

The Liquidation of Storm Financial

Salutory lessons for investors

Tucker & Cowen Solicitors have been recently engaged by the liquidators of Storm Financial Limited, one of the largest financial services companies in Australia.

In 2008, Storm Financial Limited ("Storm") was a company with some 14,000 clients under investment advice, well over a billion dollars of funds under management, and as at 30 June 2008 had an audited net profit of approximately \$28 million.

By 9 January 2009, administrators had been appointed to the company, clients were threatening law suits for substantial losses, over \$500 million in equity for clients had been wiped out and the business was insolvent and in ruins. Over \$100million in claims have been submitted to the liquidator for consideration at this time, and the assets seem unlikely to discharge the main secured banks' indebtedness let alone meet any of the claims of unsecured creditors.

Tucker & Cowen Solicitors have been engaged by the liquidators, Messrs Khatri and Worrell of Worrells Solvency & Forensic Accountants, to investigate the collapse of the company and to assist in its winding up.

As is now well known, throughout 2008, share markets worldwide suffered significant downturns, the greatest seen since the Great Depression of the early 1930s. Storm was a financial advising company, whose principal strategy consisted of "gearing" by borrowing against real estate or other assets to invest in managed index funds, and then defer the gear up against that investment by taking out margin loans. Many Storm clients were therefore geared well in excess of 50% against the total value of their investments, which of course proves catastrophic with an approximate decline in the Australian All Ordinaries Index of 47% throughout calendar 2008.

The Regulator - ASIC

Given that Storm held a financial services licence to advise clients from the Australian Government regulator, the Australian Securities and Investments Commission ("ASIC"), it is unsurprising that the regulator took a considerable interest in the liquidation. Indeed, the regulator's detailed investigations had begun slightly before the appointment of the administrators on 9 January 2009 by private examinations commenced in December 2008. ASIC provided funding to Tucker & Cowen Solicitors and Worrells for the purpose of investigations, and of conducting a lengthy examination.

We conducted an examination that went for well over a month of hearing days in the Federal Court of Australia, examining the directors, officers, bankers, insurers, senior investment advisers, clients and others to determine the cause of the collapse, the consequences of the collapse, and to investigate potential prosecutions under the Corporations Law and other securities laws against any persons who may have contravened those provisions.

Those investigations are still at a preliminary stage. We are presently assisting the liquidators to prepare their final reports to ASIC in relation to the nature and causes of the collapse, and in relation to further investigations and any potential prosecutions that may be considered warranted. Those findings are still confidential at this stage.

The Lessons

Of particular interest was the rapidity of the collapse in this particular case. As noted above, the company had an extensive client base and considerable net profits at 30 June 2008, and yet six months and nine days later was insolvent, in administration with many of its clients financially ruined for the rest of their lives. It was particularly distressing in that a number of the clients of Storm who took financial advice were elderly or retired persons, who quite literally lost all of their life savings, and more in the collapse.

The lessons seem to be:-

1. Storm had a consistent model of advice whereby substantially the same advice was given to most of their clients. Storm's directors argue that this is because the advice was only given to the sort of clients that the advice suited. Nevertheless, the losses suffered by many clients demonstrate that there were serious risks involved with the advice.
2. Although it is perhaps a lesson that has been learned many times before, everyone needs to be aware of the dangers of gearing. Gearing or leverage can certainly rapidly increase returns when times are good and markets are rising. It has an equal and opposite effect when markets are falling.
3. The rate of the fall in stock markets in late 2008 around the world was such that margin calls and stop losses did not operate as they ought to have, and clients who thought they had reserve or protected positions because of stop losses or margin calls, found that they in fact lost everything and those did not work.
4. Terms and conditions need to be read carefully. Most of Storm's clients had margin loans through the Commonwealth Bank of Australia. The Commonwealth Bank's terms and conditions provide the bank is not actually obliged to make any margin calls at all, and it is up to clients to monitor their own investments. Therefore, as always, be aware of the fine print.

The Unusual Aspects

The speed of the collapse also means that many of the usual issues such as insolvent trading or substantial voidable transactions will only arise on a much smaller scale than Storm. However, that will give rise to unusual considerations about breaches of directors' duties and/or breaches of the financial licensing provisions of the securities legislation. If prosecutions are in fact launched, it is likely that some of these will be novel and it is the first time some of the provisions may have been used for prosecution. The lesson is that directors of companies involved in the financial services industry certainly need to consider worst case scenarios, and thoroughly prepare for what might occur.

Of course, that may lead to less spectacular growth in boom times, but that lack of performance will be more than made up by the comfort directors can feel when times go bad that they had adequate provisions for the worst.

Tucker & Cowen Solicitors were ideally placed to assist the liquidators with this administration, given not only our strong expertise in insolvency and litigation, but our experience in corporate and commercial matters, all of which were required to form the team to assist the liquidators in relation to the liquidation of Storm. This was particularly the case because of the lack of available assets, and the public funding provided via ASIC, which required a tight team to manage the investigations and reporting under extremely tight time and budgetary guidelines.

The liquidators retained the expertise of Tucker and Cowen for this important liquidation, with the team led by Richard Cowen and Senior associate Dan Ryan.

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