; and*
- (b) *the creditor concerned is bound by the deed.*

2.4 Section 444J (Guarantees and indemnities)

444J Guarantees and indemnities

Section 444H does not affect a creditor's rights under a guarantee or indemnity.

2.5 Section 445G (When Court may void or validate deed)

445G When Court may void or validate deed

- (1) *Where there is doubt, on a specific ground, whether a deed of company arrangement was entered into in accordance with this Part or complies with this Part, the administrator of the deed, a member or creditor of the company, or ASIC, may apply to the Court for an order under this section.*
- (2) *On an application, the Court may make an order declaring the deed, or a provision of it, to be void or not to be void, as the case requires, on the ground specified in the application or some other ground.*

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- (3) *On an application, the Court may declare the deed, or a provision of it, to be valid, despite a contravention of a provision of this Part, if the Court is satisfied that:*
- (a) *the provision was substantially complied with; and*
 - (b) *no injustice will result for anyone bound by the deed if the contravention is disregarded.*
- (4) *Where the Court declares a provision of a deed of company arrangement to be void, the Court may by order vary the deed, but only with the consent of the deed's administrator.*

3. Pre-Lehman

In a number of decisions that predate the insertion of section 444J into Pt 5.3A of the *Corporations Act*,³ the courts have held that a DOCA which purports to prevent a creditor from enforcing guarantees or indemnities given by directors or related parties of the company that is the subject of the deed is invalid. Importantly, the decisions demonstrate that, even before the decision of the Full Federal Court in *Lehman*, there was authority to the effect that section 444D of the *Corporations Act* is concerned only with those "claims" that creditors have against the company that is the subject of the deed. That finding is reaffirmed by the Full Court in *Lehman*.

*Re Andersens Home Furnishing Co Pty Ltd*⁴ (**Andersens Home Furnishing**) concerned an application by Andersens Home Furnishing Co Pty Ltd (**Andersens**) to set aside a DOCA which had been approved by the creditors of Edshar Pty Ltd (Administrator Appointed) (**Edshar**). Andersens supplied and marketed floor coverings. It entered into a franchise agreement with Edward and Sharon Lacy (the **Lacys**). The Lacys subsequently acquired Edshar and were appointed directors of the company. With the consent of Andersens, the Lacys transferred their interest in the franchise agreement to Edshar pursuant to a Deed of Covenant. In addition, Edshar entered into a lease of premises for the purposes of the franchise business. Pursuant to both the Deed of Covenant and the lease document, the Lacys guaranteed the performance by Edshar of its obligations under the franchise agreement and lease. Administrators were appointed to Edshar. A motion that a DOCA be executed was carried at the second meeting of creditors. Clause 5.3 of the DOCA provided:

- 5.3. Upon carrying out of the terms of this Deed the Creditors shall be deemed to have absolutely released and discharged the Directors in relation to any personal guarantee of the Directors in respect of any liability of the company to the Creditors.

Justice Demack, Supreme Court of Queensland, held that cl 5.3 went beyond what was permissible under Pt 5.3A and set aside the DOCA in its entirety. His Honour held:

The object of Pt 5.3A is to maximise the chances of a company continuing in existence or, if that is not possible, to obtain a better return for the creditors than would result from the immediate winding up of the company (s 435A). However, there is no provision in Pt 5.3A which enables the majority of creditors to extinguish the personal obligations which Lacys may have assumed in respect of some of

³ Section 444J of the *Corporations Act* was introduced by the *Corporations Amendment (Insolvency) Act 2007* (Cth), s 3, Sch 4, Pt 1[30]. That section now makes it clear that creditors' rights under a guarantee or indemnity are unaffected where a debt is released by acceptance of the terms of a DOCA pursuant to section 444H of the Act.

⁴ (1996) 14 ACLC 1710.

Edshar's debt. S 440J restricts the enforcing of the guarantee against Lacys during the administration of Edshar. The fact that the Court may give leave to proceed against a director to enforce a director's obligations under a guarantee (s 440J(1)) assumes that those obligations continue to exist and are not caught up in the administration. Indeed, a secured creditor of a company is not bound by a deed unless that creditor voted in favour of its execution (s 444D(2)), so that a secured creditor's rights continue to exist and are not necessarily caught up in the administration.⁵

His Honour referred to the decision of the New South Wales Court of Appeal in *Hill v Anderson Meat Industries*⁶ (**Andersons' case**) in which the Court unanimously held that when a debt is extinguished pursuant to the terms of a scheme of arrangement approved by the Court under section 181 of the *Companies Act 1961* (Cth), that extinguishment is by operation of law since it is that section which gives the scheme its operative effect and not the agreement of the parties. In that case, the court-approved scheme of arrangement provided for the substitution of a right to participate in distributions for the original debt, which was extinguished. The Court held that the extinguishment of the principal debt occurred by operation of law and, accordingly, did not result in the discharge of the guarantor. Applying that decision to the case before him, Demack J held:

...Lacys have given a guarantee to Andersens that they will meet Edshar's debts. If the Deed operates as a discharge of Edshar's obligations to Andersens, it does so by virtue of s 444D and not by virtue of any agreement between Edshar and Andersens. In those circumstances it does not discharge Lacy's obligations to Andersens. **In the words of s 444D(1), the deed binds all creditors of the company so far as it concerns claims arising on or before the day specified in the deed. The claims that are referred to are claims against the company, not claims a creditor might make against a person who has guaranteed the payment of the debts of the company, cf *Brash Holdings Ltd v Katile Pty Ltd* (1996) 1 VR 24.** The person who has given the guarantee, i.e. Lacys, is a contingent creditor of the company, and so is bound by the Deed: *Re Zambena Pty Ltd* (1995) 13 ACLC 1020.

All of this is clear in s 444H which speaks of the extent to which the deed "releases the company from a debt". The first purpose of Pt 5.3A is to release the company from debt and to allow it a fresh start. If that is not possible then the second purpose is to provide a better return for the creditors than would be obtained from immediate winding up (s435A). This also releases the company from debt. The latter purpose may be achieved if the business of the company is sold as a going concern.

However, by this Deed, the creditors' meeting has purported to release Lacys from personal obligations they have assumed towards Andersens and the landlord. There is no statutory authority to do this. There is no common law or equitable basis for doing this. Consequently, cl 5.3 is beyond the power of the creditors' meeting, unless, of course, the creditors who are affected by the clause vote in favour of the execution of the deed. The provision, cl 5.3, is

⁵ Ibid at 1713. In this regard, his Honour relied on the following case law: *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457; *Hill v Anderson Meat Industries Ltd* (1972) 2 NSWLR 704; *Gan v Sanders* (1994) 15 ACSR 298; *Re Southern World Airlines Ltd* (1993) 1 NZLR 597; *Buttle v Allen as Official Liquidator of Buttle and Co Sharbrokers Ltd (In Liquidation)* (1994) 1 NZLR 396.

⁶ (1972) 2 NSWLR 704 at 706 per Jacobs P and 709 per Hutley JA; followed in *Commercial Banking Co of Sydney Ltd v Gaty* (1978) 2 NSWLR 27; *Re Knebel Woodworking Co Pty Ltd* (1985) 3 ACLC 739; *Re Southern World Airlines Ltd* [1993] 1 NZLR 597; *Gan v Sanders* (1994) 15 ACSR 298; 1; *Ehrenfeld v Oriana Nominees Pty Ltd* [1999] WASCA 222. cf *Daewoo Singapore Pte Ltd v CEL Tractors Pte Ltd* [2001] SGCA 53.

unfairly discriminatory against Andersens, which voted against the motion to execute the Deed.⁷
(emphasis added)

Justice Demack held that deleting cl 5.3 and allowing the administration to proceed would still give the DOCA a wider effect than Pt 5.3A permitted. One of the sources of funds for the DOCA was the net proceeds from the sale of the Lacys' home. As his Honour explained, however, the net proceeds of sale were not assets of Edshar to be distributed to the creditors of Edshar. Whilst the administrator could have treated the net proceeds as a discharge of the Lacys' obligations to repay the loans made to them, the DOCA referred to the net proceeds as being the Lacys' property. In the circumstances, Demack J ordered that the DOCA be terminated pursuant to section 445D of the *Corporations Law*.

Similar circumstances arose in *M & S Butler Investments Pty Ltd v Granny May's Franchising Pty Ltd*.⁸ The first respondent, Granny May's Franchising Pty Ltd (**GMF**), entered into a franchise and licence agreement with the first applicant, M & S Butler Investments Pty Ltd (**M & S Butler**). Each of the second and third applicants entered into the franchise and licence agreements as personal guarantors of the indebtedness of M & S Butler. The second applicants, the Butlers, were directors of M & S Butler. The applicants defaulted in respect of their obligations under the franchise agreement. GMF terminated the franchise and licence agreements. The parties commenced proceedings as follows:

1. GMF, for the recovery of fees under the franchise agreement pursuant to the guarantee given by each of the second and third applicants;
2. GMF, for the winding up of M & S Butler; and
3. each of the applicants, seeking to have the franchise agreement declared void or unenforceable on the grounds of misleading and deceptive conduct.

Prior to the commencement of proceedings for the winding up of M & S Butler, the company was placed into voluntary administration. At the second meeting of creditors, a majority of creditors voted in favour of a proposal for the execution of a DOCA. GMF voted against the proposal. Amongst other things, the DOCA prevented creditors from bringing or continuing proceedings against M & S Butler in respect of its own property or in respect of any guarantee of the company's indebtedness. In this action, GMF sought a declaration pursuant to section 445D of the *Corporations Law* that the DOCA, or its provisions, was oppressive, unfairly prejudicial or unfair to GMF and that the deed be terminated. Justice Spender, Federal Court of Australia, ordered that the DOCA be terminated. One of the grounds for termination was that the deed was unfairly prejudicial to GMF in that it purported to prevent GMF from seeking to enforce personal guarantees given by the directors of M & S Butler. Justice Spender held:

A deed of company arrangement can only deal with *company* property; it is not competent for an administration under Pt 5.3A of the Law to exempt directors from their personal guarantees.

This much is made clear from s 440J which restricts the enforcing of any guarantee against the directors of a company during the administration of a company. However, a director's obligations under a guarantee continue to exist: this is implied by the fact that the court may give leave to proceed against a director to enforce those obligations. There is accordingly no power in a majority

⁷ (1996) 14 ACLC 1710 at 1714.

⁸ (1997) 24 ACSR 695.

of creditors to restrain the enforcement of personal obligations under guarantees.⁹ (emphasis in original)

His Honour rejected the applicants' submission that the deed should remain on foot but be varied, so that all references to the director's guarantees are removed. Justice Spender observed that the power of the Court to terminate a DOCA under section 444D is discretionary and must be exercised having regard to the interests of creditors as a whole and in the public interest.¹⁰ In addition to finding that the DOCA was unfairly prejudicial to GMF, Spender J held that the deed did not comply with Pt 5.3A. In particular, the administrators of M & S Butler failed to comply with section 439A, which requires that, if a DOCA is to be proposed, a statement setting out details of the proposed deed must accompany the written notice convening the creditors' meeting. Material details concerning the tangible assets of the company were not supplied to the creditors. It could not be said therefore that the creditors had an informed view before voting on the proposal to adopt the deed. Justice Spender concluded that the deed ought to be terminated under section 444D on the ground of non-compliance with Pt 5.3A.

Another case concerning the validity of a provision of a DOCA purporting to release creditors' claims against a guarantor director is *Helou v Mulligan Pty Limited*.¹¹ The appellant, Helou, was a director and shareholder of Belmore Meats Prestons Pty Ltd (**Belmore**). The respondent, Mulligan Pty Limited (**Mulligan**) was a trade creditor of Belmore. Helou had given a written guarantee to Mulligan for the trading debts of Belmore. Belmore was placed into administration and the creditors resolved that the company enter into a DOCA. Mulligan was bound by the deed as a creditor of Belmore. The deed provided for the establishment of a "Pooled Fund" into which was paid the realised assets of Belmore and of a related company. Helou also contributed to the Fund. The deed further provided for proofs of debt and for the payment of a divided out of the Pooled Fund with respect to "Admitted Claims". Clause 10 of the deed prohibited any creditor of the company from, *inter alia*, commencing or continuing with any proceedings against the company. Mulligan commenced proceedings against Helou to enforce the guarantee. Whilst Helou accepted that the sum claimed was owing by Belmore to Mulligan, he submitted that this sum was no longer "due and payable" within the terms of the guarantee by virtue of cl 10 of the deed. The New South Wales Court of Appeal upheld the finding of the Court below that the DOCA did not release the rights of Mulligan as against Helou. The Court held:

- Although the deed prevented Mulligan from exercising the procedural rights stipulated in cl 10 – save that legal proceedings and enforcement process could still be brought with leave of the Court pursuant to section 444E – it did not render debts that had become due and payable no longer due and payable.¹² The right (with leave) to bring enforcement proceedings pursuant to section 444E of the Act demonstrates 'the limited and procedural nature of the moratorium effected by the deed'.¹³

⁹ *Ibid* at 703.

¹⁰ *Ibid* at 704.

¹¹ (2003) 21 ACLC 1220.

¹² *Ibid* at 1224 per Mason P (with whom Sheller JA and Davies AJA agreed).

¹³ *Ibid* at 1223 per Mason P (with whom Sheller JA and Davies AJA agreed).

- Creditors' enforcement rights were converted by the deed into rights to prove and to participate in a Pooled Fund. If and when a final dividend was paid the debt would be discharged and released, but that had not yet occurred in this case. The right to prove is a 'special legal machinery', but the relationship of debtor and creditor subsists.¹⁴

In dismissing the appeal, the Court took into account the purpose of the guarantee and the deed. The Court observed that the function of a guarantee, namely, to give the creditor a right to go against a third party in the event of the principal debtor's inability to pay, would be frustrated if it ceased to operate according to its terms merely because the debtor had entered into a DOCA.¹⁵ The Court concluded:

To the extent that the scheme [established by the deed] operated to suspend Belmore's personal liability to make immediate payment to the respondent, this was for the purpose of transforming the creditor's rights against Belmore into rights against or in respect of the assets in the Pooled Fund. The scheme is therefore aimed at the continuance of the creditor's just claims to receive immediate payment and not at its defeasance.¹⁶

By way of contrast, Kenny J, sitting in the Federal Court in *Handberg v Smarter Way (Aust) Ltd*¹⁷, held that the operation of section 553C of the *Corporations Law* (the mutual credit and set-off provisions), incorporated into a DOCA, was available to the company under the deed to extinguish a debt owed by the company jointly and severally with two others. This was because the creditor was a debtor for a higher amount to the company under the deed and thus, accordingly, the creditor had 'recovered the full amount of the debt' due to it by means of set-off.¹⁸

The question of whether a DOCA could validly release creditors' claims against third parties generally was expressly left open by the Court in *Gan v Sanders*.¹⁹ In that case, the appellant sought to enforce a deed of guarantee pursuant to which the respondents guaranteed to the appellant repayment by Luxville Pty Ltd (**Luxville**) of a sum of money. Following the appointment of administrators, the creditors of Luxville resolved that the company would execute a DOCA, which contained a provision restraining creditors from instituting or prosecuting any legal proceedings in relation to any debt incurred by the company. Justice Mandie, Supreme Court of Victoria, held:

In my opinion, very clear words would be required to justify the interpretation of such a provision in a deed of company arrangement as intended to stay proceedings against third parties, including guarantors.²⁰

According to his Honour, the relevant provision of the DOCA in this case was only intended to govern the relationship between the company and its creditors.²¹ His Honour continued:

¹⁴ Ibid at 1224-1225 per Mason P (with whom Sheller JA and Davies AJA agreed).

¹⁵ Ibid at 1225 per Mason P (with whom Sheller JA and Davies AJA agreed).

¹⁶ Ibid at 1226 per Mason P (with whom Sheller JA and Davies AJA agreed).

¹⁷ (2002) 20 ACLC 856.

¹⁸ Ibid at 863.

¹⁹ (1994) 15 ACSR 298.

²⁰ Ibid at 300-301. This is consistent with the observations of Rares J in *City of Swan v Lehman Brothers Australia Ltd* [2009] FCAFC 130 at [116].

I leave aside the question whether a provision protecting third parties such as guarantors and affecting the rights of creditors against third parties is a term which the current provisions of the *Corporations Law* could be taken to permit to be included in a deed of company arrangement, or which would be properly within the power of the creditors to approve or authorise as part of such a deed.²²

Justice Mandie rejected the respondents' submission that the DOCA released and discharged the debt and that, accordingly, there was nothing left to be the subject of the guarantee. The DOCA provided for the discharge of creditor claims only if the administrator had paid to the creditors their full entitlements under the deed. As in Andersons' case, the debts were extinguished by operation of law and thus the respondent guarantors remained liable.

4. ***Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited***

4.1 **Background**

The primary judge made orders pursuant to section 411(1) of the *Corporations Act* approving schemes of arrangement between four related companies, which were members of the Opes Prime Group (the **Scheme Companies**), and their respective creditors. The appellant was a creditor of one or other of the Scheme Companies. The schemes were the product of a mediation between the liquidators of the Scheme Companies, Australia and New Zealand Banking Group Limited and ANZ Nominees (together **ANZ**), Merrill Lynch International and Merrill Lynch International (Australia) Limited (together **Merrill Lynch**), and the Australian Securities and Investments Commission (**ASIC**). A number of claims had been made or foreshadowed in relation to the affairs of the Scheme Companies:

1. ASIC had foreshadowed claims against ANZ and Merrill Lynch, Opes Prime Stockbroking Limited (one of the four Scheme Companies) and its directors;
2. some creditors of the Scheme Companies had commenced legal proceedings against ANZ and Merrill Lynch and the Scheme Companies; and
3. the liquidators foreshadowed claims against ANZ and the receivers (earlier appointed as such of the Scheme Companies) and against Merrill Lynch.

The object of the schemes was to achieve a global settlement of all Opes-related claims and proceedings against ANZ and Merrill Lynch and other parties, and their respective related entities, in exchange for:

1. ANZ and Merrill Lynch paying \$226 million in cash; and
2. the receivers and Merrill Lynch releasing cash and assets of the Scheme Companies (worth an estimated \$27 million).

²¹ On this point, see also *Re Carey Builders Pty Ltd (subject to a deed of company arrangement)* (1997) 23 ACSR 754 at 774, in which White J, Supreme Court of Queensland, held that a provision in a DOCA, which purported to prevent creditors from pursuing any guarantees they held from the directors of the company under administration, was confined to the relationship between the company and its creditors. Further, it was held that the extinguishment of the company's debts was by operation of law and not by agreement, and therefore, did not operate to discharge the guarantor. In the circumstances, his Honour held the DOCA did not discriminate against the applicant creditor (who had disapproved of the DOCA) in this respect.

²² *Ibid* at 301.

Those monies were to be provided to the liquidators for distribution to creditors in accordance with the schemes. Pursuant to those schemes, all of the claims by creditors, including the legal proceedings against ANZ and Merrill Lynch, and the claims foreshadowed by the liquidators, were to be released. In addition, ASIC agreed to provide a release to ANZ and Merrill Lynch in relation to its foreshadowed claims.

The appellant contended that a scheme of arrangement between a company and its creditors can affect those creditors *only in their capacity as creditors of the company*. That is, a scheme may not bind a person who is a creditor of a company on account of that person's claim against a third party other than as a creditor of the company.

4.2 The decision

In summary, the Full Court of the Federal Court held:

- Third party releases are permissible under section 411 of the Act. According to their Honours, there was nothing in the Act to prevent a company including a term, as part of a scheme of arrangement, pursuant to which creditors agree to discharge not only the debts and liabilities of the company, but also the liabilities of, for example, sureties for the same debts and liabilities of the company.
- There must however be some element of 'give and take'; that is, the creditors must receive something in return for the benefit conferred on the third party. In this case, the Court took into account the fact that without the release and indemnity provided for in the schemes, the sum to be provided by ANZ and Merrill Lynch would be reduced significantly, thereby reducing the benefits received by creditors.
- Section 411 ought not to be construed narrowly. Section 411 is 'intended to provide a flexible mechanism to facilitate compromises and arrangements between insolvent companies and their creditors as an alternative to liquidation'.²³
- There are however limitations on the extent to which a scheme of arrangement purporting to be between a company and its creditors can purport to affect property of the creditor that has no connection with the company or the relationship of creditor and debtor between the creditor and the company. There must be an 'adequate nexus' between a release or indemnity, on the one hand, and the relationship between the creditor and the company, as creditor and debtor, on the other hand. In this case, the claims of creditors against the Scheme Companies and the claims against ANZ and Merrill Lynch substantially overlapped. Without the release, there would have been no compromise or arrangement.

5. ***City of Swan v Lehman Brothers Australia Ltd***

5.1 Background

On 28 July 2009, Rares J reserved eight questions under section 25(6) of the *Federal Court of Australia Act 1976* (Cth) for the consideration of the Full Court.²⁴ The questions

²³ *Fowler v Lindholm, in the matter of Opes Prime Stockbroking Limited* [2009] FCAFC 125 at [73].

concerned the proper construction of a number of provisions in the DOCA of Lehman Brothers Australia Limited (**Lehman Australia**) and their validity under Pt 5.3A of the Act.

The plaintiff creditors (three local government councils) had invested in collateralised debt obligations (CDO) sold to them by Lehman Australia. Following the collapse of Lehman Brothers Holdings Inc (**Lehman Brothers**) in the United States of America, administrators were appointed to Lehman Australia in September 2008. At the second meeting of creditors in May 2009, a resolution was passed by the statutory proportion of creditors (a majority in value and in number) to execute a DOCA. The administrators, on behalf of Lehman Australia and Lehman Brothers Asia Holdings Limited (in liq) (the fourth defendant) (**Lehman Asia**), executed the DOCA and appointed themselves as deed administrators.

In return for receiving priority in the distribution of the proceeds of the assets of Lehman Australia, the CDO investors agreed, pursuant to the DOCA, to release any claims they had against other Lehman entities. In particular, the deed:

- provided that the deed administrators shall have the sole conduct and control of any insurance claim and an absolute discretion regarding the prosecution and resolution of any such claim and that they will pay any proceeds into the litigation creditors' fund established by clause 6 of the deed (clause 7.1);
- provided for a moratorium in favour of Lehman Australia and the Lehman entities that remained operative until the deed terminated, preventing any creditor (whether or not its claim was admitted or established under the deed) proceeding or taking any steps to proceed to obtain the winding up of, or prosecution of proceedings, enforcement of judgment debts or arbitral awards, set-offs or cross-claims or the participation in any arbitration proceedings against, Lehman Australia or Lehman entities (clause 9.1). The moratorium also prevented litigation creditors seeking leave to proceed against Lehman Australia from proceeding to enforce a charge in respect of an insurance claim for a period of 24 months (clause 9.2(b)). Only after which time, if the deed administrators gave written consent or, failing that, a Court granted leave, could a litigation creditor commence or prosecute legal or arbitral proceedings against Lehman Australia for the purposes of establishing its entitlement to relief for an insurance claim (clause 9.2(c)); and
- provided that on payment in full of the final dividend for litigation creditors, all Claims by them against Lehman Australia or Lehman entities and all insurance claims, except for preserved contractual rights, are released, discharged or extinguished (clause 11.5). In addition, clause 11.6 provided that litigation creditors must accept their distribution under the deed in full satisfaction and complete discharge of all Claims and all insurance claims, with the exception of their preserved contractual rights and a litigation creditor must, if called on, execute and deliver to the deed administrators a form of release of any such Claim or insurance claim as they may require.

²⁴ *City of Swan v Lehman Brothers Australia Ltd* [2009] FCA 784.

'Lehman Entity' was defined in the DOCA to mean Lehman Bros (the parent company of both Lehman Australia and Lehman Asia), and any body corporate not incorporated in Australia that was partly or wholly owned directly or indirectly by Lehman Bros at, or in 6 months prior to, 15 September 2008.

The plaintiffs commenced proceedings to challenge, first, the validity of the deed as being beyond the scope of Pt 5.3A of the *Corporations Act* and, second, the resolution to enter into the deed under section 600A. Alternatively, the plaintiffs sought to have the deed terminated pursuant to section 445D. The plaintiffs contended that the deed, as a matter of law under Pt 5.3A, could not release creditors' claims, and impose limitations on the rights of creditors, against third parties other than the company the subject of the deed.

The central issue for the Full Court of the Federal Court was whether Pt 5.3A, and in particular section 444D(1), permitted the execution of a DOCA that deprived creditors of causes of action against entities *other than* the company the subject of the deed.

5.2 The decision

The Full Court of the Federal Court, comprising Stone, Rares and Perram JJ (in separate judgments), held that the DOCA was void and of no effect. In so far as the DOCA purported to extinguish the plaintiffs' rights to sue other members of the Lehman Group, it was held that the deed went beyond what was contemplated and permitted under Pt 5.3A of the Act.

According to the Full Court, the practical effect of the DOCA in this case was to prevent the plaintiffs from suing other members of the Lehman Group (or their insurers) during the period of the deed administration and to require the plaintiffs to release those parties from such claims on the deed's coming to an end. Their Honours held that, despite inconsistencies in the drafting of clauses 7, 9 and 11 of the deed, the intention of those clauses was to provide in the DOCA for a moratorium on creditors taking action against the Lehman Entities and to provide for the release of Lehman Entities, *including (but not limited to) Lehman Australia*.²⁵ Having come to this conclusion, the Court had to decide whether a DOCA, such as that under consideration, was valid under Pt 5.3A of the Act. In so doing, their Honours made a number of important findings.

(a) Arrangements under Pt 5.1 differ significantly from the administration of a company under Pt 5.3A of the Act

Their Honours rejected the defendants' reliance upon Pt 5.1 of the Act, dealing with schemes of arrangement which was the subject of the Full Court's decision in *Opes*, as justifying a broader construction of Pt 5.3A. The defendants suggested that because some decisions under Pt 5.1 have approved compromises or arrangements under that Part, which have had the effect of causing or requiring creditors of the company to release persons other than the company, a DOCA under Pt 5.3A was capable of achieving the same result. The Court held that the circumstances in which compromises and arrangements can be made under Pt 5.1

²⁵ [2009] FCAFC 130 at [10]-[18] per Stone J; at [65]-[68] per Rares J; at [131]-[134] per Perram J.

differ significantly from the administration of a company under Pt 5.3A. For example:

- Pt 5.3A requires directors of the company to resolve that they, or a majority, hold the opinion that the company is insolvent or likely to be insolvent at some time in the future (section 436A(1)); Pt 5.1 imposes no such precondition;
- the interests of creditors is not a focal point under Pt 5.1 because the continuing solvency of the reorganised debtor is not in doubt; and
- Pt 5.3A provides for important procedural steps with respect to a company's administration to be taken without Court supervision; in contrast, Pt 5.1 provides a significant supervisory role for the Court including the convening of scheme meetings and approval of the proposed scheme(s).

Given these differences, as Stone J concludes, 'it would not be surprising to find greater latitude in what might be provided for in respect of compromises and arrangements under Pt 5.1 than in a deed of company arrangement under Pt 5.3A'.²⁶

Justice Perram doubted whether the cases which the defendants relied upon did in fact support the proposition that third party releases are permissible under Pt 5.1. His Honour held that, as at 1992 (when Pt 5.3A was introduced), a third party release could not be approved under a scheme of arrangement.²⁷

Though noting the recent decision of Finkelstein J in *Opes*²⁸ and the decision of the Full Court on appeal,²⁹ approving a creditors' scheme of arrangement that effected the compromise of claims against third parties, Justices Rares and Perram held that there was, for present purposes, no need to express a view about the correctness of those decisions.³⁰

(b) Pt 5.3A does not confer upon the administrators, the company and the creditors an 'entirely free rein' in respect of what is included in a DOCA

The Court held that Pt 5.3A is concerned solely with the direct relationship between the company under administration and its creditors. In particular, the Court referred to section 444J which provides that the release of debts referred to in section 444H does not affect a creditor's rights under a guarantee or indemnity. According to Rares J, section 444J is indicative of a broader intent by Parliament not to restrict the rights of creditors against third parties. As his Honour explained:

²⁶ Ibid at [23].

²⁷ His Honour referred in particular to *Re Buildmat* (1981) 5 ACLR 689; *Re Glendale* (1982) 7 ACLR 171 and [1982] 2 NSWLR 563; *Bridges v Hershon* [[1968] 3 NSWLR 47.

²⁸ (2009) 258 ALR 362.

²⁹ *Re Fowler v Lindholm; Opes Prime Stockbroking Ltd* [2009] FCAFC 125.

³⁰ [2009] FCAFC 130 at [143] per Rares J; at [107]-[111] per Perram J.

By enacting s 444J, the Parliament made clear that by giving a release of its debt, the company did not release the creditor's other rights against third parties, such as other (solvent) companies in the group, directors, officers and members of the company and their relatives.³¹

In this case, the mere nexus between the impugned provisions of the DOCA and the payment of Lehman Australia's creditors was held to be insufficient to justify the destruction of creditors' rights to sue insurers or other Lehman entities for their independent legal liabilities.³²

It is because of the emphasis on the direct relationship between the company under administration and its creditors that, according to Rares J, the power in section 439C(a) (the power of creditors to pass a resolution that the company execute a DOCA) does not extend to authorising the creditors to use Pt 5.3A to deprive non-consenting creditors of their legal rights against persons other than the company.³³

(c) Section 444D(1) refers only to 'claims' against the company under administration

The Court observed that, with the exception of section 444J, Pt 5.3A does not expressly permit or forbid a DOCA to interfere with creditors' rights against an entity other than the company under administration.³⁴ According to their Honours, however, the absence of that detail in the legislation and the implicit interference with vested property rights that would occur if third party releases were available indicated that Parliament did not intend to permit such an interference. Accordingly, their Honours held that section 444D(1) must be construed as referring only to "claims" that creditors have against the company under administration.³⁵ The Court referred to the 'long established principle that a statute should not be interpreted as taking away an existing right unless it does so by clear words that are not reasonably capable of another construction'.³⁶ Applying that principle to Pt 5.3A, Rares J held:

The fundamental issue here is whether the property of creditors, separate and apart from their rights to sue or prove against a company, can be appropriated by a majority of other creditors for the benefit of them or third parties. In my opinion, Pt 5.3A does not contain either express words or unmistakable clarity of language to lead to such a draconian interference with the proprietary rights of creditors against third parties or other creditors of a company in administration.³⁷

³¹ Ibid at [77].

³² Ibid at [114]-[115].

³³ Ibid at [92].

³⁴ Ibid at [27] per Stone J; at [84] per Rares J

³⁵ Ibid at [38] per Stone J; at [85] per Rares J; at [136] per Perram J.

³⁶ Ibid at [29] per Stone J; see also [74]-[76] per Rares J.

³⁷ Ibid at [114]-[115].

Justice Rares specifically rejected the defendant's submission that because sections 445D, 447A and 600A gave the Court power to set aside or vary provisions such as those of which the plaintiff complained, Pt 5.3A should be construed as authorising them. His Honour held:

The fact that Parliament enacted safeguards empowering the Court to protect against exercises of powers under Pt 5.3A cannot be used to extend the literal meaning of s 444D(1) to a subject matter that its grammatical and literal meaning will not carry.³⁸

(d) 'Getting around' the limitation in Pt 5.3A

Despite the limitation in Pt 5.3A with respect to the release of creditors' rights against third parties, Justices Rares and Perram observed that Pt 5.3A does not prevent creditors consensually (i.e. unanimously) arriving at a wider arrangement or compromise, the effect of which can be included in a DOCA, to adjust their legal rights, interests, liabilities and obligations as 'part of an overall rescue package for the insolvent company'.³⁹ A complimentary consensual agreement or deed may be executed which binds the creditors and, to the extent they have to perform obligations, third parties to comply with the terms of the DOCA.⁴⁰

(e) Impugned provisions unseverable from deed

The Court refused to make an order under section 445G severing the impugned provisions from the DOCA and declared the deed void in its entirety. Their Honours also refused to make an order pursuant to section 445G(3) validating the impugned provisions of the deed. In so holding, the Court took into account the following factors:

- the impugned provisions in the DOCA were integral to the overall proposal put to creditors;
- the deed, absent the impugned provisions, would give the deed a fundamentally different operation to that proposed;
- the deed's lack of substantial compliance with Pt 5.3A,⁴¹ and
- the injustice caused to creditors as a result of severing the impugned provisions from the DOCA.

³⁸ Ibid at [91]. See also observations of Perram J at [159]-[160].

³⁹ Ibid at [92].

⁴⁰ Ibid at [122].

⁴¹ Note that in both *Re Andersens Home Furnishing Co Pty Ltd* (1996) 14 ACLC 1710 and *M & S Butler Investments Pty Ltd v Granny May's Franchising Pty Ltd* (1997) 24 ACSR 695, lack of non-compliance with Pt 5.3A was also cited by the Court as a ground for terminating the deed (as opposed to varying the deed or severing the impugned provisions) under section 445D of the *Corporations Law*, as it then was.

6. Implications of the Full Federal Court decision

6.1 Third party releases are not permissible under Pt 5.3A of the *Corporations Act*

The decision of the Full Federal Court in *Lehman* is authority for the proposition that a DOCA cannot effectively release or compromise the rights of creditors against a person or entity other than the company that is the subject of the deed. Consistently with the approach adopted by the Courts pre-*Lehman* in the cases summarised in Part 3 above, the Court confirmed that section 444D of the Act is confined only to those arrangements affecting the rights and obligations between the company and its creditors.

6.2 Not every DOCA that does release third parties will be void

The Full Court did not conclude that every DOCA purporting to release or compromise creditors' rights against third parties will automatically be set aside. The Court has express statutory power under section 445G of the *Corporations Act* to excise provisions of a DOCA without declaring the whole of the deed void. Indeed, Perram J makes it clear in his judgment that section 445G may be utilised even where the deed in question is wholly void.⁴² The very purpose of the section is to relieve breaches of Pt 5.3A.

In considering whether a DOCA which contains third party releases will survive a challenge, it is important to consider the following:

1. whether the deed complies with Pt 5.3A of the Act;
2. whether severing the impugned provisions will alter the operation of the deed; and
3. whether validating the impugned provisions will cause an injustice to creditors.

The central reason for the Full Court refusing to make an order under section 445G in *Lehman* was because the impugned provisions were integral to the overall proposal put to creditors and, as Rares J described them, were a part of the 'package deal'.⁴³ Severing one or more of the invalid clauses would have given the deed a fundamentally different operation to what was intended when the resolution authorising it was passed. As Perram J explained:

I do not think that it is really open to doubt that the establishment of the litigation fund, on the one hand, and the moratorium and releases, on the other, are inextricably interconnected. Since the latter are invalid it must follow that the former is too. With those provisions excised from the deed it no longer operates, if it operates at all, in a manner resembling its former self. Neither the creditors nor the company could have understood themselves to be putting in place such a stunted instrument. It follows that the deed is invalid. Putting the matter more formally, crucial provisions in the deed are invalid and they are inseverable from its balance. There are, no doubt, elements of the deed which, viewed in isolation, appear to be supportable. However, once it is accepted that they are inextricably bound up with invalid provisions, they fail too — not because of want of power; rather, because they no longer embody that which was intended by their authors.⁴⁴

⁴² Ibid at [154].

⁴³ Ibid at [123].

⁴⁴ Ibid at [154].

The injustice caused to creditors by validating the impugned provisions of the DOCA in *Lehman* was an important consideration, in the judgment of Rares J, not to make an order under section 445G(3). The effect of the clauses on the rights of creditors was so significant that the injustice caused by validating the clauses was indubitable. As his Honour held:

The usurpation of the private rights of creditors to sue or seek remedies against each other and third parties including insurers, is so obviously significant that the injustice of an order validating those clauses cannot be gainsaid. The benefits of those clauses to the Lehman entities and third parties were a vital part of the creditors' resolution that generated the deed of company arrangement. And, the obverse of those benefits were the very detriments of the creditors whose rights were purportedly denied them by the invalid clauses... I am not satisfied that no injustice would result from the plaintiffs being denied their rights to pursue the remedies available to them against other persons that the invalid clauses seek to negate. No order under s 445G(3) could or should be made to save the deed.⁴⁵

6.3 Third party releases under Pt 5.3 of the *Corporations Act*

The decision of the Full Court in *Lehman* has focused attention on the Court's reasoning in *Opes*. The English Court of Appeal recently considered the Full Court's decision in *Lehman* and *Opes* in a decision concerning a proposal by the administrators of Lehman Brothers International (Europe) to use a scheme of arrangement under Pt 26 of the *Companies Act 2006* (UK) to facilitate the return of trust assets.⁴⁶ The Court observed that the Full Federal Court's decision in *Opes* was consistent with English authority, in particular the decision of David Richards J in *Re T & N Ltd (No 3)*,⁴⁷ and agreed with the principle established in those cases. Lord Justice Patten held:

It seems to me that an arrangement between a company and its creditors must mean an arrangement which deals with their rights inter se as debtor and creditor. That formulation does not prevent the inclusion in the Scheme of the release of contractual rights or rights of action against related third parties necessary in order to give effect to the arrangement proposed for the disposition of the debts and liabilities of the company to its own creditors.⁴⁸

The Court observed that the judgments in *Lehman* distinguished between section 444D and section 411 on the grounds that the DOCA procedure is unsupervised and therefore more restricted in what it is intended to achieve. It acknowledged that the Full Court in *Lehman* was careful not to endorse the correctness of the decision in *Opes* and 'even go so far as to suggest that it is inconsistent with earlier authority'.⁴⁹

Interestingly, Justice Emmett, sitting in the Federal Court of Australia, only recently cited *Opes* and the decision of the English Court of Appeal as authority for the proposition that third parties releases are permissible in a scheme of arrangement under section 411.⁵⁰ His

⁴⁵ Ibid at [125].

⁴⁶ *Lehman Brothers International (Europe), Re Insolvency Act 1986* [2009] EWCA Civ 1161.

⁴⁷ [2005] EWHC 2870 Ch.

⁴⁸ *Lehman Brothers International (Europe), Re Insolvency Act 1986* [2009] EWCA Civ 1161 at [65] (the Master of the Rolls and Lord Justice Longmore agreeing).

⁴⁹ Ibid at [53] – [55].

⁵⁰ *In the Matter of Lift Capital Partners Pty Limited (In liquidation)* [2009] FCA 1523.

Honour granted orders under section 411 that the plaintiff companies convene a meeting of creditors for the purposes of considering a scheme of arrangement which required creditors to give a release and indemnity to third parties. His Honour held that, although the schemes had this 'unusual characteristic' (third parties releases and indemnities):

...I do not consider that there is any reason why a bargain might not be struck between a company and creditors whereby the creditors are bound to enter into an arrangement with third parties. So long as there is some elements of give and take, such that the creditors receive something in return for the benefit conferred on a third party, there is no reason, in principle, why that term could not be a part of a scheme of arrangement, as contemplated by section 411 of the Corporations Act.⁵¹

Justice Emmett did not refer to the decision in *Lehman*.

The findings in *Opes* are likely to be the subject of argument in the *Lehman* appeal to the High Court of Australia, as evidenced in the transcript to the hearing for the application for special leave to appeal.⁵² In opposing the application, counsel for the respondent submitted that the Full Federal Court's approach in *Lehman* was supported by the statutory language in, and structure of, Pt 5.3A. In particular, counsel observed that:

- there is a complete absence of any provision in Pt 5.3A which regulates claims held by creditors of the company the subject of a deed against third parties;
- section 444E prohibits a person the subject of a deed from bringing claims against the company, except by leave of the Court. No such protection exists with respect to claims by creditors against third parties. In addition, section 444H provides that a DOCA releases *the company* of a debt only in so far as the deed provides for the release, and the creditor concerned is bound by the deed. If a deed is set aside and therefore no longer binding on creditors, no release can be operative. Again, no such protection exists for creditors in respect of releases granted to third parties. The result is that the Act protects claims upon the company more than claims against third parties.

Counsel concluded that, for the appellants' case to succeed, they must be able to point to some policy reason why there has been a decision by the legislature to, in effect, prejudice the claims of creditors against third parties. It was contended that no such argument was put forward by the appellants other than reliance on the Full Federal Court decision in *Opes*. One then has to assume, counsel submitted, that the decision in *Opes* was correct.

Justice Hayne proceeded to refer counsel for the respondent to the paragraph quoted above from the decision of Lord Justice Patten. His Honour put to counsel that the effect of the respondent's argument was to deny the validity of the reasoning adopted by the English Court of Appeal 'when translated to the DOCA provisions of the Australian Act'.⁵³ Counsel submitted that this was not a case in which it was appropriate to determine the correctness of the decision in *Opes*.

⁵¹ Ibid at [35].

⁵² *Lehman Brothers Holdings Inc v City of Swan & Ors* [2009] HCATrans 323 (11 December 2009).

⁵³ Ibid.

7. Conclusion

Both the *Opes* and *Lehman* decisions arose in the context of large insolvent corporate groups and significant pending or anticipated litigation. This may be contrasted with the more simple factual circumstances of the pre-*Lehman* cases discussed in Part 3 of this paper. Such complex insolvencies and related litigation are likely to be a continuing feature of the commercial environment (consider, for example, the many insolvent managed investment schemes at present). It is arguable that a mechanism is required by which the numerous corporate entities and creditors who are party to these insolvencies can agree upon and be bound by a commercial resolution in order to avoid the cost and inconvenience of ongoing litigation. The suggestion by the Court in *Lehman* that creditors' claims against third parties may be released by way of a complimentary consensual arrangement or deed is likely to be impractical or impossible to achieve in many or most of these complex insolvencies.

The Court in *Lehman* appeared to be particularly concerned about the prospect that a majority of creditors may interfere with the proprietary rights of minority creditors against third parties. However, the ability of majority creditors to bind the minority is a fundamental feature of Pt 5.1 and Pt 5.3A of the *Corporations Act*. Few would argue that it would be proper for a scheme of arrangement or a DOCA to purport to release claims against third parties that are wholly unrelated to the circumstances of the company entering the scheme or DOCA, or where nothing was to be provided to creditors in return for the release. However, in many cases, the circumstances of the claims to be released against third parties may be closely related to the circumstances of the company entering the scheme or DOCA and the creditors may receive a significant offer in return for the release. In such a case, it may be difficult to see a distinction between the release of creditors' claims against the company and creditors' claims against 'third parties' – hence the 'nexus' test used in *Opes*.

Having said that, the Court in *Lehman* made a number of persuasive points about the statutory interpretation of Pt 5.3A and the previous authorities which support the view that a DOCA cannot release claims against third parties.

It will be interesting to see whether the High Court of Australia upholds the decision of the Full Federal Court in *Lehman*, and whether the Court will comment on the *Opes* decision in a case concerned only with the provisions of a DOCA. It may be that, as Justice Stone observes in her judgment in *Lehman*,⁵⁴ the legislature should intervene to amend Pt 5.3A to provide for specific circumstances where a DOCA may release claims against third parties.

⁵⁴ [2009] FCAFC 130 at [44].

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