HOW EFFECTIVE IS YOUR SECURITY — THE IMPACT OF RECENT CASES

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LINTER GROUP

I must say that when I read David's paper (which I had the privilege to read some time ago), I felt to some extent that I was being asked to walk into the lion's den. He did press his case that Mr Justice Southwell was, as he put it towards the end of his talk, totally off the wall. Obviously I have a different perspective. The client for whom I acted was very pleased with the result. I might also add that the twenty-eight banks, which substantially he represents, were also very pleased with the result. I might also mention that the decision has been the subject of an appeal, but it has now substantially been settled. There are a few loose issues lying around, but none that affect relationships as between Linter and the various defendants. So, like it or not, the decision is there and as David says, it is not a decision which can be ignored. On the other hand, as he said, it is also a decision which turned very much upon its peculiar facts; it was a function, as he also said, of the 1980s corporate frenzy. At that time you had leveraged entrepreneurs like Goldberg able to obtain relatively large sums of money from banks which in retrospect did not always look at the credit risk the right way.

The position of Citibank is interesting because Citibank has two interests in this case. It had an interest upon which David focused as a constructive trust as well as a secured interest. Indeed the issue between Citibank and Linter was very much one of timing. Citibank, as you will read in David's paper, had a claim arising out of an interest because a joint venture between Linter and one of its holding companies had created a trust over a particular debt in favour of Citibank, that trust had been breached by Goldberg when he diverted the money to Linter and ultimately used that money to acquire the Brick and Pipe interests. From that point of view, Citibank had a very similar interest to Linter and indeed we were (acting for Linter) somewhat apprehensive that Citibank may well get up on that point. Indeed, so far as David's tracing points are concerned, I agree that the **Islington** case is probably the preferable view and that Mr Justice Southwell in this case, probably because the issue was not fully argued before him for a variety of reasons, did not really get that point right.

Citibank also had an interest because it had a third mortgage over the shares in question, a mortgage which it gained in the dying days of Goldberg's empire. So you need to bear in mind when looking at Citibank's position that it had two separate interests.

I think it is fair to say that quite apart from the tracing exercise, Citibank's constructive trust claim fell foul of both knowledge and waiver on the part of the relevant Citibank executives who knew, not long after Goldberg diverted the money, that he had done so and took no action. And there was also another problem that they faced which only came out really in the course of the trial and that is because Goldberg's accounting methods were somewhat creative or unique (indeed several editions were fairly creative and unique), the security which they had, that is a declaration of trust by the relevant company over a particular debt was of doubtful utility. The debt did not exist at that point.

The next point I would like to focus upon is the issue of directors' duties and in particular David's comments on a group. Goldberg's group, if any of you had any experience of it and given that most of you are banking lawyers and given that most of the banks in Australia seemed to deal with him there is a fair chance some of you did, was extremely convoluted. Historically that has always been so. Indeed I can remember when I was a solicitor in another firm which acted for Goldberg in the late 1970s I was aware then that his structure had been expressly set up to avoid a consolidation and that continued to be the case right up to the death knell.

To talk about a group is a bit of a misnomer in Goldberg's sense because it was not a group in the traditional sense - far from it. Furthermore, you have got to think of the history of the Goldberg group, Linter in particular. Linter was a public company until 1988 when Goldberg made a successful takeover bid for it. It had at that stage substantial financing lines in place based upon negative pledges. Those negative pledge arrangements remained in place post Goldberg's acquisition. The negative pledge agreements did not have, probably because at the time they were put in place it was not thought relevant, any limitation upon 'upstreaming'. What happened after Goldberg got control was that he used Linter effectively as a cash cow. Large sums went out of Linter (on an unsecured basis, I might add) to his other companies.

When we came to this particular structure, that is the structure to acquire Brick and Pipe, as David said, there was a totally separate chain set up. It was separate from the other companies in the 'Goldberg Group', being controlled by new trusts established for the benefit of Goldberg's children.

David speculates, and indeed as he is entitled to, that was probably done for tax purposes. That group was controlled by quite distinct trust from the trusts which controlled the other older and more convoluted Goldberg group. It is perhaps worthy to bear in mind that because Linter had a negative pledge type arrangement it could not have, through one of its subsidiaries under the existing negative pledges, gone out, bought Brick and Pipe shares and given a security over those shares specific to CIBC or indeed anyone else. This structure on one view was probably set up so as to get around the negative pledge arrangement.

It also should be borne in mind that it was an integral part of the liquidator's case that there was no argument that acquisition of Brick and Pipe was itself a breach of duty on the part of the directors. Rather had Linter or one of its subsidiaries acquired Brick and Pipe shares directly the liquidator would have had no case, but rather there was an arrangement whereby effectively Linter took the risk as an unsecured creditor of a company which had no assets other than Brick and Pipe shares in circumstances where those shares were charged to someone else to secure a debt independent of Linter.

David made one slight error in dealing with this issue where he talked about warranties. I think from recollection that Linter did not guarantee the Brick and Pipe facility. If did not of itself give warranties. However, the financing vehicles which were directed by some of the directors of Linter, that is Goldberg and his son-in-law Furst, did give warranties.

The question of whether there was a group here is I think fairly difficult. My view is that there was not a group and that the argument which was put in the **Equiticorp** case would not apply to the Goldberg situation. Both judgments, including **Equiticorp** emphasised that each director of each company owes a duty to that company primarily. Some transactions may be acceptable if done for the benefit of the group as a whole. But you still have the question of a duty to the particular company of which you are a director and you also seem to get growing authority where the duty is owed not only to the company, but also to the creditors of that company. That is perhaps particularly noteworthy in a situation where you have differing creditors. Linter had, at the end of the day, a huge volume of creditors - quite distinct from other Goldberg companies. There was no common interest so far as the creditors were concerned.

The real issue is what can one do to protect yourself from it? David gave you some very helpful comments. I certainly endorse each of those. Certainly in a group like the Goldberg group which is

controlled effectively by one man, there is no earthly reason why shareholder ratification cannot be obtained. It is quite easy to do. Proper inquiry cannot be ruled out. If you are dealing with an entrepreneurial group you now have to be aware that because the directors have duties to the various companies within the group, you have to look at each company as it stands and the use of special purpose vehicles for acquisitions merely emphasises that position when one is considering what the group's 'equity' contribution to a particular transaction is.

Interestingly in this situation there was money put in by Goldberg companies other than Linter. There were, for reasons I do not quite know, subordination agreements executed in relation to those loans. Again, there would be no reason why a subordination arrangement cannot be expressly put in train to protect the position. The lesson is, that careful due diligence beforehand, careful understanding of exactly what it is you are dealing with, the nature of the vehicle you are dealing with can pay considerable dividends.