



David Winterbottom, KordaMentha

Gwalia bombshell hits Australian banks

Australian banks are struggling to come to terms with an unexpected court decision in the long-running Sons of Gwalia v Margaretic case which gives shareholders dramatic new claims on a company's assets in an insolvency.

"It's a big problem for Australian banks," says David Winterbottom, a partner with national insolvency boutique KordaMentha in Sydney.

"It could have a big impact on the banks' ability to lend, and the cost of loans," says Winterbottom.

"The banks won't be able to guarantee that the balance sheet they are looking at is the real situation," he says. "If the company goes into insolvency, half the shareholders might have a claim."

Dominic Emmett of law firm Corrs Chambers Westgarth in Sydney adds: "It could be a big problem for distressed investors in Australia, and for Australian banks trying to raise debt in the US".

The Australian Bankers' Association is urgently preparing a paper for the Australian Securities and Investments Commission (ASIC) on how the Sons of Gwalia decision will impact on the ability to lend and the cost of loans.

Winterbottom adds: "It's a very, very interesting situation. My feeling is that the law will be changed."

The case

Sons of Gwalia was a publicly listed gold mining company. On 29 August 2004, administrators were appointed. It now appears that, at the time, the shares in the company were worthless.

On 18 August 2004, the shareholder who subsequently brought a case against the company bought 20,000 shares in Sons of Gwalia at a cost of A\$26,200.

The respondent alleges that, in breach of the stock exchange listing rules, the company had failed to notify the Australian Stock Exchange that its gold reserves were insufficient to meet its gold delivery contracts and that it could not continue as a going concern.

The respondent says that he was a victim of misleading and deceptive conduct and that the first appellant contravened certain sections of the Trade Practices Act 1974 and section 12DA of the Australian Securities and Investments Commission Act 2001.

The shareholder claims to be entitled to compensation, his claim being for the difference between the cost of his shares and their value (nil). There are many other shareholders with similar claims.

The shock decision

At the end of January the Australian High Court handed down its landmark decision in Sons of Gwalia v Margaretic.

The decision clears the way for all shareholders of a failed publicly listed company to rank on an equal footing with lenders, and suppliers of goods and services, to share in the returns from the company's collapse and to participate in its reorganisation.

Dominic Emmett, an insolvency partner with Australian law firm Corrs Chambers Westgarth, says: "Shareholders with damages claims for having been misled as a result of breach of disclosure obligations rank equally with creditors, whether such shareholders bought on market or are subscribers".

"The decision has given rise to much controversy in Australia

because it is said many distressed investors bought into the Sons of Gwalia debt on the basis that all shareholder claims were subordinated," says Emmett.

It was also controversial because of the potential the decision has on the capacity of Australian issuers to raise debt generally, particularly in the US, he adds.

At a practical level

Emmett says that those brokering work-outs or restructurings of listed entities will now more likely need to take into account a new 'shareholder creditor class'.

Administrations and liquidations of listed entities may become more complex in having to adjudicate shareholder claims, leading to delays in dividends and distributions.

In structuring debt raisings, says Emmett, mechanisms to distance shareholder creditors from others may be established. These may be set up by simply granting security or by separating the listed vehicle from a Group's operations.

They can also be arranged by unwinding consolidated group structures which had previously been put in place to obtain relief from certain accounting and tax reporting requirements.

Separately, Emmett has advised on two of Australia's biggest recent insolvencies (see opposite).

A full transcript of the Sons of Gwalia ruling is available at: http://www.austlii.edu.au/au/cases/cth/high_ct/2007/1.html

Hedge funds to invest more in distressed companies

Investing in distressed companies will become even more attractive to hedge funds in 2007 as markets conditions continue to favour the strategy and it has outperformed expectations.

Virginia Parker, founder and chief investment officer of US-based hedge fund of funds firm Parker Global Strategies, said during the firm's 2007 Hedge Fund Outlook event that the strategy performed better than expected and that trend will continue into the new year.

According to Edhec Alternative Indexes, distressed strategies have returned 13.4 per cent this year.

A low rate of defaults, expected to be between 2 per cent and 3 per cent, will favour distressed strategies, added Marti Murray, president of hedge fund Murray Capital Management. Distressed investing should also see strong returns as demand from corporate and private equity investors for mergers and acquisitions activity is likely to remain high.

Sectors where hedge funds can expect to see the most opportunities include auto suppliers, airlines, paper and packaging, home building, sub-prime lending and healthcare.

There are several factors that could have a negative impact on returns in distressed investing. These include a recession, severe losses in private equity or banking sectors or a spike in default rates, Murray said.