Piper Alderman

Waging a war on two fronts fatal to claim

The New South Wales Supreme Court has recently decided that an Australian company that simultaneously brought a breach of contract claim in New South Wales and Germany against a Cayman Islands company, a German company and a UK company, should have the New South Wales action stayed on the basis that New South Wales was a clearly inappropriate forum for the resolution of the dispute. Dispute Resolution Partner, Tom Griffith, and Senior Associate, Lisa Farrand explain the decision.

The facts of this case are redolent of a university choice of law exam question.

The plaintiff was Kim Michael Productions Pty Ltd (**KMP**), a business operating in the entertainment industry and the defendants were TI Cayman, TI Germany and Tanjong UK, one of whose businesses is the operation of a tropical islands themed resort (the **Resort**) in Germany near Berlin.

KMP's claim related to production costs alleged to have been incurred in developing a proposed show to be performed at the Resort. One of KMP's allegations was that it was a term of the alleged contract that the funds payable to it for producing the show would be paid into a New South Wales bank account. On the defendants' forum challenge, KMP successfully argued that the defendants' failure to pay the funds constituted a breach of the contract that occurred in New South Wales, and that therefore the New South Wales Supreme Court had jurisdiction to hear and determine the dispute. On that basis, it was held that KMP could serve the defendants that were located outside of Australia in compliance with the relevant rules of court of the New South Wales Supreme Court.

The Court (Justice Howie) observed that the contractual term that required payment into a New South Wales bank account constituted only a tenuous connection with New South Wales, and that this was relevant to the determination of the second aspect of the defendants' forum challenge – namely that New South Wales was a "clearly inappropriate forum".

On the same day that the proceedings were filed in the New South Wales Supreme Court, KMP brought proceedings in Germany against the same parties and involving the same subject matter. Justice Howie identified that the relevant test was whether the local proceedings were "productive of serious and unjustified trouble and harassment" or were "seriously and unfairly burdensome, prejudicial or damaging".

In concluding that the test was satisfied, Justice Howie took into consideration the following factors:

- the parallel proceedings in Germany
- the proper law of the alleged contract was that of Germany
- matters of convenience such as the location of documents and witnesses, and
- the tenuous connection with New South Wales constituted by the late-asserted failure to pay an interim invoice into a New South Wales bank account.

Justice Howie noted that the conduct relied upon in support of the repudiation (which was the central claim in the proceedings) occurred almost entirely outside of New South Wales with persons who were and still are outside New South Wales, as a result of the contract that entirely occurred outside the state, where the contract was operating under foreign law and concerned the plaintiff performing its contractual obligations outside the state.

Justice Howie concluded that the proceedings were prima facie vexatious because of the proceedings already under way in Germany. More than that, Justice Howie stated that he was "thoroughly convinced" that the local proceedings were "productive of serious and unjustified trouble and harassment" or were "seriously and unfairly burdensome, prejudicial or damaging" and that accordingly, New South Wales was a clearly inappropriate forum for the determination of the dispute.

Piper Alderman Partner, Tom Griffith acted for the defendants in these proceedings.

Third-party releases and deeds of company arrangement: *Lehman Brothers v City of Swan*

Insolvency Partner, Amanda Banton and Lawyer, Anna MacFarlane summarise the High Court's judgment delivered on 14 April 2010 in which the Court held, as the Full Court of the Federal Court held in first instance, that, properly construed, Pt 5.3A of the Corporations Act (Cth) 2001 does not permit third-party releases within DOCAs.

The important features of the judgment:

- Third-party releases are not permitted in deeds of company arrangements (**DOCAs**).
- Third-party releases are permissible in creditors' schemes of arrangements.
- There may be scope for a DOCA to provide its administrator with sole control of claims by creditors of an insolvent company's policy.

Background to facts

On 15 September 2008, Lehman Holdings filed for Ch 11 Bankruptcy in the US. On 17 September 2008, Lehman Asia followed suit and appointed provisional liquidators. Then, on 26 September 2008, voluntary administrators were appointed to Lehman Brothers Australia Ltd (**Lehman Australia**), and the DOCA was executed on 12 June 2009.

Prior to entering into external administration, Lehman Australia sold collaterised debt obligations (**CDOs**) to the first to third respondents (the plaintiffs in the original proceedings) all of which are local government councils. It is that act which has lead to potential claims against entities related to Lehman Australia (**Lehman Entities**), including Lehman Holdings, and it is those claims that were the subject of the third-party releases in the DOCA.

Clause 7 of the DOCA gave the Deed Administrator sole conduct and control of any insurance claim of the plaintiffs in respect of the insurance of Lehman Australia or the Lehman Entities (excepting Lehman Asia). Clause 9 provided a moratorium on all claims of the creditors against Lehman Australia and the Lehman Entities for the duration of the DOCA. Clause 11 provided for a corresponding release of the Lehman Entities from liability upon termination of the DOCA.

Judgment

Subsection 444D(1) of the *Corporations Act* provides that 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 section 444A(4)(i)".

It is this section which gives a DOCA its binding force. Lehman Holdings submitted that the inclusion of the words "so far as concerns" enable a DOCA to include third-party releases in respect of claims that have a connection or association with the claim against the company the subject of the deed. Further, it argued the claims of Lehman Holdings were connected with those of Lehman Australia because the claim arose out of the same transactions. Lehman Asia alternatively submitted that where the claims against the insolvent company interlock with other entities, the DOCA concerns a creditor's claim "if it provides for a regime of provisions which relate to that claim".

The joint judgment of Chief Justice French, Justices Gummow, Hayne and Kiefel held "there was no textual footing" for reading "claims" as including claims against any person other than the company the subject of administration. In reaching this conclusion, their Honours considered section 444A, and the corresponding regulations , schedule 8A clauses 5 and 6 which specifically direct attention to the company. In particular, clause 5 refers to the discharge of "debts or claims which [creditors] have or claim to have against the company".

While Justice Heydon similarly held that a DOCA cannot affect the debts of an entity other than the company the subject of the DOCA, he approached the question in a substantially different manner. His Honour held that in accordance with the principle of statutory construction as set out in *Mabo v Queensland [No 2]* "clear and unambiguous" words are required for a statute to extinguish property rights without fair consideration, and that "there can be no doubt" that the claims of the plaintiffs are proprietary rights. He went on to hold that while the words "so far as concerns" are "elastic words", they cannot be construed as permitting the inclusion of claims against entities other than the company because this would require clear and unambiguous words.

Schemes of Arrangement

The Court referred to the decision in *Fowler v Lindholm*, delivered by a differently constituted Full Court of the Federal Court approximately three weeks prior to the Full Court's decision in these proceedings. The Lehman Entities relied on *Fowler v Lindholm* in support of their submissions that third-party releases are permissible in DOCAs.

In that case, the Court held that it had power to approve the Schemes containing the provision for release and indemnity [of third parties].

The High Court explicitly stated that they should not be read as criticising the judgment in *Fowler v Lindholm*. It held that unlike section 444D(1), the provision of Pt 5.1 which makes certain compromises or arrangements binding on creditors (section 411(4)) does not qualify the extent to which creditors are bound.

The Court emphasised the differences between the wording of the two sections referred to above and, more particularly, the timing and extent of court involvement. While court approval is required prior to the commencement of a scheme of arrangement, no such approval is required to enter into the DOCA. Indeed there is no mandatory requirement of court involvement in relation to a DOCA at all.

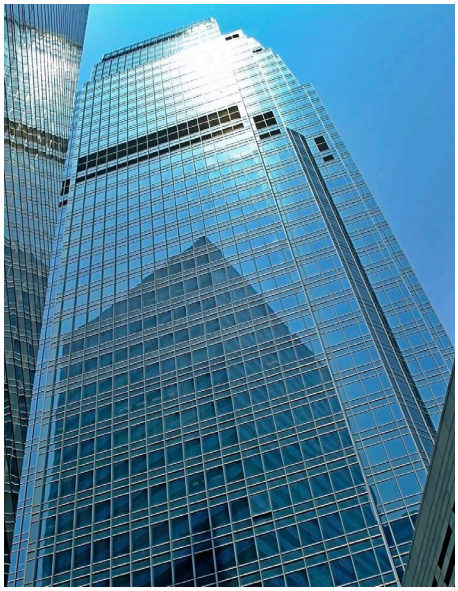
Justice Heydon did, however, seem to invite an appeal on the issues of third-party releases under Pt 5.1.

For now, third-party releases under creditors' schemes of arrangement are permissible. However, the question remains open for examination by the High Court. Accordingly, should a scheme of arrangement require a third-party release, it would be advisable to include corresponding documentation between the third party and the creditor which provides for the release.

Administrator's control of the insurance claims of creditors

The joint judgment suggested that clause 7 of the DOCA might have bound the creditors in respect of their insurance claims against Lehman Australia. If this were correct, the Deed Administrator would have enjoyed sole conduct and control of those claims, the fruits of which would have been then formed part of the "Litigation Fund", which in turn would have been distributed to all of the "Litigation Creditors" on a pari passu basis. This is in direct contradiction to the situation in liquidation and possibly state law. Section 562 of the *Corporations Act* requires liquidators to apply the fruits of any insurance claim to the party in respect of whom the liability was incurred, to discharge the entirety of the liability. For example, in liquidation, if one Litigation Creditor was wholly successful in their claim but a second Litigation Creditor was wholly unsuccessful, the first would receive damages in the full amount of their claim and the second would receive nothing, whereas, under the procedure outlined in clause 7, the second creditor would receive payment to the same value as, and to the detriment of, the first creditor. While the comments of the Court are purely obiter, as the parties agreed that if it were held that clauses 9 or 11 were not binding on the creditors then the whole of the DOCA should fail, these comments will no doubt be the subject of much discussion.

Piper Alderman Partner Amanda Banton acted for the councils in these proceedings.



Sheraton Mirage: the Court confirms the ability to sell through subsequent charges

Lisa Farrand, Dispute Resolution Senior Associate, reviews the decision of the Supreme Court of Queensland in St George Bank Ltd v Perpetual Nominees Limited & Anor.

This decision is a reminder that in the state of Queensland, the holder of a first registered fixed and floating charge can sell personal property the subject of the charge free of the interests of subsequently registered charge holders.

On 12 February 2010 the Supreme Court of Queensland ruled in favour of Westpac Banking Corporation's (**Westpac**) application to sell the property and undertaking of the company which operated the Sheraton Mirage Resort and Spa at Main Beach on the Gold Coast, SP Hotel Investments Pty Ltd (Receivers and Managers Appointed) (**SP Hotel**).

The Court declared that the purchaser would take the property and undertaking of SP Hotel unencumbered by the interests of subsequent charge holders, Perpetual Nominees Limited (**Perpetual**) and LJK Nominees Pty Ltd (**LJK**).

The proceeding was originally commenced in the name of St George Bank Limited, however as a result of a transfer of the rights and obligations of St George to Westpac effective 1 March 2010, Westpac was later substituted for St George as the applicant in the proceeding.

Westpac, Perpetual and LJK, in the priority listed, each held securities over the land on which the Sheraton Mirage stands and the assets and undertaking of SP Hotel. The borrowers, Desmarest Pty Ltd (the previous owner of the Sheraton Mirage) and SP Hotel, defaulted under the Westpac facilities and securities resulting in a liability to Westpac in excess of $68 million.

On 19 March 2009 Westpac appointed Michael McCann and Graham Killer of Grant Thornton as Receivers and Managers of SP Hotel. On 23 November 2009 Westpac entered into contracts to sell the Sheraton Mirage (comprising the land, assets and undertaking of the hotel) to Pearls Australasia Mirage 1 Pty Ltd (**Pearls**).

The purchaser's right to take the land on which the Sheraton Mirage was situated unencumbered was not in issue; section 86 of the *Property Law Act* 1974 (Qld) clearly provides that when a mortgagee exercises its power of sale over land, the purchaser takes the land free of the mortgagee's interest and free of subsequent encumbrances.

The dispute arose because in Queensland there was no similar statutory provision relating to a mortgagee's sale of personal property, in this case the business assets of the SP Hotel. Both Perpetual and LJK refused to provide Westpac with releases under their fixed and floating charges, preventing the settlement of the sale without judicial intervention.

The respective priorities of Westpac, Perpetual and LJK were not in issue (Deeds of Priority gave Westpac priority up to $78 million). The issue before the Court was whether, upon completion of the contracts, Pearls would take the property and undertaking of SP Hotel free of the respective interests of Perpetual and LJK.

A threshold question for consideration by her Honour was whether the Minister for Natural Resources, Mines and Energy and Minister for Trade had properly consented to Westpac selling the land via private contract as opposed to public auction in accordance with section 346(1) of the *Land Act* 1994 (Qld). Her Honour found that this requirement had been satisfied.

In the absence of legislation dealing with the rights of a purchaser acquiring personal property from a mortgagee in possession, her Honour considered the position of Pearls pursuant to the general law. She reasoned that, in principle, when a mortgagee sells under a power of sale, that sale defeats the rights of all subsequent charge holders, whose remedy is then against any surplus money in the hands of the vendors. Her Honour said that this reasoning was consistent with a mortgagee exercising its power of sale, holding any surplus proceeds on trust for subsequent mortgagees according to their priorities, and ultimately for the mortgagor.

Accordingly, her Honour decided that as long as Westpac had the necessary powers given by the charge and "conveyancing mechanisms", it could convey the legal interest in the SP Hotel to Pearls free of the interests of Perpetual and LJK.

The "conveyancing mechanisms" referred to by her Honour are the requirements of section 84 of the *Property Law Act*. That section essentially provides that a mortgagee shall not exercise its power of sale unless and until notice of the intended sale has been given to the mortgagor in accordance with the section.

Perpetual and LJK argued that the notice served by Westpac on SP Hotel did not comply with section 84. Whilst the notice contained a full description of the land, it did not contain any description of the other property (including the assets and undertaking of the hotel) secured.

Her Honour said that the notice was "clumsily drafted". The notice referred to the Charge and Mortgages "in respect of the property including that described as [the land] (Property)." She said that "Property" might mean only the land or it might mean "property including the land". But even if it meant only the land, notice that the other property might be sold was sufficiently given by the words "or exercise all or any of the other powers conferred by the Securities…or by the *Property Law Act* 1974…"

In any event her Honour was not persuaded that the notice needed to contain a description of the property to be sold. She took the view that section 84 did not require this, pointing out that the purpose of the section is to enable the recipient to understand with reasonable certainty what it is required to do, and the notice served by Westpac satisfied this requirement.

Her Honour made a declaration that, under the contracts for sale dated 23 November 2009, Pearls would take the property and undertaking so conveyed to it free of any interest of Perpetual and LJK. Her Honour ordered Perpetual and LJK to pay Westpac's costs of the proceeding to be assessed.

Admissibility, Dispute Resolution and the ACCC – without prejudice privilege

Dispute Resolution Senior Associate, Ben Hartley, looks at the decision in ACCC v Allphones Retail Pty Ltd (No. 3) in which the Federal Court ruled on whether certain documents, created for a dispute resolution process, where admissible in evidence and whether such documents could be 'used' in the proceedings.

The Australian Competition and Consumer Commission (**the ACCC**) commenced three sets of proceedings against Allphones Retail Pty Ltd (**Allphones**) and in two of those proceedings, against certain executives of Allphones. The ACCC alleged that Allphones had engaged in misleading and deceptive conduct and unconscionable conduct contrary to the provisions of the *Trade Practices Act 1974*. By notice of dispute dated 29 August 2008 – at which time only when only one of the ACCC's proceedings had been issued - Allphones commenced a dispute resolution procedure with its franchisees pursuant to the Franchising Code of Conduct. Importantly, Allphones engaged BDO Kendalls (**BDO**) to prepare investigative accountant's reports (and calculations) for the purpose of the dispute resolution procedure commenced by it. The ACCC was provided with copies of the material prepared by BDO (two reports and a supporting calculations document), but on a without prejudice basis for the purpose of the dispute resolution procedure commenced by Allphones (with the ACCC having been invited to participate in the mediation). The ACCC was prepared to accept that the documents were provided to Allphone's franchisees on a confidential and without prejudice basis, but they were not prepared to accept that they were provided to it on that basis. The parties could not agree on the 'use' of the documents in the three proceedings and accordingly the ACCC requested that the court make certain rulings on the admissibility and use of the BDO documents.

The ACCC sought to argue that the two BDO reports and the supporting calculations were business records of Allphones and BDO and were therefore admissible pursuant to section 69 of the *Evidence Act 1995* (Cth) (**the Evidence Act**). Further, the ACCC submitted that Allphones had failed to prove that the documents fell within either subsections (1)(a) or (1)(b) of section 131 of the *Evidence Act*. Allphones rejected these submissions saying that it had proven the facts necessary to engage section 131(1) of the *Evidence Act* and it was the ACCC that had failed to bring the case within the exceptions to confidentiality found in section 131(2). Relevantly, section 131(1) of the *Evidence Act* states:

131 Exclusion of evidence of settlement negotiations

1. Evidence is not to be adduced of:

a. a communication that is made between persons in dispute, or between one or more persons in dispute and a third party, in connection with an attempt to negotiate a settlement of the dispute; or

b. a document (whether delivered or not) that has been prepared in connection with an attempt to negotiate a settlement of a dispute.

Section 131(2) sets out a number of instances where section 131(1) will not apply, for example, if the substance of the evidence has been disclosed with the express or implied consent of all the persons in dispute.

As the first BDO report was obtained by Allphones for the purpose of negotiating and mediating its disputes with its franchisees Justice Foster held that this document fell within section 131(1)(b) and as such the document was not to be tendered. His Honour referred to the oft quoted joint judgment in the High Court of *Field v Cmr for Railways for NSW* where their Honours commented on the purpose of without prejudice communications:

The purpose is to enable parties engaged in an attempt to compromise litigation to communicate with one another freely and without the embarrassment which the liability of their communications to be put in evidence subsequently might impose upon them. The law relieves them of this embarrassment so that their negotiations to avoid litigation or settle it may go unhampered.

While the High Court was referring to the common law in its judgment in *Field*, the rationale underpinning section 131(1) is identical, though use of the words, *'in connection with'* in this section may in fact extend the privilege over and above the common law. In any event, the ACCC did not invoke any of the exceptions to section 131(1) as set out in section 131(2), choosing instead to argue that the first BDO report was prepared for mixed purposes, namely use in court and not simply for the dispute resolution procedure invoked by Allphones. This submission was rejected by Justice Foster. In addition, his Honour also held that he need not decide whether the first BDO report was a business record on the basis of section 69 of the *Evidence Act* without the authors of the report being called to prove that document.

In relation to the second BDO report and supporting calculations, the ACCC sought to argue that these documents were provided for the sole purpose of complying with certain undertakings given to the court by Allphones in the proceedings and therefore they could not be privileged by reason of section 131(1) of the *Evidence Act*. Justice Foster rejected this argument stating that Allphones had committed to providing these documents to its franchisees prior to the undertakings being given, with the undertakings also facilitating provision of the documents to the ACCC. The logical corollary is that the undertakings were not the source or reason for the document's creation and thus his Honour found that the second BDO report and the supporting calculations were protected by reason of section 131(1)(b). Further, the language of section 131(1) did not encapsulate a sole (or dominant) purpose test. However, as the provision of the second BDO report and the supporting calculations to the ACCC were made under the guise of an order of the court, these documents were subject to an implied undertaking as to confidentiality. Accordingly, as it was likely that that the evidence in one proceeding was to be the evidence in all proceedings, his Honour was prepared, on the basis of the implied undertaking, to grant leave for the ACCC to 'use' the second BDO report and the supporting calculations for the purposes of all three proceedings. The concept of 'use' was not discussed by his Honour, although it is clear that 'use' was to be distinguished from admissibility and as such the documents could be used, provided that their use did not breach the privilege attaching to them.

The decision is important as it demonstrates the importance the court is prepared to place on the public policy rationale underpinning the without prejudice privilege. In this case, the documents created for and on behalf of Allphones for the purposes of a dispute resolution procedure were keep confidential to the extent that they were not admissible in the three proceedings commenced by the ACCC. The decision is also encouraging in circumstances where a commercial party has actively sought to engage a regulator in a dispute resolution procedure and provided it with documents to be used for the purposes of settlement; it would be contrary to the rationale underpinning the without prejudice privilege and codified in section 131(1) of the *Evidence Act*, for a regulator to subsequently seek to tender those documents as being admissible under the *Evidence Act*. Had the decision been otherwise, commercial parties would have been discouraged from actively engaging with regulators for the purposes of resolving disputes and at the cost of a greater use of the resources of the court. Finally, the decision underscores the care that needs to be taken when producing documents for the purposes of dispute resolution procedure, more so if the documents are to be provided to a third party.

Arnold & Ors v Minister Administering the Water Management Act 2000 - still waters run deep

Corporate Associate Will Fennell considers the High Court's recent decision regarding the application of section 100 of the Commonwealth Constitution to the reduction of NSW bore water licence rights pursuant to the National Water Initiative

The appellants were individuals and corporations conducting farming operations in the Lower Murray region of New South Wales. In November 2006, pursuant to the *Water Management Act 2000* (NSW), certain bore licences held by them were replaced with 'aquifer access' licences. The appellants entitlements to groundwater were significantly reduced under the aquifer access licences.

The appellants challenged the replacement of their bore licences, broadly under two heads. First, on the basis that the acquisition of the bore licences was not on 'just terms', contrary to section 51(xxxi) of the Commonwealth Constitution. Second, the appellants argued that the Commonwealth/State funding agreement which brought about the licence replacement contravened section 100 of the Constitution.

The appeal on the basis of section 51(xxxi) of the Constitution failed, for the same reasons given in the High Court's decision in the immediately preceding matter, *ICM Agriculture Pty Ltd v The Commonwealth*. Accordingly, this article deals with the Court's reasoning in respect of the section 100 arguments, which ultimately were unanimously dismissed by the Court.

Section 100 and the Funding Agreement

Section 100 relevantly provides that:

> *The Commonwealth shall not, by any law or regulation of trade or commerce, abridge the right of a State or of the residents therein to the reasonable use of the waters of rivers for conservation or irrigation.*

The Appellants' bore licences were held by them pursuant to section 112 of *the Water Act* 1912 (NSW). Section 50 the *Water Management Act 2000* (NSW) allowed the Minister to make plans in respect of water management areas, or areas of the State not within a water management area.

The CEO of the National Water Initiative (established by agreement dated 25 June 2004 between NSW, Vic, QLD, SA, ACT, NT & Commonwealth Governments) had the power to administer financial assistance to particular projects relating to Australia's water resources. Accordingly, by agreement dated 4 November 2005, between the Commonwealth and New South Wales Governments entitled "*Water Smart Australia Project: Achieving Sustainable Groundwater Entitlements*" (**Funding Agreement**) New South Wales was provided funding to a maximum of $55m to reduce water entitlements of water holders in, inter alia, the Lower Murray Groundwater system.

The appellants argued that, amongst other things, the Funding Agreement was a contravention of section 100 of the Constitution.

Relying on the authority set down in *Cole v Whitfield* that the High Court can refer to drafting history to ascertain the contemporary meaning of legislative drafting, Chief Justice French considered the drafting history of section 100. Amongst other reasons relating to the literal meaning of "*waters of rivers*", his Honour held that:

> *The drafting history in my opinion makes clear that the qualification on Commonwealth legislative power imposed by section 100 was directed to the application, to the waters of rivers, of legislative powers with respect to trade and commerce and navigation and shipping. The subject matter of the limitation originally contained in the proposed s52(viii), as adopted at the Melbourne session of the Convention in 1898, was rivers which could be used for navigation or shipping.*
>
> *…Against this background, and without suggesting that the prohibition is limited to navigable rivers, there is no plausible basis for construing the limitation as applying to underground water in aquifers.*

Noting that a number of issues concerning the construction of section 100 were raised in the case including:

- the validity of the previous decision in *Morgan v The Commonwealth* which held that the prohibition in section 100 applied only to laws capable of being made under the trade and commerce power and section 98 (as endorsed by three Justices in the *Tasmanian Dams* case);
- whether "residents therein" in section 100 applies to individuals (and accordingly whether it can be said not to apply to corporate appellants); and
- whether *"as between riparian States and their residents section 100 guarantees access to the use of the waters for the purposes mentioned, or does no more than impose a restriction upon the exercise of the power by the Commonwealth"*

Justices Gummow and Crennan held that it was "*unnecessary to consider these matters*" because the appellants failed to show that they had the right "*to the reasonable use of the waters of rivers for conservation or irrigation*". Their Honours gave three reasons why the bore licences were not "waters of rivers" within section 100:

- First, section 100 was a compromise between the colonies of NSW, Victoria and South Australia in respect of the Murray-Darling. By 1855, South Australia's use was primarily as a trade route, Victoria was using the river for irrigation, and NSW claimed the exclusive use of the Murray above the border with SA.
- Second, distinct common law principles were in place at the time in respect of the use of groundwater and surface water; and
- Thirdly, like Chief Justice French, they referred to the definition of "waters of rivers" provided in Quick and Garran's *The Annotated Constitution of the Australian Commonwealth (1901):*

> *A river is a stream flowing in a defined channel; and the waters of a river are the waters flowing over its bed and between its banks. Rainwater flowing over or percolating through the soil, but not flowing in a defined channel, is not the water of a river*

Justices Hayne, Kiefel and Bell also agreed that the Lower Murray Groundwater Source is not encompassed within the phrase "*waters of rivers*" in section 100. Furthermore, referring again to Quick and Garran, their Honours also held that the purpose behind section 100 was

> *to mark a particular limit upon the power of the federal Parliament to regulate navigation.*
>
> *…As those authors went on to say, "the object of [section 100] is to limit the paramountcy of the navigation power so far as it may interfere with 'the reasonable use' of the waters for State purposes" of conservation and irrigation. The Federal Parliament's legislative powers with respect to navigation have no immediate intersection with the extraction, for use in irrigation, of groundwater that percolates through the soil and does not flow in a defined channel.*

Conclusion

The decision in *Arnold* makes it clear that "*waters of rivers*" does not extend to underground river systems associated with bore water extraction. Accordingly, it seems any challenge to a State Government's reduction of bore water entitlements under the National Water Initiative is likely to fail on the basis of section 51(xxxi) (following the decision in *ICM Agriculture*) and under section 100 following the decision in *Arnold*.

CSR demerger – ain't so sweet

Dispute Resolution Partner, Tom Griffith and Corporate Lawyer, Vasyl Nair review the Full Federal Court's recent decision in CSR's appeal from earlier orders withholding the Court's consent for the convening of a shareholders meeting to consider a demerger of CSR's sugar and building products divisions. At the heart of both decisions was concern over CSR's future asbestos-related liabilities.

Facts

On 8 October 2009, CSR Limited (**CSR**) sought orders in the Federal Court of Australia for the convening of a meeting of its shareholders. The purpose of the meeting was for the shareholders to:

- consider a scheme of arrangement (**Scheme**); and
- approve an explanatory statement summarising the Scheme.

The Scheme involved the demerger of CSR's sugar and renewable energy business to create:

- Sucrogen (a sugar and renewable energy company); and
- CSR (a building products company) (**New CSR**).

Implementation of the Scheme would leave New CSR with substantially less capital than CSR. On 17 December 2009, a number of objectors to the Scheme (and the Australian Securities & Investments Commission (**ASIC**)) sought leave to intervene in the proceedings on the basis that the Scheme would prejudice asbestos claimants who have, or may have, a claim against CSR (or New CSR as the case may be) for injuries sustained from asbestos exposure. The matter was adjourned to allow the objectors and ASIC to obtain expert evidence in relation to the Scheme.

CSR's application to convene the Scheme meeting came before the Federal Court of Australia on 29 January 2010. On 3 February 2010 the Court (Justice Stone) handed down judgment withholding consent for the scheme meetings.

Decision at First Instance

Upon review of expert material produced by CSR, ASIC and the objectors, the Court concluded that there was a great degree of uncertainty:

- involved in the actuarial estimates of future asbestos related claims; and
- surrounding New CSR's provision for asbestos claimants after the demerger.

As a consequence, Justice Stone declined making the orders sought by CSR for the Scheme meeting on the basis that:

- she could not be satisfied that the Scheme, if implemented, would not involve an unfair or oppressive result; and
- the material in the explanatory statement could not provide adequate disclosure to the shareholders of CSR of New CSR's ability to meet its future liabilities in relation to asbestos claimants.

Reasons for decision

A scheme of arrangement is implemented in three stages pursuant to part 5.1 of the *Corporations Act 2001* (Cth):

- There is a first Court hearing (or convening hearing) at which the Scheme company seeks orders for the convening of a meeting of shareholders to consider the scheme and if appropriate, resolve to approve the Scheme;
- secondly, the meeting of the shareholders is held and a vote on the proposal; and
- finally, there is a second Court hearing at which the Scheme company seeks approval from the court for the implementation of the future scheme.

Justice Stone held that the statement of principle by Justice Emmett in *Re Central Pacific Minerals NL* was applicable to the role of the court at a first court hearing:

> *At the stage of convening a meeting, the Court will give consideration to compliance with such preliminary matters as are relevant to the holding of the meeting. Of paramount importance is the need to ensure that there will be sufficient disclosure, to those who will be affected by the arrangement, of its details and effect…In considering whether to convene a meeting the Court will take into account questions of public policy as well as commercial morality.*

CSR attempted to limit the scope of the preliminary matters to be considered at the first meeting by relying on a comments made by Justice French in *Re Foundation Healthcare Limited*. Specifically, CSR asserted that it was inappropriate for the court to consider issues associated with the proposed capital reduction on asbestos claimants at the first court hearing.

Justice Stone disagreed with this interpretation on the basis that the capital reduction was a condition precedent to the Scheme and held that:

> *If at the first hearing the Court has a concern about the fairness of an element of a scheme such that the Court would not be prepared to approve the scheme without that issue being resolved, it would, in my view, be entirely inappropriate (to use French J's language) for the issue not to be raised at the earliest opportunity.*

Employing this approach, Justice Stone was satisfied that the impact of the capital reduction on asbestos claimants should be considered in the context of the Scheme at the first court hearing as a matter of public policy, commercial morality and fair disclosure to shareholders.

Upon consideration of the capital reduction on asbestos claimants in the context of the Scheme, Justice Stone declined to make the orders sought by CSR.

The issues on Appeal

CSR's raised 3 main arguments on appeal.

First, it contended that her Honour erred in proceeding on the evident assumption that CSR's projections and actuarial estimates did not encompass the category of claims in the future by persons who have not yet been adversely affected by exposure to asbestos – it said that the actuarial estimates did not omit that category of claims.

The Full Court (Chief Justice Keane and Justice Jacobson) appear to have accepted this contention.

Second, CSR contended that her Honour acted on a broad view of "public policy" or "commercial morality" without articulating the particular aspects of public policy or commercial morality relevant to the discretion under section 411(1) of the Act.

Third, CSR contended that the evidence before the Court negatived any material prejudice to New CSR's ability to pay all its creditors, which would have been the only consideration that might justify a negative exercise of the discretion under section 411(1).

Both Justice Stone and the Full Court were unable to conclude that it was more likely than not that persons with asbestos-related claims would be unable to satisfy those claims against New CSR if the demerger were to be implemented.

Ultimately the Full Court majority concluded that the inquiry under section 411(1) was not intended to resolve difficult questions on which reasonable minds might differ. Instances where it was appropriate to decline to order the convening of a meeting would be those where the order would be futile because the scheme as proposed was unlikely to be finally approved. The Majority of the Full Court held that

a. the consideration that the reduction in capital would increase the risk of non-payment of New CSR's creditors in a theoretical rather than a material way is not a consideration which would warrant blocking the demerger as a matter of public policy or commercial morality by refusing to order the first meeting; and

b. the prospect that the reduction in capital associated with the demerger of CSR may materially prejudice the ability of New CSR to pay all its creditors including asbestos claimants is not so clear as to warrant the conclusion that the scheme could never be approved and justify the order made below on this basis.

By reference to some of the disparate statements about the level of scrutiny to be applied to a proposed scheme at the first Court hearing, Justice Finkelstein reinforced the majority's conclusion, and by particular reference to Justice Santow's decision in *Re NRMA Insurance Limited (No 1,)* observed that the majority's approach:

> *properly reflects the two stage nature of the scheme hearing process, where convening hearings often take place on limited notice, and where issues and objectors regarding a scheme may only emerge after the scheme meeting. As such, instead of saving costs and court time, hearing the merits at the convening stage may achieve the opposite. Thus an enquiry into the merits at the convening stage will only be warranted if there is a clear indication that the scheme will not be approved. The indication may appear from the terms of the scheme. Or it may arise out of an incontrovertible fact (which is the basis upon which I would qualify what is said in Re Foundation Healthcare).*

Impact

The significance of the decisions seem at first glance limited to scheme companies that have significant future contingent liabilities such as companies with asbestos-related liabilities. This view is supported by Justice Stone's statement:

> *I do not accept that the position of future asbestos claimants is to be equated with every category of current and future creditor of New CSR. Their interest arises not from some future dealing with CSR but from their involuntary exposure to asbestos products.*

Justice Stone also observed that a capital reduction by definition reduces a company's ability to meet the claims of its creditors does not of itself indicate unfairness or conflict with public policy.

Bearing in mind some other recent high profile schemes (such as Seven's proposed merger with WesTrac) it does seem that Courts are applying more scrutiny to the terms of the proposed schemes, in order to protect shareholders' (and potentially other stakeholders') interests. As the Appeal Court judgments in the CSR case show however, the time for detailed consideration of the proposal will be at the second Court hearing, when the issues are more defined and any objector's arguments will be more focussed, rather than at the convening hearing.

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