

THE SHAREHOLDER



IMF (Australia) Ltd

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HIGH COURT SAYS SONS OF GWALIA SHAREHOLDER CAN BE A CREDITOR

Shareholder rights received a huge boost when the High Court of Australia held on 31 January 2007 that a Sons of Gwalia shareholder who was agreed to have been deceived into purchasing his shares by the company's illegal conduct was entitled to rank equally with other unsecured creditors in the company's administration.

The 6-1 decision means that the claims by shareholders will not be deferred until debts owed to other creditors of the failed miner are paid. Shareholders who have lodged a Proof of Debt with Sons of Gwalia's administrators will be entitled to a dividend along with other unsecured creditors if their Proof is admitted.

IMF has lodged Proofs for more than 700 Sons of Gwalia shareholders and is also funding a similar claim by shareholders of the failed car parts manufacturer ION.

The importance of the High Court decision to shareholders was not lost on the media; the headline on the front page of *The Australian Financial Review* on 1 February read: "High Court boosts shareholder rights". Since then, large law firms and professional associations have held information sessions for clients on the ramifications of the decision, which has now been referred to the Corporations and Markets Advisory Committee (CAMAC).

The *ratio* of the High Court's decision was that Luka Margaretic, whose test case was funded by IMF, was not making a claim in his "capacity as a member of the company". The *Corporations Act* stipulates that only a claim made by a member in his capacity as a member is postponed until debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.

Chief Justice Murray Gleeson said that the law did not contain a general policy that, in an insolvency, "members come last". Rather, the law requires "a line to be drawn between a shareholder claiming in the capacity of a member and a shareholder claiming otherwise than in the capacity of a member". To draw that line, the Chief Justice said it was necessary to analyse the nature of a claim, not its effect on other creditors.

The nature of the claim brought by shareholders is one where various persons are seeking compensation from Sons of Gwalia for loss in the same way as any other person who is damaged by a wrongful act of the company and subsequently who makes a claim. It just so happens that they are also shareholders.

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FINANCE BROKERS SETTLEMENT

For the victims of the Western Australian finance broking scandal who have passed away since legal action was initiated more than five years ago, the news came too late. But on 18 February 2007, IMF announced the State of Western Australia had finally agreed to a procedure whereby victims of the scandal will receive compensation.

IMF has worked for more than five years on behalf of thousands of elderly people who lost their life savings by investing in pooled mortgage schemes that were marketed by hundreds of finance brokers in Western Australia.

IMF has signed an agreement with the WA State Government whereby the State will establish a \$26.6 million fund to compensate victims of the scandal.

Between 1992 and 1998 about 3,000 investors lost more than \$100 million through the activity of the finance brokers, who lent the investors' money to questionable borrowers who subsequently defaulted. The lenders found that the security for their loans fell well short of the amount lent against that security because of false or inflated valuations. False statements were also made about the ability

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FINANCE BROKERS—CONT FROM PAGE 1

of the borrowers to repay the loans.

The settlement announced on 18 February relates to the action funded by IMF against the Finance Brokers Supervisory Board, which was a claim for damages as a result of misfeasance in public office.

In order to ensure that IMF's clients received settlement monies, IMF agreed to a condition imposed by the State of Western Australia that IMF give up part of its contractual entitlement to fees even though not a single client of IMF had called for the fee to be reduced.

IMF takes some solace in the fact that more than 400 clients have said they will pay IMF the full entitlement voluntarily.

IMF expects most, if not all, IMF clients will now elect to take part in the Fund. Payments under the Fund will be made to those IMF clients who elect to take part and agree to have their actions against the State dismissed.

Other victims who are not IMF clients may also make an application to receive monies from the Fund.

Each of the mortgages were prepared by solicitors and the action against those solicitors for damages claiming negligence is continuing.

Meanwhile, IMF announced on 9 March 2007 the conditional settlement of the Lawyers Private Mortgages matter.

Solicitors for the former trustee of an investment trust (and the trustee itself), were being sued by investors for negligence, breach of duty, breach of trust and for misleading and deceptive conduct.

IMF announced to the ASX on 22 March that the conditions of the settlement had been met.

See the "Shareholder info" tab at www.imf.com.au for all IMF's recent ASX announcements.

INSURANCE DISCLOSURE

IMF is supporting the Federal Treasury's moves to make disclosure of insurance arrangements compulsory as part of the reforms relating to compensation arrangements in the financial services sector.

As present, one of the biggest difficulties for shareholders in seeking to bring an action against a company or its directors—and assessing the risks of bringing such an action—is the inability to ascertain whether the company or its directors will have the benefit of an insurance contract which will respond to the conduct being alleged.

One of the main risks of bringing litigation is that there will be no money at the end of the process to pay the claim. This may occur not only if the company or its directors have insufficient assets to pay the damages, but also if the insurance company decides not to honour the policy because the conduct of the insured party invalidated the insurance contract.

Corporation Regulation 7.6.02AAA, which remains in draft form and was released for comment in November 2006, is seeking to introduce a mandatory framework for professional indemnity insurance for the financial advisory industry by requiring a financial services licensee to hold adequate professional indemnity insurance cover.

The draft regulation proposes that the terms of the licensee's insurance arrangements are set out in the product disclosure statement.

IMF attended a "Roundtable" conference hosted by Federal Treasury in the Sydney office of the Australian Securities and Investments Commission in January. Various representatives from the insurance industry expressed concerns about the requirement for disclosure, and Treasury acknowledged that it had received feedback that disclosure of insurance arrangements might create false expectations among consumers as to potential for recovery, and might not be of assistance because consumers would not be able to understand the information.

IMF understands that disclosure will not provide a panacea, but believes provision of information such as the amount of insurance, the beginning and end dates of insurance, special provisions and the major exclusion clauses will go some way towards alleviating shareholders' present inability to assess the risks of enforcing their statutory rights to compensation.

A copy of IMF's submission to Treasury can be found at www.imf.com.au

IMF REPORTS INTERIM PROFIT, PAYS SPECIAL DIVIDEND

IMF shareholders will receive a special dividend of 3 cents per share after the company reported earnings before interest, tax, depreciation and amortisation (EBITDA) of \$4.26 million for the half year ending 31 December 2006. The net profit after tax for the period was \$2.01 million.

IMF books revenue when matters are concluded; the results were buoyed by the conclusion of 8 matters during the half year, including Sentinel and Geneva Finance.

The result for the half year does not include proceeds from the settlement of Finance Brokers or the Lawyers Private Mortgages matter. At least \$3.4 million and \$3.9 million, respectively, from settlement of these matters will be booked in the second half.

The conclusion dates of other matters currently being funded by IMF are difficult to predict precisely, but IMF is confident that one or two more investments will conclude in the second half.

For the first half, IMF's proceeds from litigation funding (which includes settlements, fees and reimbursements) was \$17.1 million, compared to \$2.2 million for the previous corresponding half year.

SelectEquities, a stockbroker which provides independent research on IMF, said after the result: "IMF's key performance metrics, such as ROI [Return on Investment] and case duration, may improve over time, following the decision in *Fostif* where the High Court ruled that the litigation funding agreement in question was not an abuse of process. This may lead to stronger financial results for the company over time."

IMF said the payment of any future dividends would be dependent upon the company's future operations and cash flow requirements. As the company's future cash flows are expected to remain lumpy, future dividends are likely to remain in the form of special rather than regular dividends.

A copy of IMF's half yearly report for the half year ended 31 December can be found under the "Shareholder info" tab, then "Recent ASX announcements" at www.imf.com.au

SONS OF GWALIA— CONT FROM PAGE 1

“What determines the present case is that the claim made by the respondent is not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of [Sons of Gwalia]...The obligations he sought to enforce arose, by virtue of [Sons of Gwalia’s] conduct, under one or more of [the *Corporations Act*, *ASIC Act* and *Trade Practices Act*],” the Chief Justice said.

The Chief Justice noted that on the one hand, extending the range of claims by shareholders would necessarily increase the number of potential creditors in a winding-up at the expense of those who previously would have shared in the available assets. But His Honour said: “On the other hand, since the need for protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.”

It is also likely that shareholders who purchased their shares directly from the company will also be able to claim. Previously, it was thought that subscribing shareholders

would be prevented from making a claim of this nature due to the operation of the High Court’s precedent in *Webb Distributors* and the so-called rule in *Houldsworth’s case*, which was derived from an 1880 case of the UK House of Lords. But the High Court in the Sons of Gwalia decision seems to have abandoned the distinction, because the ‘debt’ owed to a subscribing shareholder is also unlikely to be owed to them “in their capacity as a member of the company”. (The High Court made no binding findings on the position of subscriber shareholders in the case.)

A number of critics of the Sons of Gwalia decision have argued that the Parliament should intervene to change the law, citing possible delays to complex administrations and increased costs. IMF agrees that a number of these concerns are warranted, but are best addressed by making shareholder rights *easier to enforce*, not by taking away such rights.

The article below on this page details IMF’s submission to CAMAC on this issue.

IMF CAMAC SUBMISSION

IMF is urging the Federal Government not to overturn the High Court’s decision in *Margaretic v Sons of Gwalia* through legislation, following the referral of the issue to the Corporations and Markets Advisory Committee (CAMAC).

IMF will argue in a submission to CAMAC that to subordinate defrauded shareholders in respect of their claims against companies under external administration would make the market protection laws illusory and eschew the purpose for which the market protections were designed, namely, to enhance corporate behaviour and the efficient allocation of capital.

The legislature, in responding to concerns about the effect the decision will have on corporate administrations, should consider ways to make the investor protections easier to enforce, rather than seeking to remove those protections.

This can be achieved by removing the need for administrators to consider the circumstances of each shareholder when adjudicating Proofs of Debt, and outlining, through legislation, a methodology for quantifying loss.

Much of the uncertainty relating to how shareholder claims should be determined reflects the lack of clarity in the statutory protections for shareholders, which are silent about the principles to be applied to determine what sort of loss is recoverable.

There are other ways the legislature

can seek to protect shareholder rights given the wide-ranging nature of its review.

IMF argues that the legislature should ensure that directors’ insurance policies are made available to potential litigants in order for them to better assess the risks associated with bringing an action against directors in reliance on the investor protection regime (see article on previous page). It would also be of assistance if shareholders were able to utilise the share register of the offending company in order to facilitate communication with each other ahead of a decision to start legal action (this is currently prevented by the *Corporations Act*).

Following the High Court decision, many articles were published suggesting the debt markets would be adversely affected by the decision. But there has been no evidence that the cost of debt has risen since the decision and experience from the UK—where the law is consistent with the High Court’s decision—suggests that fears of rising costs of debt are unfounded.

IMF has prepared a submission for CAMAC and has sent a Questionnaire to all clients, asking them to lend their support to various recommendations in the submission.

A copy of the CAMAC submission can be found under the “Publications” tab, then “Legal and consumer issues” at www.imf.com.au

IMF RECOMMENDATIONS TO CAMAC

To subordinate defrauded shareholders in respect of their claims against a company in external administration would eschew the purpose for which the market protections were designed, namely, to enhance corporate behaviour and the efficient allocation of capital.

Since the need for protection of investors often arises in the event of insolvency, the benefits of the market protection regime would become illusory if shareholder claims were subordinated to the claims of ordinary creditors.

The Australian law rejects a general policy that ‘members come last’ and, after the Sons of Gwalia decision, is consistent with the law of the United Kingdom.

There is no evidence that the cost of debt will be affected by the decision; experience from the UK would suggest such fears are unfounded.

Policies must be considered to make rights of shareholders arising from the market protections easier to enforce. This can be achieved by:

removing the need for administrators to consider the circumstances of each shareholder when adjudicating proofs, and outlining a methodology to quantify loss;

making available to shareholders any directors and officers insurance policy to assess enforcement risks and making available the shareholder register to facilitate collective action; and

enhancing the Federal Court representative process to enable Shareholder claims.

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ARISTOCRAT TRIAL DATE SET, FUNDING FOR WESTPOINT INVESTORS, INSURERS DISCUSS LITIGATION FUNDING

Aristocrat action listed for trial

The shareholder action against poker-machine maker Aristocrat, which is being funded by IMF, is scheduled to proceed to trial in September 2007.

The claim has a maximum value of \$230 million, and is being run by law firm Maurice Blackburn Cashman.

The price of Aristocrat shares collapsed in February 2003 after a significant sale to a South American company fell over, resulting in the 2002 profit coming in below expectations.

Shareholders are alleging the company's dependence on a number of large sales to the relatively risky South American market in order to meet its forecast for calendar year 2002 was hidden from the market.

IMF funds litigation by Westpoint investors

IMF announced on 13 March 2007 that it would provide funding for two further class actions on behalf of Westpoint investors. IMF will provide funding for investors who received advice from authorised representatives of the licensed financial planners Quantum Securities Pty Ltd and MASU Financial Management Pty Ltd. The legal proceedings against these two financial planners, which are being run by law firm Slater & Gordon, were filed in the NSW Supreme Court on 13 March.

IMF announced on 21 September 2006 that it would fund proceedings against Professional Investment Services Pty Ltd, also in relation to advice relating to Westpoint Corporation Pty Ltd.

IMF speaks to insurers about litigation funding

The insurance sector's fascination with litigation funding continues, with IMF presenting at a number of insurance gatherings already this calendar year, including the Professional Indemnity Symposium hosted by Liberty Underwriters in Melbourne.

IMF also presented to members of Chartered Secretaries Australia in Sydney on "The impact of litigation funding on your insurance".

In the presentations, IMF told attendees that there was no evidence that litigation funding had increased D&O insurance premiums but insureds should examine the exclusions on their coverage carefully and ensure that their policies covered liability for issuing improper prospectuses and breaches of the *Corporations Act*.

Meanwhile, IMF visited Hobart in February to talk to the 7th Annual Insolvency Practice Symposium on the topic of "Protecting your interests through the use of litigation funding".

IMF at Sons of Gwalia Roundtable

The High Court decision in Sons of Gwalia, as reported in this edition of *The Shareholder*, has created a high level of interest from the media and corporate law commentators. John Walker, IMF's managing director, participated in a "roundtable" discussion hosted by Malcolm Maiden of *The Age* which was published in that newspaper on 28 February. Professor Ian Ramsay, director of the Centre for Corporate Law and Securities Regulation at the University of Melbourne, has invited John Walker to participate in two seminars on the decision to be convened in April.

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