Before the High Court

Charting the Limits of Insolvency Reorganisations: Lehman Brothers Holdings Inc v City of Swan

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Abstract

Australia’s corporate insolvency regime strives to provide flexible measures that allow stakeholders of a financially distressed company to come to a mutually beneficial arrangement. As with all insolvency laws, it is possible to bind dissenting creditors to the will of the majority in resolving these disputes. How flexible should corporate insolvency law be in facilitating corporate reorganisations? To what extent can/should individual creditors be forced to limit their rights against other stakeholders in the insolvency, including rights against third parties, in the name of collective benefit? This important question has recently been the subject of conflicting statements in several Federal Court decisions. After an expedited hearing the High Court dismissed an appeal from one of these Federal Court decisions in the Lehman Brothers case on 30 March 2010 and will release its reasons on 14 April 2010. This note considers the legal and policy issues involved in this matter.

Introduction

The global financial crisis (GFC) that began in 2007 saw a substantial tightening in business lending conditions that has made obtaining debt finance much more difficult than had previously been the case. Difficulties caused by this shift in lending conditions have been compounded by a dramatic loss of market confidence in complex funding models and opaque financial products which has dragged down the capital markets across the globe. This has had negative flow-on effects for the broader financial system as banks became more reluctant to lend, even to other substantial banks. What started as a sub prime mortgage crisis in the United States became the GFC, with many predicting another great depression.

Businesses that relied heavily on a continuous stream of funding from the debt capital markets, such as non-bank mortgage lender Rams Home Loans and infrastructure managers such as Allco Finance Group and Babcock & Brown, increasingly found it difficult to roll over significant debt funding arrangements and many substantial firms entered some form of external administration. The general lack of confidence in complex

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financial institutions contributed to negative market sentiment about even the largest financial firms, such as AIG (the largest insurance company in the world), Fannie Mae and Freddie Mac (firms that held hundreds of billions of US dollars in residential mortgages in the US) and Bear Stearns (a substantial Wall St investment bank) which had to be bailed out by the US federal government.¹

It was in this environment that Lehman Brothers, one of the five largest US investment banks and a globally significant financial services firm with operations in many countries including Australia, collapsed in September 2008. When the short term debt market lost confidence in Lehman’s ability to repay its loans, and the price of credit default insurance over Lehman’s corporate bonds skyrocketed, the adverse market sentiment against Lehman effectively shut the business down when it was unable to continue raising money to fund its business and counterparties lost confidence in its ability to complete future transactions. After unsuccessfully attempting to have the US federal government bail out the company, the company entered Chapter 11 proceedings under the US Bankruptcy Code 1978 on 15 September 2008 with similar insolvency proceedings commenced in other jurisdictions where Lehman maintained operations. The Australian Lehman subsidiary entered voluntary administration under Part 5.3A of the Corporations Act 2001 (Cth) (‘Corporations Act’) on 26 September 2008. The global insolvency administration of Lehman entities has been said to be the most complex and expensive insolvency proceedings to date, with insolvency fees estimated to top US$1 billion before the administrations around the world are completed.²

The huge scale of the Lehman collapse, and the numbers of investors and creditors adversely affected by the collapse set the scene for potentially endless litigation in several countries involving Lehman’s dealings in all types of structured financial products (including the much maligned ‘collateralised debt obligations’ or CDOs that were sold to regional councils, including the City of Swan) to equity and debt-based derivatives, custodial arrangements for assets and securities, share trading and other financial services. Lehman faces an avalanche of claims arising from its trading activities around the world. The Financial Times reported recently that over US$800 billion in claims had already been made against Lehman’s US-based assets.³ The potential for expensive drawn out litigation provides a strong incentive for Lehman entities to seek finality through ‘global settlements’ with affected parties. This has involved proposing the payment of funds by Lehman for the benefit of claimants in a particular jurisdiction on the condition that those claimants release their claims not only against the Lehman entity operating in that jurisdiction but all Lehman

² The professional fees for the insolvency administrators of Lehman’s European operations alone were over GBP150m as of October 2009, with legal fees adding up to another GBP100: Anousha Sakoui and Megan Murphy, ‘PwC fees mount to £154m in Lehman wind-up’, Financial Times (London) 20 October 2009 <http://www.ft.com> at 15 January 2010.
entities and their officers worldwide. Obviously there is little incentive for Lehman Brothers US or Lehman Brothers Hong Kong to provide funds to settle disputes in Australia if creditors of Lehman Brothers Australia can then make further claims against the parent company.

It is clear that there is utility in providing a global resolution to these disputes rather than consume the remaining Lehman assets in expensive litigation around the world. Indeed, the underlying justification for corporate insolvency law rests in the view that a mandatory collective process that compromises the enforcement of individual contract claims in exchange for a rateable return to all unsecured creditors (subject to a statutory priority list of privileged creditors such as employees) is a better system. This raises the difficult, but important, issue of how far such ‘global resolutions’ may reach. In particular, is it appropriate for insolvency arrangements to restrict, or even take away, creditor rights to sue third parties including those third parties related to the debtor company, in this case Lehman entities in other jurisdictions and their officers and insurers? Of course, there is nothing to stop individual creditors from voluntarily releasing or waiving their legal rights against third parties as a condition precedent to participating in a global resolution. It is a difficult question, however, to determine whether creditors should be forced to give up their rights on an involuntary basis. In other words, can insolvency law accommodate the compulsory acquisition of rights of dissenting creditors by use of a formal arrangement? There are conflicting lines of precedent on this question, both in Australia and in other common law countries such as the United States, Canada and England. In particular, 2009 saw two differently constituted full Federal Court benches make differing rulings on the question of third party releases.

In Fowler v Lindholm4 the court ruled that a scheme of arrangement could include a third party release. That case involved a scheme made up of several hundred million dollars provided by the ANZ Bank and Merrill Lynch to settle claims by creditors of the Opes Prime margin lending business. In contrast, in City of Swan v Lehman Brothers Australia Ltd,5 the Court ruled that a deed of company arrangement proposed by Lehman’s Hong Kong-based parent company, which included a fund of over $40 million, was invalid because it contained releases of claims that creditors of Lehman’s Australia may have against Lehman entities worldwide and its officers and insurers. If this had been the only effect of the decisions it could be said that third party releases are only permitted in schemes and not in deeds of company arrangement. However, the court in Lehman made it clear that it did not believe that the Fowler decision on this point was correct, thus creating substantial uncertainty about the proper scope of both schemes and deeds of company arrangement.

On 14 December 2009, the High Court of Australia granted special leave to appeal the decision of the Full Federal Court in Lehman. After an expedited hearing on 9 and 10 February 2010 the High Court dismissed the appeal on 30 March 2010 and will deliver

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4 (2009) 178 FCR 563 (‘Fowler’).
5 (2009) 179 FCR 243 (‘Lehman’).
its reasons for doing so on 14 April 2010. This article will discuss the important issues raised by the case and the potential implications for Australian corporate insolvency law.

The Legal Context of the Decision

Insolvency Arrangements in Australia

Insolvency arrangements may be undertaken on an informal basis simply by obtaining the consent of relevant parties to the arrangement (commonly called a ‘workout’). Alternatively, insolvency arrangements may involve a more formal agreement that is facilitated by the Corporations Act. These formal arrangements may be based on provisions in Part 5.1 of the Corporations Act (called ‘schemes of arrangement’) or Part 5.3A Division 10 of the Corporations Act (called ‘deeds of company arrangement’).

Although each of these procedures have different requirements, the content of each is largely determined by the parties involved as the statutory provisions set out merely what information must be included, not what the relevant terms must be. Both schemes and deeds may involve elements of delayed and/or compromised debt repayments, debt reorganisations including debt for equity or debt for asset swaps, asset sales, corporate spin offs or demergers and changes to the underlying business. These features are more commonly found where the underlying business is being restructured in an attempt to save it and the formal arrangement is needed to protect the company and its assets from litigation by dissenting creditors.

Where the scheme or deed is in reality a device to liquidate the company and wind down the business, as occurred with both Opes Prime and Lehman, the contents of the arrangement usually will involve a compromise of the debts and a moratorium on further action by the creditors against the debtor company. As noted above, what makes both of these cases contentious is that their arrangements also included extensive third party releases. The scope of schemes and deeds of company arrangement will now be discussed.

Schemes of Arrangement

Schemes of arrangement have been present in Australian corporate statutes since the 1870s and were the primary mechanism for corporate reorganisation prior to 1993, when voluntary administration and deeds of company arrangement were introduced into the Corporations Act. The scheme provisions are very flexible in that they do not prescribe exactly what form a scheme proposal must take. The main scheme provision is s 411 of the Act which requires a party proposing a scheme between the company and its creditors or any class of its creditors to seek court approval before distributing the proposed scheme document and explanatory memorandum to the creditors and convening a creditors meeting. If the court is satisfied that the scheme documentation complies with the requirements of Part 5.1 it will allow a creditors’ meeting to be convened to vote on the scheme proposal. A scheme

6 Corporations Act s 411(1).
A proposal must be approved by a majority of creditors (or class of creditors for a scheme limited to a particular class) that must comprise a minimum of 75 per cent of the debt held by the creditors in that class who are entitled to vote in person or by proxy. If the meeting approves of the scheme with the requisite majorities, the scheme proponents must then seek court approval to implement the scheme. While the statute provides a default set of standard terms for schemes of arrangement these may be replaced by the actual scheme document. The scheme provisions therefore allow the parties to a scheme to design an arrangement that suits their needs.

Schemes have not been a commonly used device for corporate reorganisations since the introduction of voluntary administration in 1993 because they are generally time consuming and expensive to implement due to the statutory requirement for two court approvals to be obtained before the scheme can be implemented. The deed of company arrangement procedure which may follow voluntary administration can achieve similar results but is generally much faster and simpler than a scheme of arrangement. Deeds of company arrangement are discussed further below.

Creditors’ schemes have also traditionally been plagued with problems concerning if and when creditors must be divided into separate classes. Other jurisdictions, such as the United States, have addressed the problem of dissenting classes by the use of a ‘cram down’ mechanism that binds dissenting classes of creditors by court order. However, the scheme of arrangement provisions in the Act contain no such power for dissenting classes of creditors, although minority creditors in each class are bound assuming the other requirements of s. 411 are met.

One significant advantage offered by schemes of arrangement over other formal mechanisms is the ability to vary the system of equal treatment of similar claims in insolvency (known as ‘pari passu’). The constant supervision of the court under a scheme also provides significant protection to dissenting creditors who may oppose either the initial distribution of the scheme documentation or convening of the creditors meeting and/or may oppose the final court approval of the scheme. It has been recognised that the court is not bound to sanction the scheme merely because the majority, even a significant majority, of creditors have approved the scheme proposal. This is because the court has general supervisory jurisdiction over schemes and must ensure that the scheme is not oppressive. The court is concerned with ensuring that the scheme proposal is consistent with ‘commercial morality’.

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7 Corporations Act s 411(4)(a).
8 Corporations Act s 411(4)(b).
9 Corporations Regulations 2001 (Cth) Sch 8.
10 Bankruptcy Code 1978 (US) s 1129.
11 Re Trix [1970] 3 All ER 397.
Deeds of Company Arrangement

A deed of company arrangement is more than an agreement between the company and its creditors. It is a statutory device that changes the status of the company from voluntary administration into a deed of company arrangement.\(^{13}\) It can only occur following a voluntary administration under Part 5.3A of the Corporations Act, which may be initiated by a secured creditor or liquidator, but is usually commenced by an ordinary resolution of the debtor company’s board of directors.\(^ {14}\) There is no need for court approval to initiate voluntary administration. The administration is designed to be fast and efficient in order to minimise its impact on the company’s stakeholders. The administrator’s primary responsibility is to investigate the company’s financial position and provide an opinion to the creditors at the second meeting (after an initial meeting to allow the creditors to confirm the appointment and establish a committee of creditors if necessary), which must be convened within 25 business days after appointment (although an extension of time is possible).\(^ {15}\) The purpose of the final creditors’ meeting is to determine the future of the company. The creditors are required to decide whether the company should be:

- wound up;
- placed into a deed of company arrangement (if one has been proposed); or
- removed from administration with control returned to the directors.\(^ {16}\)

Similar to a scheme of arrangement, the statute requires that certain matters be covered in a deed but the form of the deed itself is left to be determined by the parties.\(^ {17}\) This will involve a party proposing a deed, there may be multiple deeds put forward, which the administrator will then comment on in his or her report to creditors for the final meeting. The creditors then vote by ordinary majority in number, which must also correspond with a majority of unsecured debts owed by the company.\(^ {18}\) If the creditors approve of the deed, the company and the administrator have 15 business days to execute the deed.\(^ {19}\) If executed properly, the deed will take the company out of voluntary administration and the relationship between the company and its unsecured creditors will be governed by the terms of the deed.

Unlike a scheme of arrangement, there is no requirement to put the creditors into relevant classes. Furthermore, there is no requirement to seek court certification of the deed that operates under the force of Part 5.3A Division 10 of the Act. The court does however have general supervisory powers over companies operating under a deed of company arrangement. Any interested person may seek the assistance of the court to either terminate

\(^{13}\) MYT Engineering Pty Ltd v Mulcon Pty Ltd (1999) 195 CLR 636.

\(^{14}\) Corporations Act ss 436A–436C.

\(^{15}\) Corporations Act s 439A.

\(^{16}\) Corporations Act s 439C.

\(^{17}\) Corporations Act s 444A; Corporations Regulations 2001 (Cth) Sch 8A.

\(^{18}\) Corporations Act s 439C; Corporations Regulations 2001 (Cth) Reg 5.6.19, 5.6.21.

\(^{19}\) Corporations Act s 444B.
or vary the deed. In particular, the court has extremely broad powers under s 447A, which allows the court to ‘make such order as it thinks appropriate about how this Part is to operate in relation to a particular company.’

It is important to note that a significant difference between schemes and deeds of company arrangement are that the deed provisions in Part 5.3A Division 10 set out a detailed framework for the operation of the deed and how it affects different stakeholders such as secured and unsecured creditors, lessors, shareholders, etc. Section 444D specifies that the deed will only bind creditors ‘so far as concerns claims arising on or before the [commencement] day specified in the deed’. Furthermore, s 444H provides that a deed will only release the debtor company from a debt where the creditor is covered by the deed and the deed provides for a release. Clearly, deeds of company arrangement are creatures of statute and can only effect creditor rights by reason of their statutory force.

In contrast, the scheme of arrangement provisions provide only a brief statement about how the scheme binds creditors and that the court may grant approval of the scheme subject to conditions. The different regulatory techniques used for schemes and deeds were a key issue in both the Opes and Lehman cases.

The Opes Prime Litigation

The Opes Prime litigation involved a contentious scheme of arrangement proposed by the liquidator of Opes Prime, a stock broking firm involved in margin lending. Opes Prime’s margin lending arrangements were very popular because they allowed margin accounts over relatively small stocks traded on the Australian Securities Exchange (ASX), which most large financial firms (such as the major banks) would not allow to be used in margin accounts. Investors using these services claimed that they were misled into believing that their transactions were margin loans when in reality (as was clear from the loan documentation) the transactions involved a transfer of the securities to an Opes Prime subsidiary in exchange for the loan. Opes had a contractual obligation to return equivalent securities back to the investors upon repayment of the loan.

When Opes defaulted on its financing arrangements with ANZ and Merrill Lynch those institutions appointed receivers who then sold the shares held by Opes under the securities lending agreements. Large quantities of shares in small companies were sold onto what was an already falling market and many investors suffered huge losses when Opes defaulted on their contractual obligation to return equivalent securities when it collapsed. With Opes insolvent, many investors in several countries made allegations against ANZ and Merrill Lynch for their involvement with Opes Prime. Total losses from Opes Prime were well over AUD1 billion, much of which was caused by the large falls in the ASX during 2008. Claims against Opes by investors were estimated by the liquidators at over $600

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20 Corporations Act s 445D.
million. Class actions were threatened and the ANZ in particular faced extensive public criticism for its role in funding the Opes Prime business model. During this time, several other securities and financial services businesses collapsed including Chimera Capital and Lift Capital. There was considerable public concern about the role of Australia’s large banks in financially backing the failed businesses and then selling the transferred shares when the businesses collapsed further compounding the losses suffered by investors. The liquidators alleged also that ANZ and Merrill Lynch had invalidly taken security over Opes’ assets, a claim which, if upheld, could recover in excess of $275 million. The banks were therefore facing claims from the liquidators in Australia, as well as numerous investors in several jurisdictions. Clearly, a negotiated global settlement would provide a better outcome than dozens of complex court cases which would take considerable time and money.

The liquidators for Opes Prime negotiated a settlement with ANZ and Merrill Lynch after a difficult and lengthy dispute resolution process. This involved the banks paying over $240 million into a settlement fund set up using a scheme of arrangement. The key condition to the provision of this funding was that the Opes creditors agree to give a release to the banks from any claims they may have in respect of their dealings with Opes Prime.

At the first court hearing the scheme was allowed to go forward and creditors overwhelmingly approved the deal, which saw them paid approximately 37 cents in the dollar within a short time after the final vote. There is no doubt that any funds from litigation would have taken much longer and with greater costs, and without any certainty of success. The court at first instance emphasised that schemes of arrangement involve an element of give and take by both the company and its creditors. Finkelstein J stated that a scheme of arrangement could not involve a creditor giving up ‘all his [or her] claims without a compensating advantage, or a scheme which involves the confiscation of rights’ His Honour rejected the argument that the scheme involved a confiscation of rights because the banks were offering the funds in satisfaction of the claims against them. His Honour offered a test in the following terms: ‘provided there is a sufficient nexus between a release and the relationship between the creditor and the scheme company, the scheme can validly incorporate the release’. This point was not accepted by the subsequent full bench decision in *Lehman* that is discussed below.

The decision to approve the scheme of arrangement in *Opes* was unsuccessfully appealed by an individual Opes creditor (Fowler). Fowler’s primary argument was that the schemes were improperly sanctioned by the court because a scheme could ‘only bind a creditor in his or her capacity as a creditor and in no other capacity’. This direct challenge to the initial court’s sanction of the scheme including third party releases was unsuccessful. The court recognised that there must be some limit to the rights and interests that can be

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22 *Re Opes Prime Stockbroking Ltd (No 2) (2009) 179 FCR 20 (‘Opes’).*
23 *Opes (2009) 179 FCR 20, [31].*
24 *Opes (2009) 179 FCR 20, [33].*
25 *Opes (2009) 179 FCR 20, [55].*
26 *Fowler (2009) 178 FCR 563, [58].*
affected by a scheme, and noted that merely involving the company and its creditors would not justify sanctioning a scheme that confiscated a creditor’s property rights without compensation.\(^{27}\)

The Full Court’s reasoning is encapsulated by the following statements:

A scheme of arrangement between a company and its creditors or a class of creditors is no more than a proposal to vary or modify the company’s obligations in relation to its debts and liabilities owed to the creditors or class of creditors. There is nothing to prevent the company from posing, as part of the arrangement, a term to the effect that, in consideration of what the company has provided under the scheme, the creditors will 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.\(^{28}\)

There are of course different ways to implement this, one of which is to require the creditors to enter into separate agreements (by way of a deed of indemnity and release) as a condition precedent to the scheme coming into effect.\(^{29}\) For example consider the following statement from the court in *Fowler*:

[T]here is no 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 element 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 part of a scheme of arrangement as contemplated by s 411.\(^{30}\)

This is entirely consistent with existing precedent. However, what the statement is referring to is a scheme of arrangement containing a condition precedent or condition subsequent that requires the creditors to form an agreement with third parties (such as providing a deed of indemnity or release). It is well established that a scheme of arrangement cannot bind third parties, and has effect only between the company and its creditors by force of statute.\(^{31}\) It is another thing entirely to bind creditors to a release by including the transaction involving the third party in the scheme proposal itself which takes effect not by collateral arrangement (which prior precedent accepts) but by the statutory force of a scheme of arrangement.

**The Full Federal Court in Lehman**

The decision in *Lehman* was handed down on 25 September 2009 with each of the three judges (Stone, Rares and Perram JJ) giving individual opinions that invalidated the deed of company arrangement. The central issue was whether the provisions of Part 5.3A Division 10 of the *Corporations Act* could accommodate a deed that contained third party releases. The deed had been approved by the requisite majority of creditors, although the majority of creditors by value consisted of entities related to Lehman Brothers Australia.

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\(^{27}\) *Fowler* (2009) 178 FCR 563, 578.

\(^{28}\) *Fowler* (2009) 178 FCR 563, [68].

\(^{29}\) *Re Glendale Land Development Ltd (in liq)* [1982] 2 NSWLR 563.

\(^{30}\) *Fowler* (2009) 178 FCR 563, [69].

\(^{31}\) *Shaw v Royce Ltd* [1911] 1 Ch 138.
There is no requirement in creditor meetings to decide on deeds of company arrangement that related party votes be excluded. The court has jurisdiction to overturn a vote or to convene another meeting where the result of a creditors vote was determined by related parties.32

The case turned on the proper interpretation of s 444D(1) of the Act that establishes the binding effect of a deed. As noted above, that section provides ‘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’. This raises the question as to the scope of ‘claims arising on or before the date specified in the deed’, which must be no later than the date when the administrator was appointed.33 The members of the Full Court all agreed that this phrase can only refer to claims that arise because of the person’s status as a creditor of the company. All three members of the court applied principles of statutory interpretation by examining the role and purpose of deeds of company arrangement within the broader context of the voluntary administration regime in Part 5.3A. The court relied upon the fact that the deed provisions do not discuss the effect of a deed on rights against third parties except to say (under s 444J) that a deed does not affect a creditor’s rights under a guarantee or indemnity.34 Furthermore, s 444H provides that a deed only releases a creditor’s claim to the extent provided for in the deed. The members of the court also drew support from the purposive clause in s 435A which refers to the ‘business, property and affairs of an insolvent company’ and specifies that Part 5.3A (which includes the deed provisions) attempts to save the business or to provide a better return to creditors than would result from a liquidation. Clearly, the commencement of liquidation would impose no limitation on creditors pursuing rights against third parties.

Justice Rares’ opinion provides the strongest rejection of the deed. His Honour stated that allowing the deed to stand would be to ‘permit the majority of creditors to use their voting power to interfere with, indeed to confiscate, the minority’s property rights and causes of action’.35 His Honour found that the scope of claims bound by a deed could only encompass claims that were admissible under the deed pursuant to s 444A which requires the deed to include details concerning which of its debts will be released by the completion of the deed.36 Support for excluding third party releases was also drawn from the fact that s 444A mentions only the administrator, the debtor company and its creditors.37 Justice Rares held:

The literal, grammatical, and common sense, construction of s 444D(1) is that it refers to claims of creditors corresponding to those referred to in s 444A(4)(b) and (i) that will be admissible under the deed of company arrangement for payment by the company to the

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32 Corporations Act s 600A.
33 Corporations Act s 444(4)(i).
35 Lehman (2009) 179 FCR 243, [74].
36 Corporations Act s 444A(4)(d).
37 Lehman (2009) 179 FCR 243, [83].
extent that the deed provides in substitution for the rights that the creditors would have been able to exercise had the company not entered into a deed or administration.\(^{38}\)

As noted above, the appeal to the High Court was dismissed on 30 March 2010 although no reasons have been provided by the court at the time of publication. We do not know whether the High Court will address the tension between the *Fowler* and *Lehman* decisions, although the appeal only concerned deeds of company arrangement so any discussion of the scope of the scheme provisions would be obiter dicta.

## Comparative Analysis

The discussion above shows that the current state of the law regarding the use of third party releases in corporate reorganisations is uncertain. The use of debt reorganisation plans to resolve complex disputes in corporate insolvency, whether by way of a scheme or deed of company arrangement or some other collective agreement with or without judicial approval, is common in corporate insolvency laws around the world.\(^{39}\) It is therefore useful to consider how this issue is dealt with in other jurisdictions.

### England

There are two mechanisms for insolvency arrangements involving financially distressed companies in England: the scheme of arrangement and a ‘company voluntary arrangement’ (CVA). The scheme of arrangement provisions\(^{40}\) are similar to the provisions in s 411 of the *Corporations Act* and carry a common heritage.

The company voluntary arrangement procedure under the *Insolvency Act 1986* (UK) Part 1 and Schedule A1 broadly is similar to the deed of company arrangement procedure under Australian corporate insolvency law. The voting thresholds are the same and the terms of the arrangement are determined largely by the parties. One difference with Australian deeds of company arrangement is that a company voluntary arrangement in England need not involve a period of administration beforehand; although, an administrator is given the power to propose a CVA, as is a liquidator and the directors of the debtor company. Unlike s 444D(1) of the *Corporations Act*, which specifies 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’, the CVA provisions in England are broader in that they state that a CVA is ‘a proposal under [Part 1] to the company and to its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs (from here on referred to, in either case, as a “voluntary arrangement”).\(^{41}\) It might be thought that using language such as ‘a proposal’ would allow CVAs to include a wider variety of rights and claims than schemes of arrangement would, but that has not been the case. English courts have generally

\(^{38}\) *Lehman* (2009) 179 FCR 243, [87].


\(^{40}\) *Companies Act 2006* (UK) c 46, pt 26.

\(^{41}\) *Insolvency Act 1986* (UK) c 45, s 1(1).
restricted CVAs to claims arising because of the claimant’s status as a creditor and not to other rights or claims unrelated to their creditor status.

Although English courts have accepted that third parties may be involved in schemes and CVAs, just as Australian courts have accepted that schemes and deeds may involve third parties,^{42} they have not sanctioned CVAs where the proposals involve an involuntary release of third party claims. For example, in Prudential Assurance Co Ltd v PRG Powerhouse Ltd,^{43} a CVA proposal that included a release of guarantee claims against the New Zealand based parent company of an English retail business was struck out. The court found that a CVA could not include an automatic release of third party obligations, because such a clause would be based on an agreement ‘between creditors as to rights and obligations between themselves in a capacity other than as creditors of the company’.^{44} The Court did however accept that a CVA could prevent a creditor from enforcing an obligation against a third party where the third party then had a right of recourse against the debtor company.^{45} However, the Court found that the requirement in a CVA to release guarantors was unfairly prejudicial which could also allow the CVA proposal to be invalidated.^{46} It should be noted that in Lehman, the issue of whether the deed could be terminated by the court on a similar basis under s 445D was not considered given the court’s ruling that the deed could not contain a third party release.

Another case in 2007, this time concerning schemes of arrangement and asbestos claims, is also instructive. In Re T&N (No 3),^{47} the court held that the term ‘arrangement’ in the scheme provisions should not be limited by a requirement that a scheme must only alter existing rights between the debtor company and its creditors.^{48} David Richards J stated that a scheme is not ‘necessarily outside the section, because its effect is to alter the rights of creditors against another party or because such alteration could be achieved by a scheme of arrangement with that other party.’^{49} His Honour applied a nexus test, which was then applied by Finkelstein J in Opes and implicitly approved in the appeal of that decision. His Honour did note however that ‘[t]he looser the connection between the subject-matter of the scheme and the relationship between the company and creditors concerned, the more substantial might be the objections on discretionary grounds to sanctioning the scheme.’^{50}

More recently, in another Lehman Brothers related matter in November 2009, the Court of Appeal for England and Wales refused to sanction a scheme of arrangement that required Lehman creditors to give up rights they had as beneficiaries of trust property held

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^{42} Shaw v Roece Ltd [1911] 1 Ch 138 (applied to CVAs in Prudential Assurance Co Ltd v PRG Powerhouse Ltd [2007] EWHC 1002 (Ch)); Re Glendale Land Development Ltd (in liq) [1982] 2 NSWLR 563.
^{43} PRG [2007] EWHC 1002 (Ch) (‘PRG’).
^{44} PRG [2007] EWHC 1002 (Ch) [51]. For similar comments in relations to schemes of arrangement in Australia see Bridges v Hershon [1968] 3 NSWR 47, 55 (Asprey JA).
^{45} T&N [2007] EWHC 1002 (Ch), [60].
^{46} Insolvency Act 1986 (UK) c 45, s 6; PRG [2007] EWHC 1002 (Ch) [97].
^{47} T&N [2007] 1 All ER 851 (‘T&N’).
^{48} T&N [2007] 1 All ER 851, [53].
^{49} T&N [2007] 1 All ER 851, [53].
^{50} T&N [2007] 1 All ER 851, [54].
by various Lehman entities as part of a settlement.\textsuperscript{51} In that case, Lehman entities had acted as custodian over thousands of securities transactions and it became difficult to determine which client/investor owned which particular parcel of securities. The Lehman administrators therefore proposed a global resolution that involved Lehman creditors agreeing to compromise claims they may have against Lehman entities in respect of custodial services provided to them in capacities other than as creditors of Lehman. The Court of Appeal rejected the view that a scheme could cover any rights held by a creditor, rather the rights altered by the scheme must relate to the person’s capacity as a creditor.\textsuperscript{52} However, Patten LJ went on to say: ‘[t]hat 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.’\textsuperscript{53} Contrast this with comments by the Master of the Rolls who, although in agreement with Patten LJ’s conclusion that trust property could not be included in a scheme of arrangement, seemed to impose a casual requirement on the derivation of the claim seeking to be compromised by the scheme. The Master said:

If a person’s claim cannot be said to render him a creditor or a member, then it appears to me to follow that the subject matter of the claim could not be covered by the arrangement. The fact that he may, in connection with a different claim, be a creditor, does not justify him being treated as a creditor for the purpose of the first claim.\textsuperscript{54}

It is difficult to assess the precedent value of this statement given that it seems inconsistent with the previous comments of Patten LJ and the third member of the court, Longmore LJ, merely agreed with the decisions of both Patten LJ and the Master of the Rolls. It is possible however to see Patten LJ’s comment regarding a release of contractual rights as being mere obiter given the issue under consideration involved proprietary rights in a trust rather than mere contractual rights. Of course, even if the Masters’ comment is ratio decidendi that would only be persuasive and not binding in Australia, although it should be very valuable given the common origins and similar nature of the scheme provisions in both Australia and England. It should be noted that the appeal to the High Court of Australia in the Lehman case involves the statutory wording of the deed, and not scheme, provisions.

\textbf{Canada}

In Canada there are two mechanisms for insolvency arrangements involving corporations in financial distress, a formal proposal under Part III of the \textit{Bankruptcy and Insolvency Act}, RSC 1985 (‘\textit{BIA}’) or a plan of reorganisation under the \textit{Companies’ Creditors Arrangement Act}, RSC 1985 (‘\textit{CCAA}’). It is typical for large corporate reorganisations to be undertaken using the \textit{CCAA} rather than the \textit{BIA} as the \textit{BIA} procedure is very rule driven and is therefore

\begin{itemize}
\item \textsuperscript{51} \textit{Re Lehman Brothers International (Europe) (in admin)} [2009] EWCA Civ 1161 (‘LBI’).
\item \textsuperscript{52} \textit{LBI} [2009] EWCA Civ 1161, [65] (Patten LJ). See also \textit{Bridges v Hershon} [1968] 3 NSWR 47, 55 (Asprey JA).
\item \textsuperscript{53} \textit{LBI} [2009] EWCA Civ 1161, [65].
\item \textsuperscript{54} \textit{LBI} [2009] EWCA Civ 1161, [78].
\end{itemize}
less flexible than the CCAA provisions that are specifically tailored to corporate rescues and reorganisations.55

The inclusion in CCAA plans of third party releases has been accepted in several Canadian insolvency cases.56 The most authoritative decision is the recent ruling by the Ontario Court of Appeal concerning the restructuring of the Canadian asset backed commercial paper market. In that case (Re Metcalfe & Mansfield Alternative Investments II Corp57) Blair JA rejected that such releases were an improper confiscation of rights (much the same as both Federal Court decisions in the Opes Prime matter rejected this argument in respect of the schemes of arrangement). His Honour placed particular emphasis on the class voting system used in CCAA proceedings and the requirement for final court approval of the reorganisation plan. These requirements are both broadly similar to the requirements of a scheme of arrangement under Australian law and bring Blair JA’s reasoning in line with comments in the Federal Court in Lehman explaining why the result regarding third party releases in Opes Prime was different.58 That is, deeds of company arrangement have a consolidated simple majority vote with no court approval, whereas schemes (may) have class votes and require two court approvals.

His Honour adopted a similar test to that used in Opes Prime, that is ‘the CCAA permits the inclusion of third party releases in a plan of compromise or arrangement to be sanctioned by the court where those releases are reasonably connected to the proposed restructuring.’59 Although his Honour also recognised that something more than the proponent’s willingness to provide funds to support the plan is needed in order to create the necessary nexus between the release and the arrangement.60 As his Honour said ‘there must be a reasonable connection between the third party claim being compromised in the plan and the restructuring achieved by the plan to warrant inclusion of the third party release in the plan.’61

Blair JA accepted the following factors as relevant to the identification of the sufficient nexus between the releases and the arrangement:62

(a) The parties to be released are necessary and essential to the restructuring of the debtor;

(b) The claims to be released are rationally related to the purpose of the Plan and necessary for it;

(c) The Plan cannot succeed without the releases;

56 See for example, Re Canadian Airlines Corp (2000) 265 AR 201 (Alberta); Re Muscle Tech Research and Development Inc (2006) 25 CBR (5th) 231 (Ontario).
60 Re Metcalfe (2008) 296 DLR (4th) 135, [69].
(d) The parties who are to have claims against them released are contributing in a tangible and realistic way to the Plan; and

(e) The Plan will benefit not only the debtor companies but creditor Noteholders generally.

Blair JA did point out that several earlier cases had refused to sanction reorganisation plans that included third party releases. However, his Honour distinguished those cases on the basis that the releases in those matters bore little relationship with the reorganisation attempt other than the fact that they involved creditors or the reorganised company, albeit in other capacities which therefore did not satisfy the requisite nexus between the release and reorganisation.63

If this standard were applied to the Lehman matter, it is possible that some of the claims against Lehman entities and officers could have the necessary nexus in that they were involved in designing the allegedly misleading products and funding the marketing and distribution of those products. However, the breadth of the proposed release could also catch other totally unrelated claims held by creditors against other Lehman entities.

United States

Section 524(e) of the US Bankruptcy Code 1978 provides that, with limited exceptions, the release of debts under bankruptcy ‘does not affect the liability of any other entity on, or the property of any other entity for, such debt.’ For present purposes, this section means that a plan of reorganisation under the Chapter 11 procedure does not automatically discharge third party debts.

There are however conflicting views about whether reorganisation plans may or may not include third party releases. Several decisions in the Courts of Appeal for the Second, Third and Seventh Circuits have granted temporary and permanent injunctions under the broad equitable injunctive power given to the US Bankruptcy Court under s 105(a) of the Bankruptcy Code. Some decisions allow third party releases in reorganisation plans on the basis that s 524(e) does not expressly prohibit them.64 Other decisions that have allowed the releases only where there is unanimous creditor approval,65 or have otherwise limited their effect to creditors who voted in favour of the reorganisation plan.66 Other cases have noted that third party releases should only be allowed in rare circumstances because they are a

64 In re Airadigm Communications Inc., 519 F3d 640 (7th Cir 2008); In re Drexl Burnham Lambert Group Inc, 960 F2d 285 (2nd Cir 1992); In re All Robbins Co, 880 F2d 694 (4th Cir 1986).
65 In re Specialty Equipment Co, 3 F3d 1043 (7th Cir 1993).
66 In re West Coast Video Enterprises, Inc, 174 BR 906 (BankrEDPa1994); In re Arrowmill Dev. Corp, 211 BR 497, 506–07 (BankrDNJ1997); In re Zenith Electronics Corp., 241 BR 92, 111 (BankrDDel1999).
device ‘that lends itself to abuse’. Various decisions have proposed lists of relevant factors similar to those mentioned in the Canadian cases (see above).

On the other hand, the Courts of Appeal in the Fifth, Ninth and Tenth Circuits have interpreted s 524(e) as prohibiting third party releases in Chapter 11 plans altogether and have therefore refused to grant injunctions under s 105(a).

Therefore, in neither the US, Canada or England is there a clear legal mandate to include third party releases in insolvency arrangements. Courts in England and Canada allow releases for schemes and reorganisation plans under the CCAA respectively, although there are still conflicting decisions and the laundry list of relevant considerations do not provide clear guidance on the application of the nexus assessment. In each of these jurisdictions, the strongest support for third party releases has come from mass tort claims, particularly asbestos-related claims.

**Conclusion**

The proper scope of deeds of company arrangement is a fundamental issue for the future efficacy of voluntary administration as a tool for restructuring and reorganisation in Australia. Although both Lehman Brothers and Opes Prime were businesses winding down, the High Court’s decision to uphold the Lehman case will significantly limit the ability to use deeds of company arrangement, and hence voluntary administration, as a means of restructuring companies in financial distress. This is because corporate reorganisations, particularly those involving multinational groups, will often involve a range of complex and overlapping claims that make a global resolution a better solution than pursuing individual enforcement across different jurisdictions.

An efficient insolvency regime is not the only regulatory policy goal at play in this dispute. The goal of investor protection and promoting better corporate disclosure practices is an equally important policy goal. Striking down the deed of company arrangement in Lehman allows the investors who purchased derivative products from Lehman and its subsidiaries in Australia, allegedly in circumstances that were misleading or deceptive, to seek compensation from other Lehman entities and their insurers. It should be noted however that the cost and scale of the worldwide collapse of Lehman may make it unlikely that the Australian plaintiffs will be fully compensated even if they are able to pursue

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67 *In re Metromedia Fiber Network, Inc.*, 416 F3d 136, 142 (2nd Cir 2005) (‘No case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique.’)


69 *In re Zale Corp.*, 62 F3d 746 (5th Cir 1995); *In re Lowenshuss*, 67 F3d 1394 (9th Cir 1995); *Abel v West*, 932 F2d 898 (10th Cir 1991).

Lehman entities offshore. The High Court has previously held that the goal of an efficient insolvency regime should not be used to limit the scope of investor protection and compensation laws.71

The Lehman litigation highlights a tension that is steadily building in Australian law between providing investors with compensation for defective corporate disclosure and promoting an efficient, and effective, set of corporate rescue laws that facilitate the restructuring of viable companies in financial distress. Each of these policy goals are equally valuable and form important functions in making Australian capital markets attractive to local and overseas investors. The courts should not be left alone in considering these tensions, a more comprehensive review of policy in this area is warranted.

On its face, it is possible to see the Lehman case as purely one of statutory interpretation, one of a growing number of cases slowly teasing out the scope and meaning of the provisions regulating deeds of company arrangement. Of course, much will depend upon how the High Court’s reasons address the issues under consideration in the appeal. On the other hand, as the above discussion demonstrates, the decision is an important development for the broader issue of how far Australian corporate insolvency law should go in facilitating corporate restructuring. In short, the decision raises an important policy question regarding how flexible should our corporate insolvency laws be? The above discussion has shown that different jurisdictions take different approaches to the question of whether third party releases should be included, with both Canada and England adopting a nexus test for allowing reorganisation plans to include third party releases, but the United States taking (perhaps unusually in the area of debt restructuring) a more conservative approach in refusing to allow third party releases as a matter of course, although as always with US law there are conflicting authorities. It is an open question as to whether the Lehman releases would satisfy a nexus test if imposed on the deeds in question. However, this may be a question that requires a policy driven legislative treatment rather than a case by case assessment from the courts.