

Butterworths Corporation Law Bulletin

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FEATURE

[264] *Re CSR Ltd*

By Andrew Silberberg, Partner, Arnold Bloch Leibler and Richard Hewett, Solicitor, Arnold Bloch Leibler

Introduction

The Federal Court refused an application to permit a meeting of shareholders to consider a scheme of arrangement and an accompanying explanatory statement to enact a demerger. On appeal, the Full Court of the Federal Court held that refusal of such an application is only appropriate where it is 'clearly bound to fail'. The appropriate forum for determining more substantive matters such as the merits and fairness of a proposed scheme of arrangement is a subsequent hearing to approve the proposed scheme of arrangement, which occurs after a court approved meeting of shareholders.

Facts

On 17 June 2009, CSR Ltd (CSR) announced that it would pursue the demerger of its businesses to create two entities listed on the Australian Securities Exchange (ASX), Sucrogen and CSR (New CSR). Sucrogen would focus on sugar and renewable energy businesses in Australia and New Zealand, while New CSR would focus on premium branded building products and aluminium investments. The primary purpose of the demerger was to facilitate better realisation of the value of these businesses for CSR shareholders.

To pursue this demerger, CSR sought orders from the Federal Court of Australia pursuant to s 411(1) of the Corporations Act 2001 (Cth) (Corporations Act) for the convening of a meeting of its shareholders to consider a scheme of arrangement pursuant to Pt 5.1 of the Corporations Act (Scheme) and for the approval of the explanatory statement summarising the Scheme (Convening Hearing). This is the first of the three broad stages to effect such a demerger, the remaining two stages being the shareholders' meeting to approve the Scheme (or a meeting of creditors if their rights are being rearranged) and a subsequent Federal Court hearing at which the court's approval is sought for the scheme (Approval Hearing).

In order to grant approval of a scheme, a court may, pursuant to s 411(4)(b) of the Corporations Act, "grant its approval to a compromise or arrangement subject to such alterations or conditions as it thinks just" and must not, pursuant to s 411(17), approve a scheme unless "it is satisfied that the compromise or arrangement has not been proposed for the purpose of enabling any person to avoid the operation of any of the provisions of Chapter 6 or there is produced to the Court a statement in writing by ASIC stating that ASIC has no objection to the compromise or arrangement".

The proposed CSR demerger would result in all liabilities regarding present and future asbestos related claims resting with New CSR while the capital in New CSR would be reduced compared to the existing CSR. This would result in a reduction in potential funds available to creditors, including present and future victims of asbestos exposure as the provisional funds CSR set aside for asbestos claims (A\$446.8 million) would go from representing 10% of CSR's total assets to 18% of New CSR's total assets. Given this potential impact on present and future claimants for compensation for asbestos related diseases (Asbestos Claimants), an unusual alliance of objectors opposed the application, consisting of James Hardie Industries NV and James Hardie 117 Pty Ltd (James Hardie); the Asbestos Injuries Compensation Fund Ltd and associated entities (AICF) and the Attorney-General of New South Wales (NSW) (together, Objectors).

Convening Hearing

The Convening Hearing was before Stone J in *Re CSR Ltd* (2010) 264 ALR 461; [2010] FCA 33; BC201000265 on 29 January 2010. A Convening Hearing is rarely opposed and is typically heard as an ex parte application. However, given the potential effect on Asbestos Claimants the Objectors opposed the application. The Objectors made a

number of submissions, most prominently that the demerger would reduce the ability of New CSR to meet its liabilities to Asbestos Claimants given the reduction in capital in such a way as to be unfair or oppressive. It was also submitted by the Objectors that the disclosure in the scheme documentation (including the Scheme Booklet) regarding the effect of the demerger on the ability of New CSR to continue to meet its liabilities to asbestos related claimants was inadequate. Moreover, it was argued that the risk that these projections and assessments may be wrong was not a risk which should be borne by Asbestos Claimants. It was also argued that the risk was not fanciful given previous revisions by CSR increasing their estimated Australian liabilities by 57.2% and United States liabilities by 89.1%. ASIC did not oppose or support the application by CSR although it was 'currently content' with the form of disclosure in the explanatory statement by CSR. Nevertheless, it did make submissions concerning factors the Court should consider regarding asbestos claimants.

Stone J held that orders should not be made unless the court was "clearly satisfied that the potential claimants would be no worse off if the order were made than they would be otherwise". CSR, the Objectors and ASIC tendered no less than 11 expert actuarial reports analysing CSR's asbestos liabilities and commenting on the analyses of each other report tendered (all but one of the reports was the subject of confidentiality orders because of the sensitive commercial material they contained). In light of the conflicting expert actuarial evidence, Stone J held that the conflicting expert evidence presented highlighted the inherent uncertainty involved in attempting to determine the extent of future asbestos related claims, and therefore the uncertainty as to the ability of New CSR to meet future asbestos claims.

CSR argued that it was inappropriate for the court to consider issues associated with asbestos claims at the Convening Hearing. This is because the proposed capital reduction did not form part of the Scheme before the court, and therefore the court was not required to consider the advantages and disadvantages of the capital reduction. However, these submissions were rejected. Her Honour held that as a matter of substance, if not form, the proposed capital reduction was part of the Scheme and that, as

a matter of public policy, commercial morality and fair disclosure to shareholders, it should be considered in the context of the Scheme. Additionally, it was held to be appropriate for the court to consider the proposed capital reduction on Asbestos Claimants at the Convening Hearing even though it was a matter for the court to determine at the Approval Hearing, post the shareholders' meeting. Her Honour continued stating that if a court has a concern during the Convening Hearing about an element of a scheme such that the court would not be prepared to approve the scheme at the Approval Hearing without that issue being resolved, it would be inappropriate that the issue not be raised at the earliest opportunity.

Upon this basis, her Honour declined the application to convene a meeting of shareholders to consider the Scheme. Her Honour was not satisfied that the Scheme 'would not involve an unfair or oppressive result' or that the provisions made in respect of asbestos related claims following the demerger were 'consistent with commercial morality'. Moreover, due to the inherent uncertainty of the expert actuarial reports, the material in the CSR explanatory memorandum to shareholders could not provide adequate disclosure to CSR shareholders of New CSR's ability to meet future liabilities.

Appeal

Inability to pay claimants

CSR argued that its expert actuarial estimates encompassed the category of claims in the future by persons who have not yet been adversely affected by exposure to asbestos in compliance with s 256B of the Corporations Act which states that a company may not reduce its capital unless the reduction:

- "is fair and reasonable to the company's shareholders as a whole";
- "does not materially prejudice the company's ability to pay its creditors"; and
- "is approved by shareholders under s 256C".

Keane CJ and Jacobson J agreed with CSR's submission that their expert actuarial evidence did "not contain any suggestion that one may reasonably predict that CSR will not be able to pay all its creditors, in the event of

the demerger proceeding, even in scenarios of extraordinary stress” (emphasis in original). Their Honours deemed that “a theoretical risk of non-payment, falling short of material prejudice to the prospects of non-payment” is insufficient grounds to reject an application.

‘Public policy’ and ‘commercial morality’

In contrast to Stone J who 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 in s 411(1), Keane CJ and Jacobson J outlined the scope of these two concepts. Their Honours referred to ss 256B and 1324 of the Corporations Act as providing clear guidance as to the circumstances upon which the capital of a company must be preserved. Given that there was nothing in the expert actuarial assessments made on behalf of CSR that there would be insufficient funds available for future asbestos claimants (other than a disclaimer in the Grant Samuel report), their Honours determined that there was no basis to the ‘public policy’ and ‘commercial morality’ arguments preventing a meeting of shareholders. However, their Honours went out of their way to say that it was in no way a criticism of Stone J given that her Honour was unable to make a full assessment in the absence of the ability to cross-examine the authors of the Grant Samuel and other reports submitted to the court. It should also be noted that the Convening Hearing before Stone J occupied just one day — a remarkably short period of time to consider given the issues to be argued.

Putting in train the processes of s 411

Continuing from this theme, Keane CJ and Jacobson J engaged in the broader discussion as to when a Convening Hearing court should exercise its discretion to refuse an application for the convening of a shareholders meeting. Their Honours drew on a long line of authority to state that there is “a clear want of utility in putting in train the processes of s 411 [where there] is a good reason to decline to order the convening of the first meeting.” Their Honours elaborated stating that a court “should not promote the waste of resources and the raising of false hopes or the creation of unnecessary concern and anxiety by

promoting a process which will clearly not proceed to consummation under s 411(4)(b)”. In addition to concluding that the issues Stone J held to be fatal to CSR’s application were indeed not fatal, their Honours stated that there are other procedural opportunities to address non-fatal issues, most notably the Approval Hearing.

Their Honours continued that the Convening Hearing is an inappropriate forum for an in depth analysis of the arguments of the parties. It was, after all, an interlocutory hearing, which during the Convening Hearing before Stone J was a mere day long. Their Honours concluded that a reduction in capital can occur notwithstanding that it may involve an increase in the abstract risk to those with claims against the company. Stone J would have been acting within the bounds of a proper exercise of discretion to refuse the order if her Honour was able to find that CSR could not negative a material risk that New CSR would be unable to pay its debts in consequences of the reduction in capital. But her Honour neither made such a finding nor could have made such a finding with the available materials.

Their Honours concluded that the discretion of her Honour should have been exercised to allow the shareholders to vote on the demerger allowing the Objectors to mount a “better informed and more focused challenge to the reduction of capital by the means open to [the Objectors], either pursuant to s 1324 of the Act, or by way of opposition on the application for final approval under s 411(4)(b) of the Act”.

Judgment by Finkelstein J

Finkelstein J in his own judgment “largely agreed” with Keane CJ and Jacobson J; however, his Honour added some insightful commentary on the demerger process before the courts.

His Honour stated that the function of the Convening Hearing is “emphatically not” to consider the merits or fairness of the proposed scheme. Rather, it is to determine “whether there should be one or more meetings and to decide the manner in which that meeting, or those meetings, should be summoned and conducted”. The main concern for a Convening Hearing court is determining whether any issue is likely to be fatal to the court approving an application.

There are two lines of authority regarding the proper approach of a court at the Convening Hearing. The first line suggests that a court should confine itself to ensuring that procedural and substantive requirements are met. The second approach is to look at the merits of the scheme to determine if a court is likely to approve the arrangement when it returns for the Approval Hearing. His Honour opined that the first approach is preferable stating that “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” and that it is “preferable for a court to defer resolution of the contentious issue to the approval hearing (meaning that the applicant effectively bears the risk of the scheme not being approved due to inadequate disclosure).”

As to public policy and commercial morality his Honour stated that “consideration of what is contrary to ‘public policy’ cannot extend beyond considering the interests of members, creditors and persons who in the future might deal with the scheme company or invest in its shares.” An enquiry into whether a scheme is fair or reasonably is sufficient for this purpose and a consideration of public policy in his Honour’s view adds

“nothing”. Finkelstein J continued that “commercial morality” is problematic when applied to discretionary decision making as “commercial morality” is a continually evolving set of criteria that is “ill defined and largely subjective”.

Adding to Keane CJ and Jacobson J’s judgment regarding the potential inability to pay claimants, his Honour stated that it was “more theoretical than practical” and therefore it was “not appropriate to refuse the scheme on a merely theoretical fear of adverse consequences.”

Conclusion

Whilst it is the role of the Approval Hearing to determine whether the proposed scheme should be approved, the Convening Hearing court may prevent putting the s 411 train in motion, where it is “clearly bound to fail”. However, such cases are rare and even this case, with relatively exceptional circumstances, was not such an instance. In the absence of such exceptional circumstances, the appropriate forum for determining more substantive matters such as the merits and fairness of a scheme is the Approval Hearing.