Australian Government

Corporations and Markets Advisory Committee

SHAREHOLDER CLAIMS AGAINST INSOLVENT COMPANIES

Implications of the *Sons of Gwalia* decision

Collated Submissions

December 2008

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Purpose of this collation

All submissions received on the discussion paper *Shareholder claims against insolvent companies: implications of the Sons of Gwalia decision* (September 2007) are published on this website under Submissions.

This paper collates the submissions under various topics. Its purpose is to assist readers to identify the range of views of respondents on each of these matters.

Any collation involves a degree of judgment as to the division of each submission. Also, it may be more difficult in a collation to identify general themes in particular submissions. Persons seeking to understand the overall views of particular respondents are advised to consult the uncollated submissions.

List of respondents

1. The Australian Securities and Investments Commission (ASIC)
2. The Australian Bankers’ Association Inc (ABA)
3. The Australian Financial Markets Association (AFMA)
4. Baker & McKenzie
5. Christine Brown (University of Melbourne) and Kevin Davis (University of Melbourne) (Brown and Davis)
6. Chartered Secretaries Australia (CSA)
7. Duncan Brakell
8. Evan Sylwestrzak
9. Jason Harris (UTS) and Anil Hargovan (UNSW) (Harris & Hargovan)
10. IMF (Australia) Ltd (IMF)
11. KordaMentha
12. Corporations Committee of the Law Council of Australia (Law Council - Corporations Committee)
13. Insolvency and Reconstruction Committee of the Law Council of Australia (Law Council – Insolvency Committee)
14. Marina Nehme (University of Western Sydney) and Claudia Koon Ghee Wee (Central Queensland University) (Nehme &Wee)
15. QBE Insurance Group (QBE)
16. Insolvency Practitioners Association (IPA)
17. Arnold Bloch Leibler
18. NSW Law Society Business Law Committee
19. Michael Duffy (Monash University)
20. Law Institute of Victoria

1 General comments

Law Council – Insolvency Committee (majority)

Members of the Law Council Insolvency and Reconstruction Committee do not have a unanimous view concerning whether shareholders should be able to bring claims against the company of which they are members. However, the vast majority of members of the Committee support a change in the law to restore what was thought to be the position in respect of shareholder claims after the decision in *Webb Distributors*, consistent with Option 2 in the Discussion Paper.

This submission sets out some arguments as to why shareholders should not be able to bring such claims. It then deals with some arguments as to why they should. The submission deals in passing with an issue of particular importance for members of the Committee: the practical issues that arise for liquidators and administrators of insolvent companies if the law remains as it is, in particular, the negative effect on the efficient reorganisation of a listed company.

The Committee supports a change in the law to reflect what it described as 'option 2' in the Discussion Paper. This is broadly consistent with the law as generally understood prior to *Sons of Gwalia*, which was that such claims were excluded from proof but could be taken into account for the purposes of the final adjustment of rights of contributories amongst themselves and, to that extent, a member with a claim of this kind, against the company occupied a preferred position to other members: *Webb Distributors* at pp 35, 38-39. Members having such claims would not be entitled to lodge a proof of debt or otherwise participate in the insolvency unless and until all creditors had been paid in full.

Law Council - Corporations Committee

The members of the Corporations Committee have carefully considered the Discussion Paper and over the last 2 years have closely monitored the general debate surrounding shareholder claims in light of the *Sons of Gwalia* decision and the relevance to those claims to the rule in *Houldsworth's case*.

In summary the Corporations Committee favours a legislative response along the lines of Option 2 as set out in section 7.4 of the Discussion Paper, for the reasons set out there. The Corporations Committee finds those arguments much more compelling than the arguments in favour of the other options set out in the Discussion Paper.

In that regard the Corporations Committee favours the majority view set out in the submissions of the Insolvency and Reconstruction Committee of the Law Council of Australia on this Discussion Paper and agrees with the analysis in that submission that supports that position.

QBE

We note the submission from Chartered Secretaries Australia (CSA) dated 17 December 2007. In general, QBE agrees with CSA's position as detailed in its response.

Harris & Hargovan

The High Court of Australia's decision in *Sons of Gwalia Ltd v Margaretic* (2007) 60 ACSR 292; [2007] HCA 1 has generated significant discussion concerning the

priority rights of shareholders and creditors in corporate insolvency. Initially, there was some concern that the decision would prove a disaster for insolvency administrators, particularly when combined with recent endorsement of class action litigation funding by the High Court in *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) 229 ALR 58; [2006] HCA 41. Concerns were expressed by commentators, practitioners, and academics, that the Gwalia decision would lead to a flood of claims against insolvent companies that would significantly delay their due administration and reduce non-shareholder creditor payouts giving rise to increasing debt costs for Australian companies.

To date there is little evidence that the Gwalia decision has generated widespread inconvenience for insolvency practitioners, and the current global credit crunch has driven up the price of debt for everyone regardless of the Gwalia ruling.

The terms of reference for the CAMAC Inquiry ask whether shareholders should be permitted to stand as creditors in respect of their claims for defective disclosure by the company. In addition, the terms of reference seek suggestions for improving the efficiency of corporate insolvency administrations and to better protect investors from purchasing shares on the basis of misleading or deceptive conduct. In our submission, the Corporations Act does not require amendment to overturn the effect of the decision in Gwalia. This is based on the lack of evidence of any significant detriment to the efficiency of corporate insolvencies caused by the Gwalia decision, and the policy imperative of engendering confidence in the equity markets through the promotion of quality and timely disclosure. In terms of increasing credit prices, it is exceedingly difficult in the current market to link credit price rises with the Gwalia decision. However, we do advocate below the need to make some amendments to the Act to satisfy the questions underpinning the second and third terms of reference dealing with investor protection and efficient insolvency processes. We expand on these issues below.

2 Current position

The submissions in this chapter are summarised in Sections 3.2 and 6.4 of the report.

2.1 General

KordaMentha

The current position concerning the rights of aggrieved investors in light of the High Court decision

Prior to the High Court of Australia decision in *Sons of Gwalia*, section 563A of the Corporations Act ('the Act') was interpreted to mean all shareholders including allegedly aggrieved shareholders would rank last and equally in a winding up along with all other member claims.

In its *Sons of Gwalia* decision the High Court has since interpreted that the legislation allows aggrieved shareholders to claim as creditors of the company being wound up and to rank equally with all other unsecured creditors by circumventing Section 563A of the Act and defining the aggrieved shareholder as an unsecured creditor not a member.

The decision was concerned with determining the status of the shareholder, not the merits of the claim.

ABA

Paragraph 2.4.1 of the CAMAC paper describes other rights which shareholders with aggrieved investor claims may have. In addition to claims against directors, it is also relevant to note that shareholders may in some circumstances also have claims against the promoter, underwriter or auditors (who are each likely to have a greater capacity to meet any liability than the insolvent company).

Law Council – Insolvency Committee (majority)

The Committee submits that the reasoning which would prohibit shareholders from bringing such claims against an insolvent company also applies when the company is not insolvent. Shareholders should not be able to sue the company of which they are a member at either time. This is not to deny that shareholders may be able to take action against the individual directors (or advisors) involved in a breach of the continuous disclosure regime. The point is that shareholders should not be entitled to, in economic effect, sue themselves. The Discussion Paper notes that the potential for such claims against directors may give shareholders indirect access to corporate assets, given that directors may, subject to various statutory restrictions, have indemnity rights against the company which may in turn have insurance covering its liabilities to the directors. This may or may not be so. However, in the event that it were to be a problem in practice, it would be open to insurance companies to change the wording of new policies.

The Committee submits that Australian law, particularly in relation to class action litigation, is more akin to North America in law than the United Kingdom. The Committee submits therefore that Australian law in this area should remain in step with that of the United States and Canada.

Duncan Brakell

The nature and basis of the claim

I acknowledge the widely held sentiment that a claim of this nature should not succeed such that it be granted equal standing to that of general creditors. Firstly, however, I am of the opinion that that sentiment should be set aside while a reasonable effort is made to distinguish the High Court's reasoning in this instance.

Basis of the claim: The essential issue presented by each appeal concerns the operation of insolvency provisions in the *Corporations Act 2001* (Cth) ('the Act'). It is not necessary for the purposes of this paper to repeat the full facts of the case. Relevantly, the resolution of the difference between the parties depends on whether any debt owed by the company in liquidation to the claimant shareholder is one owed in that person's 'capacity as a member of the company'.

The starting point of this examination is a clear appreciation that Mr Margaretic claimed SOG ('the company') was in contravention of s 52 of the *Trade Practices Act 1974* (Cth), s 1041H of the Act, and s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth). The basis of his claim therefore was that he was a victim of misleading and deceptive conduct and entitled to compensation.

Nature of the claim: Any conclusions drawn on this issue depend on the meaning, operation, and interpretation of s 563A of the Act. To elucidate the point of distinction, s 563A requires a line to be drawn between a shareholder claiming in the capacity of a member, and a shareholder claiming otherwise than in such capacity.[1] Gleeson CJ reasoned that it was therefore necessary to analyse the nature of the claim, and not sufficient to only describe its effect on other creditors.

I support His Honour's reasons because it is the nature of the claim that discerns Mr Margaretic's position and, when s 563A is interpreted in this context, is precisely the point to which the High Court is at pains to distinguish. The obligation Mr Margaretic seeks to enforce is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct; a contravention of federal consumer protection provisions.

Conclusion: In so far as the claim is put forward in the tort of deceit, it is a claim that stands apart from any obligation created by the Act and owed by the company to its members. Those claims are not claims 'owed by the company to a person in the person's capacity as a member of the company'.[2]

2.2 The rule in Houldsworth's case

Baker & McKenzie

We agree with the Committee's statement of the effect of the decision in *Sons of Gwalia* as it relates to shareholder claims against insolvent companies, and the balance of this submission proceeds on the basis of that statement.

Although, as the Discussion Paper points out, the High Court need not have dealt with this matter, in our view the rule in *Houldsworth's case* ought not be abrogated. There is no merit in the argument that the rule ought to be abrogated because aggrieved

[1] Per Gleeson CJ at [28].
[2] Per Hayne J at [206].

shareholders cannot agitate their claims in the voluntary administration of an insolvent company.

The policy of Part 5.3A of the *Corporations Act 2001* (Cth) is that a company in voluntary administration will either cease to be externally administered (through a deed of company arrangement or some other work-out arrangement) or go into liquidation. In the former instance, the aggrieved shareholder's shares will revert to having value for that person, allowing the shareholder to participate in the profits of the rehabilitated company. In the latter instance, the rule is inapplicable.

The United Kingdom experience is of no assistance. This is particularly so in circumstances where (as discussed in greater detail at Chapter 6 [**Overseas law**] below):

- the United Kingdom is looking to Australia for policy guidance in relation to the broader issue of shareholder claims against insolvent companies;[3] and
- US investors in the debt capital markets perceive the fundamental principles of UK law regarding shareholder claims against insolvent companies to be the same as US law.[4]

Finally, the argument that rules surrounding capital maintenance by corporations have been eroded in Australia is no justification for their complete abandonment; similar developments have occurred in the areas of tort[5] and contract,[6] however, such developments have not proven to be an entrée to abrogation of the fundamental principles touched by those developments.

The arguments made in favour of the maintenance of the rule in *Houldsworth's case* remain compelling as a matter of policy.

ABA

CAMAC's attention is drawn to the submissions with regard to maintenance of capital. Whilst the CAMAC discussion paper refers to the rule in *Houldsworth's case* having been 'abrogated' in the specified areas, the common feature in those areas (other than s 563A) is that the circumstances in which a reduction of capital can occur are specifically defined, and generally only permitted where creditors are protected - for example paragraph 256A of the Corporations Act expressly states that the rules set out in Part 2J.1 for share capital reductions and share buybacks 'are designed to protect the interests of ... creditors by addressing the risk of these transactions leading to the company's insolvency'. In circumstances where the Corporations Act carefully identifies the circumstances in which a company's capital can be reduced, and provides relevant protections for creditors, it is paradoxical for section 563A[7] to be construed to allow a company's capital base to be diminished (and potentially exhausted) by shareholders in circumstances not regulated by the Act and without any express statutory provisions providing for the protection of general creditors.

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3 As noted at paragraph 6.2 of the Discussion Paper.

4 The United States principles being built around the concept of 'absolute priority', discussed in detail in the Discussion Paper.

5 For example, the broadening of the duty of care.

6 For example, the concept of third party beneficiaries of contracts being entitled to enforce those contracts at their own suit.

7 As interpreted by the High Court of Australia in the *Sons of Gwalia* decision.

Nehme and Wee

In the *Houldsworth* case, Houldsworth purchased shares worth £4,000 from the City of Glasgow Bank which was an unlimited company. In the following year, the Glasgow bank went into liquidation because it was unable to cover its debts. Houldsworth, as a contributor, was asked to pay a sum of money to cover the debts of the company. However, he claimed that he was induced to buy the stock because of the fraudulent misrepresentations made to him by the officers of the company. The House of Lord unanimously agreed that a person who has subscribed to shares in a company may not claim damages for fraud or misrepresentation except if he has renounced his shares.

This principle has been adopted by the courts in Australia and overseas for over 120 years without real analysis of the basis of the case or criticism of it until the late 1990s. For instance, in *Re Dividend Fund Incorporated*, Anderson J applied *Houldsworth's case* as a principle of general application. The influence of *Houldsworth* was once again illustrated by *Webb Distributors (Aust) Pty Ltd and others v State of Victoria* and another where the court noted that the issue 'is not whether *Houldsworth* is right or wrong'. Additionally, McHugh J noted that 'the rule is too deeply entrenched to be set aside by judicial decision'.

However, the reasons that were underlined by the House of Lord to justify the principle in the *Houldsworth* case were not really based on solid arguments and have been contested by a number of commentators.

Some of the justifications of this case have been stated below and have been refuted by us:

- Lord Hatherley noted that: 'In truth the appellant [Houldsworth] is trying to reconcile two inconsistent positions, namely, that of shareholder and that of creditor of the whole body of shareholders including himself.' Such an argument is unacceptable because it goes against the principle of separate legal entity which was emphasised in *Salomon v Salomon and Co Ltd* and in ss 119 and 124 of the Corporations Act 2001 (Cth). A member can be a creditor of a company because the member is a separate legal entity from the company.
- Lord Hatherley continued by observing that the acceptance of the *Houldsworth* claims of damages would lead to a series of interlacing claims for damages by several members leading to endless calls. This argument was mentioned in *Re Dividend Fund Incorporated* where Anderson J noted that allowing the shareholders claims without rescission may lead to 'something akin to perpetual motion' and 'the merry carousel would go on till the end of time'. However these arguments may be justifiable for an unlimited liability company (which was the case in both these cases) but not in the context of limited liability company.
- Lord Blackburn relied in his reasoning on *Addie v Western Bank of Scotland*. However, with respect, it is very hard to deduce from his speech and from the learned lords in the Addie's case the principles they based their opinion on to justify the refusal to allow damages to be paid.
- Another argument used by Lord Cairns and Lord Selborne is that allowing a shareholder to succeed in such a claim of damages would be inconsistent with

the implied terms of the contract by which the member became a member. Accordingly, only when the members rescind their contracts due to fraud, they may be able to claim damages. If the members do not rescind the contract, they reaffirm the contract with the company and the rest of the shareholders and are not entitled to damages. However, such a justification may not be acceptable because it contradicts our laws in relation to fraudulent misrepresentation and the remedies for deceit. If a vendor fraudulently misrepresented the good that is being sold, the purchaser may take action to rescind the contract. If the purchaser elects against the rescission of the contract, he/she can still sue for damages and as a result affirm the contract while still claiming damages. Accordingly, the question that may be raised is the following: Why can't a person who was the victim of fraudulent misrepresentation when buying shares sue for damages only? What is the justification of such reasoning? Furthermore, Vincent J was unimpressed with this justification and considered that this justification 'bordered on the bizarre'.

- Another justification that Professor Gower relied on is related to the principle of capital maintenance. *Houldsworth case* recognises that the share capital is a guarantee fund for the creditors. The existence of the shares may have resulted in creditors lending money to the company. As a result, if there is a misrepresentation, the owner of the shares needs to rescind his/her shares as soon as possible. If this does not occur, damages should not be allowed to be given to any person because this will lower the capital of the company and has the potential to cause harm to the creditors. The principle of capital maintenance is a very important principle however there are a number of exceptions to this principle that may be found under the Corporations Act. For example:

  Section 256B of the Corporations Act: A company may reduce its share capital in a way that is not otherwise authorised by law if the reduction:

  (a) is fair and reasonable to the company's shareholders as a whole; and

  (b) does not materially prejudice the company's ability to pay its creditors; and

  (c) is approved by shareholders under section 256C.

  One of the requirements for a reduction to be allowed is that the company can pay its creditors when the debts are due.

  Section 257A of the Corporations Act: A company may buy back its own shares if:

  (a) the buy back does not materially prejudice the company's ability to pay its creditors; and

  (b) the company follows the procedures laid down in this Division.

  One of the requirements for a share buy-back to be allowed is that the company can pay its creditors when the debts are due.

Section 260A(1) of the Corporations Act: A company may financially assist a person to acquire shares (or units of shares) in the company or a holding company of the company only if:

(a) giving the assistance does not materially prejudice:

(i) the interests of the company or its shareholders; or

(ii) the company's ability to pay its creditors; or

(b) the assistance is approved by shareholders under section 260B (that section also requires advance notice to ASIC); or

(c) the assistance is exempted under section 260C.

One of the requirements for a financial assistance to be allowed is that the company can pay its creditors when the debts are due.

In all these three sections, if the company is able to pay its creditors, the exception to the principle of capital maintenance may be applied (subject in certain cases to other conditions). Accordingly, if the company is solvent and has no problem paying its debts when they are due, the principle of capital maintenance is watered-down. However, this is not the case in *Houldsworth*. In *Houldsworth*, a member cannot claim damages if there is no rescission even if the company is solvent and can pay its debts when they are due. Accordingly, the case applies if the company is solvent or insolvent. Such a reality should not be accepted today especially due to the number of exceptions that apply in relation to the principle of capital maintenance.

On another note, if we are applying the principle of capital maintenance, a member should not be able to rescind his contract because such a rescission will lower the capital of the company and this may affect creditors negatively. In both cases (rescission or damages), the assets of the company will be depleted.

Furthermore, claiming damages without rescinding the contract is not necessarily more detrimental to the company's asset than rescission. When rescission takes place, the plaintiff recovers the amount contributed to the company's assets. This will not always be the case for damages because the shares of the company may not be necessarily worthless.

Accordingly, we reject all the arguments that are put to support the *Houldsworth* case and we agree with Professor Gower when he noted in 1957 that the *Houldsworth* case is 'an anomaly'. The *Houldsworth* decision 'bears the stamp of its era'. McHugh J noted that this is an 'antiquated rule which is a source of injustice and inconvenience'. The principle of the case is unjust because it does not allow shareholders in case of external administration to rescind their shares nor does it permit them to claim damages.

Houldsworth case needs to be abolished by statute. If this does not take place, this case may cause further problems in relation to the extent of its application. Such problems have already appeared in the system. Here are a few of them:

- The *Houldsworth* case deals with subscribing shareholder and not a transferee shareholder. For instance, Finkelstein J, in his obiter, found it hard to apply this case to a transferee shareholder. This distinction also emerged in the *Webb* case. However, such a distinction is not justifiable because the reasoning in *Webb* was equally applicable to claims by transferee shareholders as to claims by subscribers. Kirby J noted that 'there would appear no foundation for the operation of the distinction drawn in that case [the Webb case]. *Webb Distributors* is proof once again (if further proof is needed) of the dangers of attributing undue weight to what was said in England in the nineteenth century when attempting to construe contemporary Australian legislation.'
- *Consumer protection legislations*: A number of sections have been introduced into the system to protect consumers including shareholders. However, the application of the *Houldsworth* case may cause chaos in relation to the application of such provisions because the courts are not sure if such legislation abolishes the *Houldsworth* rule. Here are a few examples of the courts' dilemma in relation to this issue:

  The Fundraising provisions: The *Houldsworth* case has caused some problems in relation to the fundraising provisions in the Corporations Act. This was illustrated in the *Cadence Asset Management Pty Ltd v Concept Sports Ltd*. At first instance, the court applied *Houldsworth* case to reject the claim of damages of an investor based on s 729. However on appeal, the Full Federal Court abrogated the *Houldsworth* rule in relation to Ch 6D of the Corporations Act. Such a decision opens the way for other sections in the Corporations Act that deal with consumer protection to escape the application of the *Houldsworth* case. However, future court might not do that and may distinguish the ration of the Cadence case.

  Misleading and deceptive conduct provisions: In the *Webb* case, the High Court applied the side wind argument to justify the use of the *Houldsworth* case in the limitation the operation of s 52 of the *Trade Practices Act* to subscribers. The High Court noted that the shareholders claims are not postponed but they are unavailable. This goes against the goals of protection of investors and the aims of the sections. However, the extent of the application of the *Houldsworth* case to the provisions of the Trade Practices Act is still uncertain. In *Tenji v Henneberry & Associates Pty Ltd*, French J noted suggested that the decision in *Webb* case may have been overtaken by the new and enhanced remedial provisions. This may mean that the claims for misleading and deceptive conduct would be unaffected by the rule in *Houldsworth's* case.

  The continuous disclosure provisions have been introduced in the Corporations Act to protect shareholders. Refusing the shareholders the right to claim damages even if there is no rescission may go against the policy behind the introduction of such provisions.

Additionally, the UK has to a large extent abolished *Houldsworth's* case recognising the limitation of this case. Section 655 of the UK Companies Act 2006 today notes that:

> *A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register of members in respect of shares.*

However, this section has not been tested and there is still confusion in the UK about the extent of the abolition of the *Houldsworth* case.

Conclusion: We strongly believe that the *Houldsworth* case should be abolished.

Harris & Hargovan

In our view, there is no need to amend the Corporations Act to abrogate the *Rule in Houldsworth's case* as the High Court's decision in the *Sons of Gwalia* case effectively excludes its operation to the vast majority of cases. In addition, the Full Federal Court's decision in *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434; [2005] FCAFC 265 effectively removes the rule in Ch 6D cases for solvent companies.

Duncan Brakell

Abrogation of the Houldsworth principle

It follows that the rule in *Houldsworth* has been abrogated for subscriber claims against a company in liquidation given s 563A exhibits a legislative intention to exclude the rule in a winding up. For the reasons set out above and below, I am of the view it is necessary that this be the case.

Does the common law accord with the legislation?: Any presumed general subordination of shareholder claims on the assets of an insolvent company to the claims of general creditors, must give way to the true meaning of the legislation that actually governs the case. In this instance, as Kirby says,

> *If any general presumptions do not accord with the legislation, properly construed, it is the legislation that must prevail for it expresses the parliamentary command. Statutory interpretation is ultimately, always, a text-based activity [at 117].*

The arguments advanced in support of, or in opposition to, the admissibility of such claims to proof were based on what was said to be the common law rule in *Houldsworth's* case, and whether that rule had received statutory recognition in the Companies (Victoria) Code.[8] The arguments of the appellants are by no means meritless, but it is interesting to note, notwithstanding the recognition *Houldsworth* attracted, that the parties in *Webb*, as was the case in *Sons of Gwalia*, placed *Houldsworth*, not the applicable statutory provisions, at the forefront of their arguments.

As Hayne J remarks, [at 188], in reference to reliance on past authority, this 'reveals the difficulties implicit in taking the state of judge-made law in the field as the

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[8] Per Hayne J at [182].

starting point for consideration of issues'[9] of the kind considered in *Webb* and indeed *Sons of Gwalia*. His Honour further states,

> *Neither Webb nor Houldsworth established any common law 'principle' that no shareholder, no matter how the shares were acquired, can have a claim of the kind now in issue against a company whose assets were to be administered as on a liquidation [at 190].*

The asserted common law 'principle' could not deny the operation of the relevant federal consumer protection and investor protection provisions. None of the considerations in *Webb* or *Houldsworth* is relevant to the present matter where there was no contract for subscription for the acquisition of shares made by the shareholder, Mr Margaretic, and the company, SOG.[10]

The relevancy of the so-called *Houldsworth* principles was earlier brought to light by Justice Gummow. His Honour remarked,

> *Neither the 'principle' attributed to Houldsworth, nor Houldsworth itself, had anything to do with the presently relevant provisions of the Act and the Code. Section 360(1)(k) of the Code cannot have been enacted on the basis that Houldsworth represents an 'entrenched rule of company law' which must be regarded as having been 'expressly considered and approved' by the legislature. The origins of s 360(1)(k) may be traced to the 1862 UK Act, which preceded Houldsworth [at 86].*

Mr Margaretic's claim is not a future or contingent claim or debt, but a certain claim framed under statute.[11] The matter is, as has been discussed, a decision of statutory construction and cannot therefore be decided on principles of general law. Whether the claim against SOG is admissible to proof in the winding up of the company depends, and depends only, upon the relevant provisions of the 2001 Act.[12] Because the statutory definition of claims admissible to proof on a winding up was changed in 1992, past authority decisions do not dictate the outcome in the present matter.

Lastly, it remains necessary to consider reasons for either retaining or reversing the High Court's decision.

Legislative reform

CAMAC has invited respondents to comment on whether the rule in *Houldsworth* should be abrogated. As the answer to that question is 'yes', the question that then arises is whether a change in the law should be supported to restore what was regarded as a settled position in respect of shareholder claims against companies in liquidation post Webb.

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9 Per Hayne J at [188]. See also the remark of Kirby J at [104].

10 Per Hayne J at [190].

11 I refer here to the temporal limits of s 553 of the Act.

12 Per Hayne J at [192].

3 The scope for shareholder claims

The submissions in this chapter are summarised in Sections 3.2.2 and 4.5.2 of the report.

3.1 General

IPA

Cost of dealing with aggrieved investors in an insolvency administration

The cost of an insolvency administrator processing and determining creditors' claims is an aspect of any administration where there is a dividend to be paid to those creditors. That cost will be greater or lesser depending on the number of claims and the complexity of issues for determination in relation to the basis of the individual claim and its quantum.

Aggrieved investor claims are invariably very high in number, are complex in their legal validity and can be difficult to quantify. Although, as the discussion paper says, an individual insolvency can sometimes have a combination of such issues, these are features of all administrations with aggrieved investor claims. We have had the benefit of reading the submission of the Law Council of Australia which describes these issues; the IPA agrees with that description.

Other issues

<u>Possible effect of streamlined processing on other actions</u>

We have discussed various methods of streamlining/commercialising the adjudication process, particularly for less material claimants, with practitioners that have had to deal with aggrieved investor claims.

This approach has merit as with these types of claimants it is likely that there will be a large number of the aggrieved investors that constitute only a small proportion of the total claim. For example in the Sons of Gwalia administration there are 4,800 claims under $50,000 and 430 claims over $50,000.

However, there may be implications of adopting a commercialised approach to these claims.

In relation to claims of aggrieved investors that they were misled by a breach of market disclosure by the company, the issue of disclosure may impact upon claims by the liquidator against third party advisers to the company, for example auditors. A compromise of claims by the liquidator with the aggrieved investors may impact upon any claim of the liquidator against the third party; or a determination of aggrieved investor claims by a liquidator may not be accepted as valid by the third party respondent to the liquidator's claim. In any event, care would be needed to ensure that any decision of the liquidator as to the resolution of shareholder claims did not prejudice rights of the company in its litigation claims.

KordaMentha

Aggrieved investor claims that are admitted as unsecured creditor claims will cause the dilution of the original unsecured creditors' voting rights at creditors' meetings and their potential returns.

Voting rights: Aggrieved investors may not have the same intention to maximise the chances of the company, or as much of its business as possible, continuing in existence pursuant to Section 435A of the Act. This could result in a different outcome at the second creditors' meeting in a voluntary administration scenario where creditors vote on the future direction and status of the company. That is, a trade creditor of an insolvent company would have a greater incentive than a member (who has proven as an aggrieved investor and thus also defined as a creditor) to vote that the company execute a deed of company arrangement to hopefully receive a better return on its claim in the long term together with a possible continued trading relationship. An aggrieved investor would be less likely to be concerned with the future of the entity and is likely to want an immediate return on its claim. Thus there is a likely divide amongst the interests of the two distinct types of unsecured creditors.

Potential returns: Not only will the aggrieved investors' claims dilute other unsecured creditors potential returns but also the pool of funds available will no doubt be reduced as they are applied to the Administrators' fees and costs of adjudicating the additional, and generally increasingly complex and possibly litigious claims.

The High Court decision of *Sons of Gwalia* threatens the voluntary administration objective noted above by introducing the possibility that the voluntary administrator may have to participate in lengthy litigation with shareholders. The sale of a business as a going concern requires swift action. Any delays as a consequence of additional litigation may threaten the prospects of the company being saved via a deed of company arrangement.

Baker & McKenzie

A reversal by the Commonwealth Parliament of the effect of the *Sons of Gwalia* decision will not preclude a remedy through litigation for an aggrieved investor. Viable avenues for relief exist for aggrieved shareholders to commence proceedings against solvent companies and to pursue their claims to judgment prior to any external administration of those companies.

An aggrieved shareholder who successfully pursued such a claim to judgment prior to external administration of a company would be entitled to participate in the subsequent external administration of that company as an ordinary unsecured creditor, as the shareholders' claim would be based on a judgment debt.

Additionally, the Discussion Paper incorrectly suggests that shareholders will have a reduced financial incentive to litigate against a company in liquidation due to the very limited assets available to ordinary secured creditors. Noting that shareholders would otherwise rank below the unsecured creditors in priority with respect to the distribution of assets, the financial incentive to litigate and receive any available share of the assets can be quite considerable depending upon the size of the shareholder's stake in the company and the value of the shares at the time of purchase.

AFMA

AFMA believes that the Committee's following statement (at page 29) will prove correct:

> *In principle, shareholders could claim as aggrieved investors in every situation where they have suffered loss and damage related to their shareholding through corporate misconduct and a remedy is open to them.*

In our view, the six month period since the High Court decision was handed down is not a sufficient timeframe to establish the veracity of this statement. The frequency of corporate insolvency actions brought by aggrieved shareholders consequent upon the *Sons of Gwalia* will only become evident after further experience, but the expectation has already had an effect on off-shore unsecured corporate bond market practices (see 5 below).

Australian class actions brought by litigation funders are both sophisticated and highly developed. Typically, litigation funders seek recovery on behalf of aggrieved shareholders against an insolvent company on a pro-rata basis of the remaining capital. This provides an incentive for litigation funders to lead aggrieved shareholder class actions. The larger the aggrieved shareholder group, the greater the economies of scale for aggrieved shareholders. This provides an incentive for aggrieved shareholders to avail of the efficiencies of grouped proceedings. These incentives for both litigation funders and aggrieved shareholders only operate to encourage an increase in class action claims based on the *Sons of Gwalia* decision.[13]

Insofar as the Committee's view 'it is arguable that the failure to properly disclose the information involves breaches of the law by a company for which shareholders can claim damages against the company as creditors', this is a matter of uncertainty based on inherent conflict of interests where a company is under financial pressure and subsequently goes into administration or liquidation:

> Despite continuous disclosure requirements imposed by the Australian Stock Exchange, it is to be expected that companies entering financial distress are reluctant to publicise every piece of adverse information which may further hasten their decline. Consequently there is likely to be some serious questioning of what constitutes information which should be provided to the market by Boards of Directors and Management.[14]
>
> *(AFMA comment: In addition, the Corporations Act 2001 also imposes continuous disclosure obligations on public companies)*

As a result, the uncertainties arising from the conflict between a Board's obligations of disclosure and its duties to its existing shareholders would likely only give rise to increased class action claims alleging false and/or misleading statements. AFMA submits that this would be established after further experience, as and when corporate insolvencies occur. The incentives and uncertainties described above would, in turn, continue to have direct and detrimental consequences for unsecured corporate bond market practices described at Chapter 5 [**Broader implications**] below.

Further, AFMA disagrees with the Committee's view expressed at page 30 of the Report. It is not relevant that 'disclosing entities represent only a small proportion of incorporated entities, albeit that they are typically larger public companies with a substantial shareholder base.' The *Sons of Gwalia* decision can only have detrimental effects on lending practices to such entities for the very reasons expressed, viz, they are mostly large public companies with large shareholder bases. The larger the shareholder base, potentially the larger the number of aggrieved shareholders who may form a class action for compensation.

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13 Legg, M & Schaffer, R, *Australian Business Law Review* at 391–392.

14 Brown, C & Davis, K, *Agenda*, Volume 3, 2006 at 250.

Modelling based on insolvencies of 30 Australian companies from 2003 to 2005 conducted by Associate Professor Christine Brown of the Department of Finance at the University of Melbourne and Professor Kevin Davis, the Commonwealth Bank Chair of Finance and Director of the Melbourne Centre for Financial Studies provides:

> that in many cases significant purchases of shares are made in a short period prior to failure, creating the possibility of substantial shareholder claims for compensation.

The findings of Brown and Davis were that:

> Based on our sample of failed companies, if all purchasers of shares in the thirty day period prior to failure were eligible to rank equally with unsecured creditors as claimants, the dilution effect would be 37 per cent, using an unweighted average.[15]

The effect of this dilution would have negative implications for the ability of unsecured creditors to recover their exposure in administrations and liquidations.

It is AFMA's view that the disincentives to shareholder actions described by the Committee ('the assets available to ordinary unsecured creditors of companies in liquidation … are very limited') and the traditional 'costs follow the event' argument are both outweighed by the incentives to aggrieved shareholders and litigation funders and the uncertainty surrounding disclosure issues upon which such claims would be based. The consequences of such increased likelihood of litigation with the attendant dilution of unsecured creditors' capital in insolvency cases are already being felt in US corporate bond investment markets as described [elsewhere in the submission].

ABA

Despite the present legal difficulties in establishing aggrieved investor claims as identified in chapter 3 [of the discussion paper], there is significant scope for shareholders to allege aggrieved investor claims at the outset of many administrations. Although such claims may ultimately not be substantiated given these difficulties, in a significant number of insolvencies of listed companies, there will be a real question about the extent of the insolvent company's compliance with its disclosure obligations, especially in relation to the matters ultimately leading to the appointment of voluntary administrators. This suspicion, in particular in the months immediately preceding the appointment of voluntary administrators, will not infrequently raise the spectre of aggrieved investor claims.

The assertion of such claims is entirely understandable given the investors, but for the establishment of an aggrieved investor claim, will almost always be out of the money. Their distress at having lost their investment will naturally facilitate the solicitation by litigation funders and other organisers of class actions to assert such claims on behalf of a significant base of shareholders. It is of course also relevant to note that in the administration process, the assertion of such claims through the lodgement of proofs of debt actually costs very little (as distinct from the commencement of legal proceedings with the risk of adverse cost orders).

The fact that following the *Sons of Gwalia* decision such aggrieved investor claims rank equally with unsecured creditors, will provide a very strong incentive for the

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15 Brown, C & Davis, K, id at Pages 247 & 248.

assertion of aggrieved investor claims, with the resultant delays and administrative problems from large numbers of claimants pursuing claims. Many of these claims will require serious and detailed consideration by the administrators, and the resultant delays and costs obviously accrue whether or not the shareholders are ultimately successful in establishing their claims.

Litigation funders are now very well established in the Australian market and litigation funding is clearly accepted in the context of insolvency administrations. That will continue. In that regard, Australia is very different to the United Kingdom and many other jurisdictions where the law inhibits or prevents litigation funding and/or contingency fee based class actions.

Michael Duffy

Summary of points in support of submission

The *Sons of Gwalia* decision on its face does appear to impact somewhat adversely on unsecured trade creditors and unsecured debenture holders.

Such adverse effect however will be limited to the small number of cases where shareholders seek damages for misleading nondisclosure against a company in liquidation and the company is uninsured for such claims.

In many cases the company will be insured against such claims (eg through a professional indemnity policy that covers misleading or negligent advice) and in that situation creditors will not be adversely affected by the equal priority given to such claims by *Sons of Gwalia*. The legal theoretical justification for the subordination of such claims – maintenance of capital – will also not apply as the claims will not be met from shareholder capital but from a separate fund (insurance).

Detailed submission

Background – Houldsworth and maintenance of capital

The pre *Sons of Gwalia* position is contained in the High Court's decision in *Webb Distributors (Aust) Pty. Ltd. v State of Victoria*[16] ('Webb'). That case had its origins partly in the House of Lords decision in *Houldsworth's Case.* The latter was summarised by Finkelstein J in *Re Media World Communications Ltd*:[17]

> *The rule which was established in Houldsworth's case (Houldsworth v City of Glasgow Bank and Liquidators (1880) 5 App Cas 317) is that a person who has subscribed for shares in a company may not, while he retains those shares (that is, if he has not renounced the contract by which he acquired those shares), recover damages against the company on the ground that he was induced to subscribe for those shares by fraud or misrepresentation.*

Houldsworth was decided in 1880, prior to both *Trevor v Whitworth*[18] in 1887 and *Saloman v Saloman & Co Ltd* in 1897.[19] *Trevor v Whitworth* is generally seen as the authority that established the rule that a company must maintain its share capital for the protection of creditors. *Saloman v Saloman* firmly established the doctrine of the company as a separate legal entity.

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16 (1993) 179 CLR 15.

17 (2005) 52 ACSR 346 at para 10.

18 (1887) 12 App Cas 409.

19 [1897] AC 22.

The decision in *Trevor v Whitworth* was based on the idea that the capital of a limited liability company should be preserved for the benefit of creditors. Lord Watson stated in that case that:

> *Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business.*[20]

Despite the rule in *Houldsworth* pre-dating *Trevor v Whitworth,* justification for the rule has been found in later cases in the capital maintenance doctrine. In *Soden and Another v British & Commonwealth Holdings Plc and Others*[21] Lord Browne-Wilkinson, in the context of the obligation to pay calls on uncalled capital noted that if such a payment were not made the capital of the company would not be maintained and the general body of creditors would be thereby prejudiced. In *Media World* Finkelstein J stated in relation to the subordination of shareholder claims to creditor claims:

> *The reasons for this subordination are the twin privileges of incorporation and limited liability. That is, if a member's liability is limited then the capital which he subscribes, or agrees to subscribe, to the company must be available for creditors.*[22]

Similarly in *Webb*[23] the maintenance of capital rule was relied upon by the majority in the High Court as one of two strands of authority supporting the *Houldsworth* approach (the other being the argument that a shareholder could not rescind a contract for purchase of shares once a winding up had begun).

This approach was also in accordance with the views of Professor LCB Gower who first criticised the *Houldsworth* decision as unsatisfactory in 1950[24] and later set out the view that the decision, though anomalous, may be explained by reference to the concept of a company's share capital as a 'guarantee fund' for creditors. Gower suggested that this conception was at the basis of the rule that a shareholder who wishes to rescind must do so promptly since the existence of his shares may have led others to extend credit to the company.[25]

The maintenance of capital doctrine has however been criticised as defective for at least two reasons:[26] (1) there is no minimum capital requirement on registration of companies in Australia[27] - some companies are registered with a capital of only $2

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[20] (1887) 12 App Cas 409, at pp 423-424.

[21] [1997] UKHL 41; [1998] AC 298; [1997] 4 All ER 353; [1997] 3 WLR 840.

[22] 52 ACSR 346 at para 8.

[23] (1993) 179 CLR 15.

[24] Gower, LCB, 'Notes of Cases' (1950) 13 *Modern Law Review* 362 at 367.

[25] Gower, LCB, Modern Company Law, 1st edition, Stevens & Sons London 1954 pp 63-64.

[26] Austin and Ramsay, *Ford's Principles of Corporations Law* 13th Edition paragraphs 20.160 and 24.360.

[27] It is noted that with the initial introduction of limited liability in England in 1855 there were initially minimum capital requirements necessitating a minimum of 20 shareholders each

(though admittedly these are generally only small proprietary companies)[28]; and (2) there is no guarantee that subscribed capital will remain – it can easily be reduced or eliminated in the course of trading.

In the High Court's decision in *Sons of Gwalia Ltd v Margaretic*[29] some doubt was cast upon the relevance of the doctrine of maintenance of capital in the modern era with Gleeson CJ noting.

> *Statutory manifestations of that principle have been modified over the years, and it may be doubted that it reflects the reality of modern commercial conditions, where assets and liabilities usually are more significant for creditors than paid-up capital.*[30]

Hayne J looked at the issue of maintenance of capital in relation to the associated issue of liability of the company to a transferee shareholder (someone who did not subscribe for the shares himself but obtained them from another shareholder) and noted in relation to the issue:

> *Maintenance of capital may be relevant to a shareholder's entitlement to recover from the company amounts that the shareholder subscribed as capital, but it has no direct relevance to the recovery from the company of damages for loss occasioned by the making of a contract to acquire existing shares in the company from a third party. It has no direct relevance to that second kind of case because the shareholder does not seek the return of what was subscribed as capital when the shares were allotted.*[31]

Gummow J[32] analysed the maintenance of capital issue from the perspective of the Gower view that paid up capital was a 'guarantee fund' for creditors. He found that there was much to be said for the view that a company satisfying its liability in tort to a member should not be characterised as attempting an unauthorised reduction of capital. He noted that Section 13 of the *Limited Liability Act 1855* (UK) had provided that a company should be wound up once three quarters of its subscribed capital stock had been lost but that after the 1862 *UK [Companies] Act* that there was no impediment to a company carrying on business even once it had exhausted its original capital through trading. The award of damages was not charged upon any fund representing capital and though large awards may adversely affect the market value of company shares they did not actually require any return of capital. Gummow J ultimately found[33] that the 'principle' of maintenance of capital attributed by the

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holding £10 shares paid up to at least 20 per cent. See Davies, Paul, *Gower's Principles of Modern Company Law,* Sixth Edition 1997, p 44.

28 Though as Anderson notes, even listed companies do not have minimum capitalisation requirements – Condition 8 to qualify for listing requires that entities satisfy either the Assets Test Rule in Listing Rule 1.3 or the Profit Test Rule in Listing Rule 1.3. looks at assets, an alternative to qualify for listing is the company's annual profit history (Listing Rule 1.2. See Anderson, Helen, *Corporate Directors' Liability to Creditors,* Thomson 2006 p 69. See also ASX Listing Rules.

29 (2007) 232 ALR 232; (2007) 81 ALJR 525.

30 At para 5.

31 At para 190.

32 At para 83.

33 At para 86.

majority in *Webb* to *Houldsworth*, as the first step in their reasoning, actually reflected an attempt to rationalise that case.[34]

It is noted that the maintenance of capital rule (as well as the need to avoid artificial inflation of the share price through self acquisition) has given rise to the general rules that the company should not buy back its own shares, distribute capital to its members or give financial assistance in connection with the acquisition of its shares.[35] The *Corporations Act*[36] makes explicit one of the purposes of the rules in stating that they are designed to protect the interests of both shareholders and creditors by, inter alia, addressing the risk of these transactions leading to the company's insolvency. The rules are however subject to exceptions where such self acquisition is allowed subject to the general requirement that creditors' interests are not prejudiced.[37] The latter requirement appears to be consonant with the principle that maintenance of share capital is about creditor protection.

The question is no doubt also tied up with the wider issue of solvency which is defined in Australia as being able to pay debts as and when they become due and payable. In the United States by contrast solvency is established by the balance sheet test meaning whether the fair value of the assets of the debtor as a going concern exceeds its liabilities including the cost of liquidation.[38]

In any event whether creditors have regard to assets and liabilities rather than paid up capital, it cannot be doubted that allowing shareholders equivalent priority to creditors will affect those assets and liabilities. In this sense the maintenance of capital argument may hint at an important issue while actually missing the point. A liability to shareholders as creditors will not actually diminish nominal paid up capital at all as the claimants' shares are unlikely to be cancelled when they receive their damages. It will however diminish the financial position of the company because it will increase a liability that might otherwise have been postponed. Thus though Gleeson J is correct in identifying assets and liabilities as the critical issue, it can be argued that recognising shareholders as creditors will in fact increase those liabilities and erode those assets. Put in another way, if the purpose of the maintenance of capital doctrine is to avoid prejudice to creditors, recognising shareholders as creditors will undoubtedly impact on that purpose. It is axiomatic that admitting such shareholders as creditors will reduce the pool available to existing unsecured creditors. This will occur whether the maintenance of capital doctrine is flawed or not.

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[34] Austin and Ramsay comment that His Honour appears to be criticising a 'misformulation of the law of maintenance of capital' in the 'capital fund principle' rather than criticising the orthodox principle of maintenance of capital. The 'orthodox principle of maintenance of capital' is said by them to be a law preventing the return of capital to the shareholders who originally subscribed that capital, rather than a law seeking to preserve the notional fund of paid-up capital, for the protection of creditors, from any diminution other than by trading activity (thus claims by shareholders who have purchased from a third party rather than subscribed do not offend the orthodox maintenance of capital principle though they do offend the capital fund principle). Elsewhere however the authors are also critical of the orthodox maintenance of capital principle. See Austin and Ramsay above n 26 paras 20.160, 24.360 and 24.505.

[35] s 259A of the *Corporations Act (Cth) 2001.*

[36] s 256A(a) *Corporations Act (Cth) 2001.*

[37] ss 256B, 257A and 260A(1) of the *Corporations Act (Cth) 2001.*

[38] Purcell, John 'The Contrasting Approach of Law and Accounting to the Defining of Solvency and Associated Directors' Declarations' (2002) 10 *Insolvency Law Journal* 192, 195. See *Bankruptcy Code*, 11 USC § 101(32) (2000).

The other side of the argument of course starts with the prima facie claims in tort or statute of creditors who also happen to be shareholders. On this view their claims as creditors should not be seen as diluting the pool available to other creditors unless their position as shareholders substantively affects their standing as creditors. Further, in many cases the company will be insured against such claims (eg through a professional indemnity policy that covers misleading or negligent advice) and in that situation creditors will not be adversely affected by the equal priority given to such claims by *Sons of Gwalia*. The legal theoretical justification for the subordination of such claims – maintenance of capital – will then not apply as the claims will not be met from shareholder capital but from a separate fund (insurance). What this means in practice of course is that payment of these claims will not adversely impact upon unsecured creditors.

This raises the question of whether there should be a different rule according to whether a company has insurance or not. This is likely to be a highly problematic proposition and opens up numerous questions. In litigation companies are typically not obliged to disclose to a plaintiff whether they are insured or not as this is generally not a question raised by the pleadings. A requirement of such disclosure may therefore be controversial.

3.2 Issues in establishing an aggrieved investor claim

Law Council – Insolvency Committee (minority)

The High Court in *Sons of Gwalia* struck the right balance between the rights of shareholders and creditors. Allowing shareholder claims will not open the floodgates as shareholders must still satisfy a causation threshold: they must prove that their loss arose out of either the market being misinformed, or any misrepresentation made to them.

Law Council – Insolvency Committee (majority)

The obligation to act judicially in the determination of such claims means that the practitioner must assess the circumstances of each individual (according natural justice to the claimant where necessary).[39] In claims for misleading and deceptive conduct such as those the subject of *Sons of Gwalia*, the shareholder must convince the liquidator or administrator that relevant conduct occurred; that the conduct caused some loss (usually loss connected with the purchase or sale of securities at prices affected by that misconduct); and of the quantum of loss suffered. The nature of such claims means that each shareholder will invariably rely on different circumstances. The shareholders' task is not necessarily an easy one: the decision of Gzell J in *Johnston v McGrath*[40] provides an example of a shareholder who was unable to prove the necessary causation. Those difficulties offer no comfort for the practitioner who must create, administer and execute a regime which accords the appropriate level of analysis and determination to each individual claim. It is not unforeseeable that the cost of adjudication may in some cases exceed the value of the claim itself.[41] Absent

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39 *Brodyn Pty Ltd v Dasein Constructions Pty Ltd* [2004] NSWSC 1230, [28].

40 *Johnston v McGrath* [2005] NSWSC 1183, 24 ACLC 140.

41 More than 75% of the shareholders' claims made in the Sons of Gwalia deed administration are for amounts of $20,000 or less. Almost 30% of the claims are for $5,000 or less: Ferrier Hodgson, *Deed Administrators' Report: Sons of Gwalia and Certain of Its Subsidiaries*, 14 June 2007, 26.

some ‘fraud on the market’ mechanism, it might be difficult to determine claims on a group basis, as matters of causation and reliance will differ in every case. Even if a fraud on the market rule were in place, breaks in the chain of causation might emerge from the facts of an individual case, requiring the issue of causation to be considered by the liquidator or administrator. With those difficulties in mind, the prediction that the *Sons of Gwalia* ruling might cause a year’s delay in making a distribution to creditors in the Ion Group administration[42] seems optimistic.[43] It seems likely that alternative compromise-based solutions to resolving high volume, low-quantum claims (such as that now proposed by the Sons of Gwalia deed administrators[44]) will become prevalent pending any legislative intervention.

ABA

The Harmer Report identifies a range of objectives and principles that should underpin a modern insolvency law. These include the following:

> *An insolvency law should provide mechanisms that enable both a debtor and a creditor to participate with the least possible delay and expense.*
>
> *Insolvency administration should be … efficient and expeditious.*[45]

Moreover, a key objective of the voluntary administration regime set out in Part 5.3A of the Corporations Act is the rehabilitation of a company: s 435A(a) of the Corporations Act.

From a practical perspective, permitting aggrieved investor claims to participate pari passu with general creditors will have a substantial adverse impact on each of the above mentioned objectives of insolvency law. This is so by reason of the inherent nature of aggrieved investor claims. Such claims are invariably complex. Moreover, in addition to all of the other factual and legal elements necessary in order to establish liability, each investor must of necessity demonstrate that they relied on the relevant act or omission that gave rise to their cause of action. The fact that this reliance is personal to them, means that individual attention must be given to the circumstances of each investor. Moreover, experience suggests that scrutiny of the investor’s alleged reliance frequently leads to the conclusion that the investor was, in fact, motivated by other considerations and factors. That being the case, any administrator or liquidator would be duty bound to scrutinise, and if appropriate, forensically test, each investor’s claim to have relied on the relevant act or omission in purchasing the relevant shares.

Accordingly, by reason of the above matters, the existence of aggrieved investor claims in an insolvency administration will produce the following adverse consequences for the due administration of the estate:

- *Cost* - the cost associated with addressing each such claim will, in total, be very substantial, particularly as the ‘reliance’ of each investor will need to be scrutinised and, where appropriate, forensically tested. In consequence, the

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[42] Sexton, ‘Gwalia ruling could set Ion payout back a year’, *The Age*, 2 February 2007.

[43] See generally McGrath + Nicol, *Ion DOCA Group Deed Administrators’ Update*, 20 September 2007, 2.

[44] Ferrier Hodgson, *Deed Administrators’ Report: Sons of Gwalia and Certain of Its Subsidiaries*, 14 June 2007, 26-27.

[45] Harmer Report, para 33.

assets of the company otherwise available for distribution to creditors will be substantially depleted.

- *Delay and increased complexity in administration* - addressing all of the aggrieved shareholder claims will take considerable time, both by reason of the complexity of such claims and the volume of them. As reliance and other issues will need to be addressed on a claim by claim basis, there is the risk of inconsistent results, and of appeals from the insolvency practitioner's adjudication. Appeals may take years to run through the various appeal courts in our court system. For these reasons, any distribution to creditors would, as a matter of practical necessity, need to await finalisation of this process. This may well delay a distribution for many years and will make the administration process far more complex and accordingly this will lead to a result that goes against the principles which the voluntary administration process is based on. Voluntary Administration is intended to be a short term process designed to facilitate either some form of rescue or restructure where possible or liquidation.
- *Rehabilitation* - a major goal of insolvency law is rehabilitation of the business enterprise. This goal is particularly evident in the voluntary administration regime in Part 5.3A. As is readily evident from the short time periods set out in the voluntary administration process, speed is essential in rehabilitating a company. Delay increases the prospect of corporate 'death' rather than rehabilitation. The complexities associated with permitting aggrieved investor claims to participate pari passu with general creditors will substantially diminish the prospect of achieving a rehabilitation through voluntary administration. They would affect the rehabilitation process in at least three ways:
  - a voluntary administrator would need to decide whether to let shareholders with aggrieved investor claims vote or not at creditor meetings and if they are to vote, to calculate the amount of the claim that the vote represents. The voluntary administrator must do so on a very limited understanding of the circumstances of their claim (as, generally speaking, the administrator will have been a stranger to the circumstances of the company until a matter of days or weeks before the creditor meeting). Given the potential magnitude of their claims, permitting them to vote would often enable that class of creditor to decide the outcome of the administration, including any rehabilitation proposal. They will have this power notwithstanding that they may ultimately turn out not to have valid claims;
  - the uncertainty as to whether such claims exist presents a further practical impediment to a restructuring of the enterprise. Within the short window of opportunity that may exist to restructure the company, it is most unlikely that the validity or otherwise of such claims would be determined. Estimation of return to creditors arising out of rehabilitation would therefore be highly problematical particularly where investor claims are potentially large, and this would eliminate the prospect for informed decisions to be made by creditors - they would not be able to compare rehabilitation alternatives by reference to likely returns to creditors. Rehabilitation options would therefore be narrowed, and options for rehabilitation that would otherwise be available might be lost;

- the significance of decisions made during the voluntary administration process, combined with the uncertainty regarding the validity of aggrieved investor claims, provides a recipe for disputation and litigation. Not only would this dilute the resources otherwise available to the company and its creditors, it will provide at the very least a distraction diverting attention and resources away from the object of achieving a prompt and efficient rehabilitation of the corporate enterprise.

Further, if aggrieved shareholder claims rank pari passu with the claims of unsecured creditors, that will make it far more difficult for a company which is experiencing financial distress and which is trying to avoid going into an insolvency administration, to successfully negotiate a financial restructuring with its creditors. Often such a restructuring needs to be done with urgency, but it necessarily requires all significant creditors to be in agreement. The approach creditors generally take in this context is to assume that creditors have the same rights and are in the same position as if the company was in liquidation. Negotiating solvent financial restructuring of a company to avoid it going into administration or liquidation is always difficult, particularly given the need to get all creditors to reach agreement. It will be almost impossible in circumstances where there exists aggrieved shareholder claims which rank equally with the claims of unsecured creditors.

IMF

Remove Consideration of Each Shareholder's Circumstances

If it is concluded that there were market protection breaches in a specified period prior to the commencement of external control, either personally by the external controller or through a test case, then:

- it can be determined who may be Shareholder Creditors by determining who purchased shares in the relevant period; and
- the next question to be answered is whether each or all of these Shareholder Creditors suffered loss by the breaches.

Section 3.2.3 of the Discussion Paper states that 'to succeed in litigation based on a corporate misrepresentation, a plaintiff shareholder must prove that the plaintiff relied on the misrepresentation or another relevant person relied on the misrepresentation'. IMF submits, with respect, that this assumption is incorrect.

It is debatable as to whether proof of reliance on misleading statements or omissions is necessary in order to prove causally connected loss and thereby have each proof admitted. This will be a key determination in the (currently reserved) decision of Justice Stone in *Dorajay Pty Ltd v Aristocrat Leisure Ltd*.

The question of what causal link must be established between contravention and loss is to be assessed by reference to the discernable purpose of the particular statute that has been contravened.[46]

The market protection laws contain no express limitation on the kinds of loss that may be recovered. Nor do they indicate what losses will be considered too removed to be recoverable. The test for causation under the misleading conduct provisions is whether any shareholder suffered loss and damage 'by' conduct of the company. For contraventions of the continuous disclosure provisions, compensation may be ordered

46 *I&L Securities v HTW Valuers* (2002) 210 CLR 109 at [26] per Gleeson CJ.

in respect of damage which 'resulted from' the contravention. Accordingly, reliance is clearly not expressly a requirement of the provisions.

Considering causally connected loss in the context of the *Trade Practices Act*, Lockhart J said in *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*,[47] in a passage quoted with approval by Gummow J in *Marks v GIO Australia Holdings Ltd*:[48]

> *What emerges from an analysis of the cases (and there are many of them) is that they do not impose some general requirement that damage [under s 82 of the TPA] can be recovered only where the applicant himself relies upon the conduct of the respondent constituting the contravention of the relevant provision.*

In *Smith v Moss*,[49] the New South Wales Court of Appeal rejected the need for there to be specific evidence of a plaintiff's reliance on misrepresentations in the plaintiff's decision-making process for causation when it observed:[50]

> *First, the essential question is causation. There may be causation from misleading or deceptive conduct if the conduct lies in failing to disclose that which in the circumstances should have been disclosed. It is not a natural use of the notion of reliance to say that there was reliance on the failure in disclosure, but causation can be found if disclosure would have caused inaction or action other than that which was taken... Secondly and more fundamentally, specific evidence of reliance is not essential for proof of causation. Such evidence may be one strand, perhaps an important one, in the factual skein, but causation may be found without it. So Wilson J said in Gould v Vaggelas (1985) 157 CLR 215 at 238.*

Similarly, while reliance may be an important component of the factual inquiry as to whether causation exists, reliance is not an element or sine qua non of the statutory cause of action relied upon by shareholders in an action for breach of the continuous disclosure laws. There are also obvious logical difficulties in relying on an 'omission'; if you are alleging that certain material information was not disclosed, on what did you rely?

IMF submits that necessary proof of causation ought to be limited to proving the shareholder:

- acquired shares in the company during a period in which the company was in breach of its legal obligations; and
- would not have purchased the shares at the price the purchase was made if the shareholder had known the true circumstances.

Inferred reliance has already been recognised in decisions considering the application of the *Trade Practices Act*. For example, where a representation is likely to induce the representee to enter into a contract and the person actually enters the contract, the Court may infer reliance.[51]

This would remove the need to gather and provide evidence of detrimental reliance by each and every shareholder upon each and every particular representation.

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47 (1992) 37 FCR 526 at 529-530.
48 (1998) 196 CLR 494 at [101].
49 [2006] NSWCA 37.
50 at [25].
51 *Gould v Vaggelas* (1985) 157 CLR 215.

Law Council - Corporations Committee

In section 3.2 of the Discussion Paper, reference is made to the roles of principles of causation and reliance in the context of civil securities law actions under Australian law. In section 9 of the Discussion Paper reference is made to the possibility of the introduction of a fraud on the market rule for civil recovery in the Australian securities law context.

The Corporations Committee is strongly of the view that it is inappropriate to consider possible changes to Australian law in relation to these matters in the context of consideration of the *Sons of Gwalia* issue. In the Corporations Committee's view such a proposal is outside the reference to the Advisory Committee described in section 1.4 of the Discussion Paper.

Changes to the requirements of reliance and causation and, in particular, the introduction of a fraud on the market rule would have profound implications to the Australian securities laws that are much broader than the issues surrounding *Sons of Gwalia*. The Corporations Committee strongly submits that if the Advisory Committee wishes to enter into an analysis of these issues a much broader range of considerations need to be considered than those that are set out in the Discussion Paper.

Harris & Hargovan

Appendix 2[52]

As a result, without law reform addressing procedural issues, *Sons of Gwalia* is therefore likely to hinder the ability of external administrators to process claims against the company efficiently, with such delays increasing the overall expense of the administration. Even in the absence of future reform of s 563A (as to which see below), it is submitted that the impact of *Sons of Gwalia* requires a better framework for dealing with mass contingent claims in insolvency. The present law, which requires proof of causation and damage, is ill-suited to the task of efficiently managing thousands of contingent claims that have not been confirmed by a court judgment. Under current law and practice, generally fixated on the need to prove causation in mass securities litigation,[53] liquidators and administrators will have to assess each shareholder claim individually, adding to the length and cost of external administration.

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[52] Hargovan and Harris, '*Sons of Gwalia* and statutory debt subordination: An appraisal of the North American experience' (2007) 20 *Australian Journal of Corporate Law* 265 at 276. See also Appendix 3: Hargovan and Harris, 'The Shifting Balance of Shareholders Interests in Insolvency: Evolution or Revolution?' (2007) 31(2) *Melbourne University Law Review* at 20.

[53] In contrast with the Australian position, shareholders in the United States benefit from the 'fraud on the market' theory of presumed reliance. The US Supreme Court in *Basic Inc v Levinson* 485 US 224 at 232 (1988) accepted and explained the 'fraud on the market' theory in the following way:

> *[i]t is based on the hypothesis that, in an open and developed securities market, the price of the company's stock is determined by the available material information regarding the company and its business…Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements…The causal connection between the defendant's fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentation.*

Judicial acceptance of the theory was based on fairness, public policy, as well as judicial economy resulting from a rebuttable presumption of reliance.

4 Implications for external administration

The submissions in this chapter are summarised in Section 3.2.3 of the report.

4.1 General

KordaMentha

It is expected that the *Sons of Gwalia* decision will lead to increased costs of adjudication of aggrieved investor claims together with the increased prospect of litigation and resulting delays in the deed administrator's or liquidator's ability to issue dividends to unsecured creditors.

The purpose of the second meeting, which generally must occur within 28 days of appointment of the voluntary administrator, is for the creditors to decide on the company's future. It is highly unlikely that an administrator will be in a position to provide details of potential shareholder actions within 28 days. Consequently, creditors at the second meeting will be forced to make an uninformed decision. It may also be uncertain who will be admitted to vote as a creditor at the meeting and for how much in light of an aggrieved investor's claim not being clearly admissible without the administrator's further investigation.

Additionally, administrations may now become subject to significant delays and cost increases as claims by shareholder litigants are likely to take months or years to adjudicate and resolve. The likelihood of court involvement in the adjudication process will rise as a consequence of the *Sons of Gwalia* decision, adding further cost.

The complexities of proving such a case will not only act as an obstacle to successful shareholder claims, but may also significantly increase the length of the insolvency administration.

ABA

In paragraph 4.1, the CAMAC paper notes that 'many of the difficulties that administrators and liquidators may encounter in dealing with aggrieved investor claims may also arise with claims by conventional unsecured creditors'. Whilst it is true that there are some similarities, it is important to emphasise one critical difference between aggrieved investor claims and ordinary creditor claims that arise in the context of a DOCA or liquidation. The principal distinction is that the inherent nature of aggrieved investor claims for listed companies will likely involve a very large class of claimants, and those claims will need to be individually assessed. It is this characteristic which creates many of the practical difficulties of the *Sons of Gwalia* decision.

An example of the cost and delay to an insolvent estate from aggrieved investor claims, although in a slightly different context, can be found in the liquidation of the Barings Bank group of companies in England in the 1990s. The relevant facts were as follows:

- There were two main groups of creditors, one of them unsecured notes, and the other perpetual subordinated notes.[54]

[54] The 1986 Noteholders were owed US$150m and the Perpetual Noteholders GBP100m.

- A substantial class of the subordinated notes brought proceedings under the *Financial Services Act* in England alleging loss suffered as a result of alleged untrue or misleading statements in the listing particulars for the subordinated notes (i.e. aggrieved investor claimants).
- If the claim of the subordinated noteholders was successful they would rank pari passu with the unsecured noteholders. If those claims were unsuccessful, the subordinated noteholders would be paid only after the unsecured noteholders had received their payment in full, which was an unlikely outcome given the anticipated recoveries in the estate.
- The litigation claim commenced by the subordinated noteholders raised many complex issues and would have led to a very expensive and difficult trial, an expense which was likely to be further compounded by appeals. Although it was generally considered that the action would not be successful, it was considered it would have survived a strike out motion.
- Although the issues in this Barings estate were complex, the claim commenced by the supposedly subordinated noteholders gave them substantial leverage and resulted in very significant delays and cost for the finalisation of the Barings estate.[55]

Clearly, there are some parallels in this example to the situation of shareholders in Australia post the *Sons of Gwalia* decision.[56] It demonstrates the consequences of litigation by investors who are otherwise ‘out of the money’ bringing complex and difficult aggrieved investor claims in order to participate in the assets of the insolvent estate.

Law Council – Insolvency Committee

As to the conduct of insolvency administrations, there is no difference between shareholder claims for misleading conduct and other claims that an insolvency practitioner must adjudicate which arise out of similar causes of action, particularly where they involve consumer claims eg class actions.

It is open to an administrator or liquidator to seek directions from the Court as to an appropriate date after which it could reasonably be said the market has not been fully informed and to rely upon shareholders to submit sufficient proof that a genuine claim exists.

4.2 Conduct of a voluntary administration

Baker & McKenzie

The statutory timeframes for convening and conducting the first and second meetings of creditors of companies in voluntary administration pursuant to Part 5.3A of the Corporations Act are tight, and effectively add up to a period of 4 to 5 weeks

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[55] The estate took around 10 years to finalise and in excess of GBP100m in professional fees. Although the majority of these costs were directed towards pursuing an auditors negligence claims (which was the principle asset in the estate), there is little doubt that the ability of the subordinated noteholders through litigation to potentially ‘unsubordinate’ themselves had a profound effect upon the estate.

[56] It is also interesting to note, as discussed below, that the effect of the s 510(b) of the US Bankruptcy Code would have been to prevent the subordinated noteholders in this instance from ‘unsubordinating’ themselves through litigation alleging that they were misled.

(assuming that extensions of convening periods or adjournments of meetings are not obtained).

An administrator has many tasks to complete during that time. Those include taking control of the company and its assets, assessing the business of the company, ascertaining the identities of the company's creditors, meeting with management to consider work-out options, communicating with creditors and so forth.

Dealing with claims by aggrieved shareholders, which might include Court applications for leave to proceed against the company and then for rescission of share subscription agreements, will be another task for administrators to conduct during the tight statutory timeframe. The completion of this task will be further complicated by the likely increase in the number of such claims as shareholders will be incentivized by the *Sons of Gwalia* decision to lodge a proof of debt as contingent creditors. Critically, dealing with such claims by aggrieved shareholders will not assist in the attainment of the central object of Part 5.3A of the Corporations Act, being resuscitation of the insolvent company.

Through placing shareholders in a position to prove in voluntary administrations, a new class of creditors is created. That class of creditors will have interests peculiar to their shareholding in the company, and that are likely to diverge from the interests of unsecured creditors.

In particular, execution of a deed of company arrangement will invariably promote aggrieved shareholders' interests, as it provides an avenue for future realisation of their equity in the company. Often, however, winding up promotes the interests of unsecured creditors, as it allows a liquidator to explore recovery proceedings that are not otherwise available to the company.

It is possible that significant further investigations will need to be conducted by an administrator as to the merits of aggrieved shareholder claims. This is because that information may be relevant to the shareholder creditors' decisions in relation to the future of the company. Plainly, the conduct of those further investigations is another complex task that will take away from the central object of Part 5.3A of the Corporations Act, and that will increase the costs of the administration.

Nehme and Wee

In the case of Voluntary Administration

Allowing aggrieved investors to be involved in the process of voluntary administration may cause problems such as:

- *Adding a burden on the administrator*: The administrator already has to investigate the situation of the company, write a report with recommendation to the creditors on the viability of the company and manage the company. Additionally, he/she has to assess which creditors' claims to accept and now, due to the *Sons of Gwalia* decision, the administrator need to be aware of which members claim should acceptable. This high demand may be unreasonable.
- Voluntary administration can achieve very fast outcome. In a short period of time, the fate of the company could be decided (for example winding up, deed of arrangement or end of administration). However, the fact that an administrator has to additionally assess the claims of members and their value

may prolong the period of voluntary administration. Such an outcome is not desired.

- One of the advantages of voluntary administration is that it does not involve court proceedings. However, if a claim of a member is rejected by the administrator, the member can take his claim to court to force the administrator to allow his/her involvement. This may make the process of voluntary administration more expensive and more complex. The process may also become subject to a number of litigations.
- Additionally if certain secured creditors are not happy that the voluntary administration resulted in a deed of arrangement that favoured members' claims, they may refuse to follow the deed of arrangement (if they voted against the deed of arrangement). Creditors may even attempt to challenge the deed of arrangement in court. This will cause a number of problems.
- Due to the involvement of the members in the process of voluntary administration, a chargee with a charge over the whole or substantially whole of a company property would think twice before putting the company under voluntary administration.

In the case of Scheme of arrangement

This discussion paper does not take into consideration creditors' scheme of arrangements and the involvement of aggrieved investors' claims in such circumstances. Allowing aggrieved investors' claims in a scheme of arrangement and allowing these members to vote in creditors meeting may make an already complex process even more complicated.

Conclusion: We strongly believe that aggrieved investors' claims should not be taken into consideration in the voluntary administration process.

4.2.1 Information to creditors

AFMA

The Committee identifies that, pursuant to sections 439A(3) and (4)(b) of the Corporations Act 2001, administrators must, within a 28 day period, convene the major meeting of creditors and send to 'as many of the company's creditors as reasonably possible' a statement setting out the administrator's opinion about whether it would be in the interests for the company to execute a deed of company arrangement (DOCA), come out of the administration or be wound up.

Further, as the Committee correctly identifies, the administrator must estimate 'the returns to creditors in a liquidation as against returns under any proposed DOCA'.

The Committee identifies that, in cases involving aggrieved shareholder claims, this imposes an additional obligation on and creates considerable difficulties for, administrators to prepare such a statement in sufficient detail within that timeframe with the result that this would be more likely to give rise to circumstances where meetings are conducted with incomplete information.

AFMA submits that this is a highly likely and undesirable outcome.

IPA

The discussion paper at 4.2.1 examines the issues involved in conducting a voluntary administration leading up to a decision by the creditors at the second meeting.

As the paper says, there are limited time frames within which to convene the meetings and prepare the s 439A report.[57] We agree that the problem of incomplete information at the meeting can arise in a voluntary administration where there are no aggrieved investor claims. In part, this is contemplated by the Part 5.3A regime in imposing a tight deadline on investigations and recommendations to creditors.

However, we suggest that the extent of incomplete information rises to another level as a result of aggrieved investor claims because they have the potential to be large in number and with a high dollar value in total. The validity and quantum of such claims is unlikely to be known, or even able to be estimated, at the stage of preparation of the section 439A report for the second meeting of creditors. This is important not only for the processes of convening the meeting and notifying creditors, but also for the administrator's consideration of the opinion that must be given of the various options open to creditors.

This has the potential to cause the meeting to be adjourned or extension of times sought in order to be able to properly evaluate such claims. While that in itself is contemplated by the Part 5.3A regime, we consider that in most or all cases where there are aggrieved investor claims, longer time periods will be required.

Nehme and Wee

Allowing aggrieved investors to be involved in the process of voluntary administration may cause problems such as:

- *Notice to creditors*: The administrator needs to send a written notice to creditors in relation to the first creditors meeting. However, if certain members are entitled for a claim, than the problem that may arise is that they should be treated as creditors and as a result should receive a written notice. How would the administrator know about these claims and how could he/she assess the worth of these claims?

4.2.2 Voting at the creditors' meetings

CSA

The potential to diminish existing creditors' rights

CSA notes that, until the High Court decision in *Sons of Gwalia*, creditors expected to have priority over shareholders in having access to the company's equity base. By ranking aggrieved investors equally with general creditors, this priority is no longer assured, which diminishes creditors' expectations and rights as they have long been supported by both statute and the common law. CSA is opposed to such a diminishing of creditors' rights.

Moreover, creditors have the choice to vote on whether a company should end the administration and resume trading (with the intent of trading out of difficulties), enter into a deed of company arrangement (DOCA) or be wound up; that is, they have the

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[57] The time frames referred to in the discussion paper have been extended under the *Corporations Amendment (Insolvency) Act 2007*.

right to vote on any proposed reorganisation of the company. As the discussion paper notes on page 39:

> *Voting by creditors in a voluntary administration on this, and other, matters is by number and value (though administrators have a casting vote where the voting outcomes by number and value differ).*

If aggrieved investors, as defined by the discussion paper, have the right to vote at a creditors' meeting, the weight of their numbers rather than the value of their (unsubstantiated) claims could decisively influence the voting, and in turn the administration outcomes. This provides aggrieved investors with an unwarranted influence in decisions affecting conventional unsecured creditors, which further diminishes creditors' rights.

CSA is opposed to the potential for investors with claims that have yet to be determined having the same rights as creditors in insolvency proceedings, particularly as their claims may never be substantiated.

AFMA

The increased and unjustified influence of aggrieved shareholders in circumstances where a claim cannot ultimately be established is a detrimental and undesirable outcome. In such circumstances, the Committee correctly identifies that allegedly aggrieved shareholders who may influence administrations or liquidations in this way will prejudice the rights of creditors with valid entitlements to the remaining capital available.

AFMA submits that this is a highly likely and undesirable outcome.

The Committee also raises the possibility of aggrieved shareholders having a loyalty to the company or wishing to revive it. However, AFMA submits that this would be highly unlikely in circumstances where litigation funders are involved since the imperative would be recovery of funds rather than a return to corporate health. This is because litigation funders are empowered to control litigation on behalf of aggrieved shareholders.

ABA

In relation to paragraph 4.2.2, CAMAC's attention is drawn to the Sons of Gwalia administration where the voting by the aggrieved investor claimants in that instance apparently influenced the outcome of a proposal to sell certain assets of the company. As we understand, this occurred in circumstances where a majority in value of creditors voted against the sale proposal. It is recommended that CAMAC consult with the administrators of Sons of Gwalia in this regard.

IMF

The Effect on Creditor Voting Argument

Arguments have also been raised that Shareholder Creditors, who will be entitled to vote at creditors' meetings, will seek to liquidate a company in situations where traditional creditors may want the company to be preserved.[58] The Discussion Paper addresses this and other arguments relating to the conduct of voluntary

[58] See Zwier L, 'Investors get more rights, but High Court decision is wrong', *The Age*, 5 February 2007.

administrations in section 4.2. In addition to presuming that Shareholder Creditors should have a lesser vote for unstated policy reasons, the argument also presumes that Shareholder Creditors will be admitted to vote at the full value of their claim under the current regime.

If a vote is required and if a claim cannot be quantified by a just estimate (which will be the case for Shareholder Creditor claims), but it is clear that the Shareholder Creditor is a creditor for at least some amount, then it is appropriate to admit the creditor for voting purposes at a nominal value of $1.00.[59]

IPA

Possible increased influence

The discussion paper refers to the fact that aggrieved investors may be more concerned to 'cut their losses' by voting at the second meeting to liquidate the company and taking a tax write-off, rather than supporting a reconstruction plan (4.2.2 of the discussion paper). We draw the Committee's attention to the fact that 'administrators' (being administrators and deed administrators under Part 5.3A of the Corporations Act) also have the power to declare shares worthless for taxation purposes.[60] Hence, in that respect, the taxation considerations may be neutral in terms of the voting considerations of aggrieved investors or at least, depending on the circumstances of the deed, there is potential for this issue to be neutral in aggrieved investors' considerations.

Notwithstanding this power afforded to administrators to declare shares worthless, aggrieved investors can often have significant and separate influence from ordinary creditors in an administration. As the discussion paper says, this can be related to their volume in number, if not in individual amount, as is the case in the Sons of Gwalia administration. Therefore it is evident that aggrieved investors, by number, will be able to influence voting, though in the instance of Sons of Gwalia it is tempered by the balance of power on the value of debt side being held by ordinary creditors.

Nehme and Wee

Allowing aggrieved investors to be involved in the process of voluntary administration may cause problems such as:

- Claim assessment: Due to the short period during which the voluntary administration takes place, the administrator may be tempted to accept all the members' claims. In the Sons of Gwalia, the members who had claims were allowed to vote in the process of voluntary administration even though the alleged fraud has not been proven nor has reliance been established. Accordingly, a number of these claims may not be successful in a court action and as a result the members would not be creditors. However, they are allowed to vote. Furthermore, the administrator allowed the members' claims to be voted to the full amount alleged by the shareholders, even in cases of 'lost opportunities'.
- If members are allowed to vote in process of voluntary administration should they have equal votes with other creditors? For fairness reason, since they are

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[59] See *Re Oriel Homes Pty Ltd* (1997) 15 ACLC 564 at 566.

[60] This applies form 21 March 2005 under section 104-145 of the *Income Tax Assessment Act* 1997, in respect of a 'CGT event G3'.

creditors, they should have the same rights as the other creditors. However, this by itself may be unfair to the rest of the creditors because such a system would allow the claims of the members to be voted at the full amount alleged by the shareholders, even though certain claims were uncertain (see above, *Sons of Gwalia* claims). Shareholders' claims in the *Sons of Gwalia* case were deemed for voting purposes to hold $250 million of the $1.1 billion of claims eligible to vote. The administrator's proposal was supported by the individual investors (most of the investors with claims were individual investors and not institutions) while the creditors were opposed to it (especially US creditors who held approximately $300 million of undisputed claims). $600 million of claims were voted against the administrator's proposal while on $320 million were voted in favour of it (Most of the people in favour of it were the individual investors). However, there was a deadlock between the majority in number and the majority in value because a poll was used. This led the administrator to cast a vote in favour of the proposal and sided with the investors. This case shows the influence that investors may have on the process of voluntary administration: If the creditors (without the shareholders involvement) votes were counted by themselves in the case of the *Sons of Gwalia*, the outcome of the voluntary administration would have been very different. Furthermore, allowing shareholders' claim may lead to the manipulation of voting in insolvency proceedings by 'insiders'.

4.3 Implementing a DOCA and conducting a liquidation

AFMA

The Committee identifies that the costs of administrations and liquidations may increase with greater complications consequent upon aggrieved shareholder claims, particularly in ascertaining the validity and quantum of aggrieved shareholder claims through the courts.

AFMA submits that this is a highly likely and undesirable outcome. The costs involved in such increased complications, inherent delays and attendant administrator or liquidator costs can only have one effect – reduction of the remaining capital of the company available for distribution to both aggrieved shareholders and unsecured creditors.

In the case of class actions brought on the basis of fraud on the market, while this may make it easier for aggrieved shareholders to bring class actions and, therefore have the potential to reduce costs in establishing claims, the question of quantum nevertheless remains, which also has the likely effect of increasing the frequency of such claims for the reasons already expressed.

Further, AFMA submits that the frequency of claims brought by aggrieved shareholders would increase in an attempt to recover losses ahead of ordinary shareholders for the reasons already referred to.

Finally, the Committee identifies that administrators and liquidators may choose to negotiate a settlement with aggrieved shareholders as they currently do with other creditors. In AFMA's view, based on Australian legal class action history, the prospect of negotiated settlements can only increase class actions brought by shareholders since such settlements encourage the availability of litigation funders to

become involved on the basis that it lowers the costs of conducting a class action by avoiding costly court proceedings.

KordaMentha

The Quantum of Potential Shareholders' Claims

The quantum of the shareholder's loss and damages in the High Court case of *Sons of Gwalia* was limited to the difference between the cost of the shares to the shareholder and the present value of those shares. This loss or measure of damages is referred to at clause 4.3 of the Paper however, this is not the full extent of the loss and damages that may be able to be claimed by shareholders in future cases, as the High Court did not place any limits on the measure of the loss and damages.

Thus the decision could result in substantial claims made by shareholders under the 'loss of opportunity' or 'loss of a chance' type of damages that are often brought in misleading and deceptive conduct and other Trade Practices proceedings. In order to establish these types of loss and damages a shareholder would need to establish that he had intended to enter into a contract to purchase the shares of another company but that he changed his intended course of action and invested instead in the insolvent company due to the false representations made by the latter (refer *The Law of Misleading or Deceptive Conduct* by Colin Lockhart, Butterworths 1998 at 11.13 under 'loss of opportunity'). The measure of damages in these instances is the 'lost profit' that the shareholder would have earned if he had invested in the first company.

If the first company was for example, BHP or Rio Tinto then the potential loss of profits to the aggrieved shareholder in the current market, being the price of the shares of these companies less the price of the shares of the insolvent company, would be substantial but would nevertheless be allowed as 'loss of opportunity'.

There is nothing in the *Sons of Gwalia* decision that prevents loss of opportunity claims by shareholders. The potential for the quantum of such claims to swamp the claims of unsecured creditors of insolvent companies is obvious.

KordaMentha is concerned that the Paper does not address this issue but rather, at clause 3.2.4, it appears to suggest that shareholders' claims would be limited to the measure of loss or damage experienced by Margaretic. KordaMentha believes this issue needs to further considered by CAMAC.

Baker & McKenzie

Deed of company arrangement

The exercise of adjudicating on proofs of debt received from aggrieved shareholders will undoubtedly be a time-consuming and costly exercise for any administrator of a deed of company arrangement. That task will delay attainment of the object of any deed of company arrangement, being return of the company to the control of its directors. As well, the professional time taken to conduct that task will reduce the funds available to satisfy the claims of ordinary unsecured creditors against the company.

It may also not be possible to deal with aggrieved shareholders' claims in a class. Companies often make numerous announcements to the market; individual shareholders will invariably have exposure to, and respond to, those announcements differently. Again, this will considerably increase the cost of adjudication of proofs of debt submitted by aggrieved shareholders.

Liquidation

Similar difficulties with adjudication on proofs of debt will be encountered by liquidators.

IMF

Cost and Delay Argument

In the aftermath of the *Sons of Gwalia* decision, a number of valid concerns have been raised about possible delays and increased costs to external administrations. A number of these concerns are noted in section 4.3 of the Discussion Paper.

Writing in *The Age* in February 2007, Mark Korda says it is difficult to prove the causal relationship between the breach of the market protection regime and loss.[61]

Leon Zwier, also writing in *The Age* in February 2007, says that shareholder damages are complicated to calculate. A result of this he says is that the administrator or liquidator will not be able to determine the quantum of claims and advise creditors of likely returns in a timely manner.[62]

Both of these concerns are valid and warrant the close attention of the legislature. However, it would be wrong for the legislature to react by abolishing the rights of shareholders arising from the market protections or subordinate these rights so as to make the rights illusory. If we abolished legal rights that were costly and time consuming to enforce, we would be left with very few rights.

Some insolvency practitioners have been calling on the legislature or Courts to clarify principles and methodologies to enable claims to be determined quickly. For example, after the decision of Justice Emmett in the first *Sons of Gwalia* case, Tony McGrath told the AFR in September 2005:

> *I would hope there's a fairly straight-forward decision tree we can all follow so the creditors at large don't have to wait too long for their dividends.*[63]

The request for a straight-forward decision tree, and the valid concerns relating to time and delay, illustrate the necessity to consider policies that will make the rights of shareholders arising from the market protections easier to enforce.

Once it is recognised that the misled shareholder is a creditor (and there is no question that this is the case), there is no logical reason why that creditor should be treated in a different way to other creditors. Simply changing the priorities (by postponing the shareholder creditor's claim) does not relieve the external administrator of duties towards those postponed creditors.

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[61] Korda M, 'Gwalia ruling creates need for new legal category of aggrieved shareholder', *The Age*, 2 February 2007.

[62] Zwier L, 'Investors get more rights, but High Court decision is wrong', *The Age*, 5 February 2007.

[63] The Australian Financial Review; 21 September 2005.

4.4 Other matters

Harris & Hargovan

Appendix 1[64]

For the efficient administration of the insolvency regime

Disgruntled members may view the *Sons of Gwalia* decision as giving them the green light to be classed as creditors and to secure a vote in administrations and liquidations. Consequently, the decision has the potential to open the floodgates for members to make mass class action claims with the support of litigation funders. The resultant litigation to stake a claim as creditor has huge potential to increase delays and increase the costs of administration and liquidation of a company. This will especially be the case in mass member class actions where individual members, as contingent creditors, will have to prove their claims for non-disclosure or misleading and deceptive conduct and prove the amount of their damages. The inevitable disagreements that will arise between administrators/liquidators and members/contingent creditors will lead to further court applications (such as we have already seen in *Media World*), resulting in a further dilution of the pool of available assets. This increased administrative burden will be particularly felt in voluntary administrations, which are conducted in a much shorter timeframe than liquidations. This much seems certain: allowing members to prove as contingent creditors will only lead to protracted litigation, applications for directions and appeals, particularly if the current trend of institutionally funded member class actions continues.

However, bearing in mind that the *Sons of Gwalia* decision merely determined the status of the litigant and did not consider the merits of the claim, the position in the above scenario may not eventuate if, in practice, members find severe difficulties in proving causation of loss and reliance.

Although, any such difficulties point to greater problems for insolvency administrators, who will need to make preliminary assessments of each claim to determine the member's right to prove, which will lead to further delays and rising administrative costs.

[64] Harris & Hargovan, 'Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies' (2007) 25 *Company and Securities Law Journal* 7 at 21-22.

5 Broader implications

The submissions in this chapter are summarised in Section 3.2.4 of the report.

5.1 General

KordaMentha

International creditors have voiced their concern that the possible dilution of creditor claims by those of shareholders will discourage investment in Australia.

International creditors believe that Australian financial statements may no longer accurately represent a company's true financial position. Shareholder claims represent a significant 'off balance sheet' contingent liability. Those who make credit or lending decisions based on the company's financial information may find their claims being diluted by those of shareholders.

QBE

Increased cost or reduced availability of finance

As part of its capital management, QBE regularly raises funds overseas, including in the US, on an unsecured basis. An indirect effect of not reversing *Sons of Gwalia* is that foreign lenders may charge a higher margin than otherwise. This is even though legal documents in relation to the fund-raising may be subject to the law of an overseas jurisdiction.

CSA

The potential to create increased cost or reduced availability of finance for companies

Should the law stand following the High Court decision in *Sons of Gwalia*, CSA believes that the resulting ambiguity with regard to the traditionally accepted investor hierarchy of claims in the event of corporate collapse has the potential to adversely affect the market for corporate debt in Australia. Banks as lenders, trade creditors and institutional investors as buyers of corporate bonds are all potentially affected, and CSA believes that the ability of Australian companies to issue debt into international markets (in competition for funds with overseas companies where creditor rights are not subject to such dilution effects) will be adversely affected if the legal position in Australia is different from that in the United States.

Potential lenders to any Australian company will be confronted with higher risk on unsecured debts (a lower recovery rate in the case of company failure) than before. Consequently, CSA is of the opinion that interest rates charged on unsecured debt will increase to compensate for the increased risk.

CSA also believes that debt investors, both in Australia and overseas, may be unlikely to acquire some corporate bonds in Australia, as such an investment would heighten their exposure to risk. In particular, US debt investors will note that:

- shareholder claims can no longer be guaranteed to be postponed behind their claims as occurs in the United States, where all claims by shareholders relating to their shares, including as aggrieved investors, are subordinated to those of conventional unsecured creditors

- there is increased potential for speculative claims by aggrieved investors to give rise to class actions.

CSA is concerned that, by affecting the opportunities for Australian companies to obtain debt finance or credit in the United States, or have the cost of doing so significantly increase, the law thereby disadvantages Australian shareholders, as increased cost or reduced availability of finance would have implications for solvent companies, not only for those subject to external administration.

CSA opposes any law that reduces the opportunity for Australian shareholders and the companies in which they invest to compete with shareholders from other jurisdictions in relation to securing finance.

ABA

Taking security

As a consequence of the *Sons of Gwalia* decision, Australian banks are reviewing their requirements and risk assessment process for lending to public companies. The decision has created an enormous amount of uncertainty and concern. At the current time, banks are assessing how the possibility of aggrieved investor claims will impact on them in calculating provisioning required under Basel II where a bank has an impaired lending exposure to a public listed company. Clearly there will be an impact. At least one major bank has adopted changes to its lending policies following the *Sons of Gwalia* decision. Those changes include the possibility of taking security over the borrower where previously that would not have been sought and additional and more regular reporting by the borrower. Ironically, if the *Sons of Gwalia* decision leads to banks switching from unsecured lending to secured lending, trade creditors and other unsecured creditors will be the most disadvantaged by aggrieved investor claims.

Effect On Availability and Cost of Credit

At a time when Australia seeks to promote itself as a financial centre in the Asia/Pacific region, it is both unhelpful and counter-productive to add upward pressure on the pricing of credit to listed companies.

Pricing of risk

The pricing and availability of credit, and the terms on which it is provided, to public companies involves a risk assessment on the part of the credit provider. It is for this reason that the impact of the *Sons of Gwalia* decision is particularly problematical for the financing of public companies. The decision gives rise to the following issues:

- The risk of shareholder claims must now be regarded as an off balance sheet contingent liability;
- That potential liability is impossible to identify or measure, notwithstanding a financier’s due diligence;
- The impact of valid shareholder claims on the balance sheet (and, in consequence, the dividend ultimately paid to a financier as an unsecured creditor) could be very substantial;
- The emerging roles of litigation funding and class action litigation in Australia exacerbate the problem.

Consequences of additional risk

The *Sons of Gwalia* decision increases the risk associated with lending to publicly listed companies. As a consequence, the ABA expects both domestic and foreign lenders to manage the resultant increase in the risk in a number of ways:

- insist on security where possible (which is not always the case);
- increase in the price of debt;
- refusal to provide the credit (particularly from foreign lenders); and
- increased levels of monitoring of the companies' businesses.

A recent paper by Professor Kevin Davis and Associate Professor Christine Browne in which they applied credit risk modelling to estimate the magnitude of effect of the *Sons of Gwalia* decision concludes that the increased return which would be required by unsecured lenders would be significant for many companies. They conclude:

> The credit risk spread on unsecured debt for Australian companies could increase substantially. This would be particularly so for companies heavily reliant on unsecured debt, those with volatile share prices, and those with a relatively high share turnover.[65]

AFMA

Increased cost or reduced availability of finance

AFMA has been informed by our members that since 2002, Australia has become increasingly reliant on US corporate bond markets.

As the Committee correctly states, US corporate bond markets are accustomed under US law to all shareholders, whether aggrieved or not, being subordinated to secured and unsecured creditors.

There are already indications that it is more difficult to raise unsecured debt capital in overseas corporate bond markets as a result of reduced risk appetite following the earlier Full Federal Court decision in the *Sons of Gwalia*.

In response to inquiries made of our members, AFMA understands that between 10 and 15 percent of US corporate bond market investors have explicitly stated that they will not invest in any unsecured corporate debt as a direct consequence of the *Sons of Gwalia* decision.

AFMA members hold the view that the *Sons of Gwalia* case will continue to have negative effects on financial markets.

The consequence of this position taken by certain US corporate bond market investors is that this would likely result in a tightening of unsecured debt capital available in the market and, therefore, increase the cost of money available from remaining US corporate bond market investors.

The decrease in the availability of debt capital is relevant in Australian corporate bond issuances, both as volume and percentages, expressed as follows:

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65 Associate Professor Christine Brown, Department of Finance, University of Melbourne, and Professor Kevin Davis, Commonwealth Bank Chair of Finance and Director of the Melbourne Centre for Financial Studies, 2006: *Agenda*; Shareholders or Unsecured Creditors? Credit Markets and the Sons of Gwalia Judgement 13(3).

Issuance Corp v Other [Source: AFMA Financial Markets Members]

Year	Corp unsecured ($M)	Percentage Corp	Other Corp Debt ($M)	Total ($M)
2002	9,087	46%	10,550	19,637
2003	5,528	25%	16,172	21,700
2004	7,297	17%	34,766	42,063
2005	9.580	17%	46,102	55,682
2006	9,717	16%	52,005	61,722
2007	3,142	8%	38,070	41,212

While the figures are dependant on a range of economic factors and have been affected by the sub-prime lending crisis in the US, they also provide indicative evidence there has been a significant reduction in corporate bond issuance subsequent to the Full Federal Court decision in the *Sons of Gwalia* in 2006. The indications are that reduced corporate bond issuances reveal a tightening of the market and reduced limits of risk appetite which are consistent with the market's negative reaction to the decision.

It may be that a consequence of the decrease in the availability of money at reasonable levels flowing from the *Sons of Gwalia* decision would be to place Australia in an uncompetitive position in relation to other unconstrained markets where the law subordinates all shareholder claims after creditors. That would have serious implications for Australian markets and the economy overall.

Furthermore, AFMA notes that the decision can only have the effect of increasing the price of lending and increase credit margins to the detriment of borrowers and increase the prospect of cross guarantees by other subsidiaries within a corporate framework.

Finally, AFMA notes that at least one major financial ratings agency, Standard and Poor's, has reacted negatively to the *Sons of Gwalia* decision (Executive Comment '*Sons of Gwalia* Decision Undermines Clarity for Debt-holders and Wider Australian Debt Markets', 7 February 2007).

That Executive Comment provided that:

> *The development of Australia's financial and capital markets has historically benefited from a relatively clear set of laws governing insolvency and the rights of the two main providers of capital creditors and shareholders. The recent decision by the High Court of Australia in the* Sons of Gwalia *case, however, diminishes the clarity between the rights of debt and equity holders in the winding up of a company. In Standard & Poor's view, this landmark decision is a negative development for Australia's financial and capital markets. Australia's capital markets are among the world's most sophisticated and efficient. The liquidity, vibrancy, and sophistication of the Australian debt market reflect, among other things, a relatively clear distinction between the rights of creditors and shareholders.*

After inquiring of our members, AFMA is informed that there has been a corresponding 33% increase in the level of secured Australian debt in the US corporate bond market since the Full Federal Court decision in the *Sons of Gwalia* was handed down. This indicates a significant change in investment behaviour in favour of secured corporate debt.

Nehme and Wee

Is there any indication of Australian financial institutions changing their approach to providing corporate finance?

There is not yet any evidence indicating a change in approach by Australian financial institutions to providing corporate finance; however, it is highly possible that a change is likely to happen in the near future. Given the increase in lending risk due to lower recovery rate in the event of company failure due to the dilution of funds by shareholders, and the delay in recovering funds, local lenders (i.e. Australian financial institutions) would demand a higher rate of return, thereby increasing the credit spreads, to compensate for the extra risk they have to bear. It is also likely that local lenders are going to be more cautious when lending to speculative-grade companies on unsecured basis – by tightening trade credit requirements, hence increasing the difficulty for such companies to borrow. Whether Australian financial institutions are going to shy away from speculative-grade companies, or increase the credit spread, Australian market liquidity is going to be greatly impaired, and none of these likelihood is going to be beneficial to the Australian economy.

Are there discernible effects on the cost and availability to Australian companies of US or other overseas finance?

It is likely that in the near future, the cost and availability to Australian companies of US and other overseas finance are going to be negatively impacted.

Australian credit market had always been a liquid and efficient one, hence popular among foreign investors - largely thanks to its clear distinction between creditors and shareholders rights. However, there is a high likelihood that this is going to change if the High Court decision on *Sons of Gwalia* case is retained – resulting in aggrieved investor claims ranked equally with unsecured creditors. It would be a challenge for Australian companies to raise funds in overseas markets, for example in the US market. US debt investors might be unaccustomed and hence reluctant to provide debt-financing to Australian companies, since US domestic corporate law postpones all shareholder claims behind creditor claims.

The financial market has always been sensitive towards information – and information affects investors' confidence, in which investors react very quickly to. The High Court decision would lessen investors' (especially overseas debt financiers) confidence about their rights to recover debt. It is only logical to deduce that most overseas debt financiers to either increase the returns required to lend to Australian companies; less willing to lend insecurely to speculative-grade Australian companies; less willing to lend without extensive security; and increase the meticulousness when lending. All these extra care that potential investors have to take before completing a deal would have delayed the whole funding process, making the Australian market less liquid and less efficient than before. When overseas investors start to shy away from Australian credit market, all Australian companies can rely on is a relatively small pool of domestic financing in comparison to the global financial market. Common financial sense has taught us that imposition of restrictive financial and legal regulations would impede financial and economic development; and a less liquid financial market does not in anyway signify a good sign of economic vitality. Confusing and complicating the distinctions of claim rights between creditors and shareholders would inevitably send the wrong signal to overseas investors and would

have diminished commitment of Australian government towards a more liquid and efficient financial market, as implicated in the CLERP reform.

If the High Court decision on *Sons of Gwalia* continued to be applied, it would be more difficult for Australian companies to raise funds in the international market, having to compete with overseas companies (e.g. from U.S.) where there is no confusion between unsecured creditors' right and shareholders' right of claim in the event of company liquidation. Overseas investors, especially trade creditors, have more than one option of countries to invest their money in – and the obvious choice would be to invest in countries that can offer safe political, legal and liquid financial platform to maximize the returns. Australia fitted all these criteria before – it would be unwise to uproot a perfectly functioning system we had in regards to the clear distinction between creditors and shareholders' claim rights.

Moving away from intuition and common financial sense into quantitative evidence, we have looked at a paper written by Brown and Davis where they have used credit risk modelling (by using option pricing theory to derive the required credit spreads) to estimate the magnitude of the required increase of returns to compensate for the increase risk on unsecured debts if the company fails. Their research has found that the increased return which would be required by unsecured lenders is significant for many companies – mainly due to the dilution effect on unsecured creditor payoffs arising from the equal ranking of shareholder claims and unsecured creditor claims. That is to say, if shareholders were to rank equally with unsecured creditors and were entitled to have a claim on the company assets, the share of funds that unsecured creditors were to claim would be lower than before, since now unsecured creditors have to compete with shareholders for the same share of funds. Due to this dilution effect, there is even less chance for unsecured creditors to recover their funds. Complicate this with the potential delay in recovering funds due to extra administrative burden caused by shareholders' participation in the administration process, it is only logical that unsecured creditors would be more cautious with their lending requirements and demanded rate of return, especially to speculative-grade companies.

Is it likely that there will be any effect on the assessment of Australian companies by rating agencies?

It is likely that there would be a negative effect on the assessment of Australian companies by rating agencies if the High Court's decision on *Sons of Gwalia* is retained. The delay to recover funds should the company fail would not be looked upon positively by the rating agencies and investors alike. Companies that are most likely to be negatively impacted are speculative-grade companies, where the likelihood of company failure is high. Unsecured debtors, especially those in speculative-grade companies, would face higher risk due to the lower recovery rate if the company fails due to the dilution of funds by shareholders; as well as the delay in recovering funds. Given the increase of risk, it is only logical that rating agencies decrease the ratings for companies facing such situations, especially speculative-grade companies.

Standard and Poor's view towards High Court decision on the *Sons of Gwalia* case is far from favourable:

> *The recent decision by the High Court of Australia in the Sons of Gwalia case, however, diminishes the clarity between the rights of debt and equity holders*

> *in the winding up of a company. In Standard & Poor's view, this landmark decision is a negative development for Australia's financial and capital markets.*

Once the rating agencies decreases the ratings for speculative-grade companies, these companies would have more difficulties in attracting debt-financing. A less liquid market would diminish Australia's once efficient capital markets.

Brown and Davis

One potential consequence of the *Sons of Gwalia* decision is that because claims by aggrieved shareholders will reduce the amount creditors will receive in failed companies, the cost of unsecured borrowing will increase for Australian companies. Where there is any risk of a company failing lenders will demand a higher interest rate to offset the lower payout which would occur should the company fail. Most aggrieved shareholder claims will arise from situations where the company has failed to keep current and, more importantly, potential investors informed of material price-sensitive information that is known to the company, in the weeks leading up to the point where the company is suspended. This was the case with Mr Margaretic, who bought around $26,000 of shares 11 days before the company was suspended, and claimed misleading and deceptive conduct by Sons of Gwalia.

To assess the likely impact on the cost of unsecured debt some idea of turnover of shares in the period prior to suspension is needed. Using historical data on the turnover of shares prior to suspension of failed companies we have estimated that unsecured creditors could have their recovery diluted by as much as 40 percent.[66] Such dilution would lead to higher expected losses on the debt and consequently a higher credit risk premium. The CAMAC Report suggests that when assessing the impact of likely claims two points should be noted. The first is that entities that are required to disclose under the Corporations Act are a small proportion of incorporated entities (albeit they are the larger ones). Second, less than 5 percent of companies that lodged an insolvency report with ASIC in 2005-2006 paid a return of 10 cents or more in the dollar to unsecured creditors, thereby reducing incentives for shareholders to litigate against the company.

The first point is somewhat irrelevant when assessing the impact of the judgement on the credit spread of publicly issued unsecured debt. Generally, only large listed companies that are rated by external rating agencies can issue debt into the capital markets. It is precisely these companies that are required to continuously disclose material information, and which are therefore affected by the *Sons of Gwalia* judgement. In previous work we have estimated the impact on credit spreads for Australian companies using modern credit risk modeling techniques based on option pricing theory. The predicted credit spread increase depends on assumptions about dilution of unsecured creditor claims, leverage ratios and ratios of unsecured to secured debt. Based on reasonable assumptions, the increase in spread ranges from around 4 basis points for low overall leverage to 160 basis points for highly levered firms with predominantly unsecured debt. These estimates will be lower to the extent that the second point raised in the CAMAC report is valid. That is, if low expected payoffs deter litigation, lower dilution of unsecured credit claims and lower increases

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[66] Christine Brown and Kevin Davis 2006, 'Shareholders or Unsecured Creditors? Credit Markets and the Sons of Gwalia Judgement' *Agenda* 13(3) 239-252.

in credit spreads are expected. Whether this turns out to be a significant deterrent remains to be seen.

The added complexities and delays to external administration of failed companies are illustrated in the following two examples. To date Sons of Gwalia Limited and Ion Limited are the two failed companies where there is a class action that involves shareholders seeking to claim as creditors in the company administration.[67] In June 2007 the administrators of Sons of Gwalia estimated a return of 12 cents in the dollar for all creditors, including shareholder claims of $250m. Based on this estimate shareholders reclassified to the status of unsecured creditors can expect to receive around $30 million in aggregate, ignoring legal costs of the class action. If legal actions against auditors, Ernst & Young and former directors are successful the administrators propose splitting shareholders into junior and senior claims with a one off payment for junior claimants with no ongoing rights and a more vigorous claim process for senior claimants with ongoing rights. The termination date for the Deeds of Company Arrangement has been extended several times from the original date of August 2005 to the most recent terminal date of 31 December 2007.

Consider now the example of Ion Limited, which was suspended from trading in December 2004, with unsecured debts in the order of $369 million as reported in the Balance Sheet for June 2004. At November 2005, the administrators advised that 'some 2,500 proofs [from shareholders] have been received totaling approximately $113m'.[68] By September 2007 the administrators under the DOCA had received more than 3,200 proofs of debt from shareholders, totaling approximately $122 million. The administrators have stated that 'they may need to approach the Court in due course for guidance on the matters of disclosure obligations, causation and the quantification of shareholders losses.'[69]

Clearly the process of collecting shareholder claims is a complex and time consuming task which results in delayed distributions to creditors. Both the SOG and ION class actions have been funded by IMF Australia, with no upfront fee payable by shareholders participating in the class action. The class action vehicle makes the pursuit of numerous small claims viable because they can be rolled into a single law suit. It also allows institutional investors to anonymously pursue losses. Class action promoters essentially have a call option on a portion of the liquidation proceeds. The easier it is to prove misleading and deceptive conduct by the failed company,[70] the greater the size of potential shareholder claims (this depends on turnover in the period prior to suspension) and the greater the liquidation spoils, the more likely a litigation funder will be to pursue that option. This suggests that low expected payoffs (in terms of proportional returns on the dollar) for unsecured creditors may not be sufficient to deter class actions on behalf of shareholders, provided the payoff is large enough to generate an adequate fee for the litigation funder.

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67 See http://www.delisted.com.au/legal.aspx

68 McGrathNicol+Partners, 2005 'Deed Administrators' Update 28 November 2005.

69 See http://www.delisted.com.au/Company/4378

70 Class action promoters and shareholders have also been aided by the recent decision in *Riley v Jubilee Mines* when the Supreme Court of Western Australia held that information could be said to have a material effect on the price or value of a company's shares when the eventual release of the information does in fact affect the share price.

Conclusion

Our message is that the credit spread on unsecured debt, which includes trade credit terms, for Australian companies could increase substantially. This would be particularly so for companies heavily reliant on unsecured debt, those with volatile share prices, and those with a relatively high share turnover. Although the CAMAC report suggests that the relatively small historical liquidation spoils might act as a deterrent to shareholder litigation, class actions will be likely provided the liquidation rewards and potential aggrieved shareholder claims are large enough. Litigation funders have a call option on a portion of the potential proceeds to shareholders and their profit motive will make pursuit of claims more likely when company non-compliance with the disclosure regime can be shown to have caused shareholder losses. As illustrated in the cases of Sons of Gwalia and Ion, pursuit of shareholder claims has the potential to seriously complicate the administration process and result in long delays in distributions to trade and other unsecured creditors.

5.2 Trade creditors

ABA

It should also be noted that while financial institutions have the capacity to change the way they provide credit to reflect the increased risk (all of which occur to the expense and detriment of the company), trade creditors will not usually be in the same position. Moreover, trade creditors will of course directly suffer from any increase in the use of security by financiers which may flow from the *Sons of Gwalia* decision.

5.3 Financial markets

Baker & McKenzie

Baker & McKenzie's Sydney-based team of US lawyers regularly advises Australian companies on accessing the US capital markets. We have assessed the effect of the High Court's decision in the *Sons of Gwalia* case on the ability of Australian companies to access the US debt capital markets through discussions with market participants, including underwriters, placement agents, institutional investors and issuers.

There are essentially three US debt markets and the reaction of investors in these markets to the *Sons of Gwalia* decision varies. These markets are:

- SEC-registered market for public offers;
- Rule 144A private placement market for 'qualified institutional buyers' (as defined in the rule); and
- traditional private placement market where US investors are insurance companies and pension funds.

Based on our experience, discussions with market participants and other sources, we believe 18 Australian entities tapped the US debt capital markets in 2007 (all since the High Court decision was rendered in January 2007) on an unsecured basis as follows:

- 1 SEC-registered bond offer for US$2.3 billion;
- 4 Rule 144A bond offers for an aggregate of US$1.8 billion; and
- 13 traditional private placements for an aggregate of US$4.1 billion.

The SEC-registered bond offer was made by an investment grade issuer. Of the four Rule 144A bond offers, two were investment grade and two were rated by credit agencies as below investment grade (ie, high yield). In contrast, issuers in the traditional private placement market are not required to obtain formal credit ratings and many of the Australian issuers in this market have not been rated by a credit rating agency.

In addition, whereas bonds issued in the SEC-registered public market and the Rule 144A market may trade (amongst 'qualified institutional buyers' in the Rule 144A market), investors in the US private placement market usually hold the bonds until maturity, which is typically 7 to 15 years (with 10 years as the most common tenor). This long-term holding makes investors more exposed to potential insolvency of issuers and the *Sons of Gwalia* decision than short-term investors or lenders. At the same time, the longer tenor offered by the US debt capital markets compared to the Australian capital markets is one of the major attractions of the US markets for Australian companies.

The number of Australian companies raising debt in the United States was arguably less in 2007 compared to recent years but this was due more to the global 'credit crunch' sparked by the sub-prime mortgage problem in the United States during the second half of 2007 rather than the *Sons of Gwalia* decision. A few Australian companies have delayed tapping the US debt markets until pricing (ie, spread over US Treasury bonds) improves.

Nonetheless, the *Sons of Gwalia* decision has had an adverse effect on the ability of Australian companies, particularly those of lesser credit quality, to tap the US debt markets. While there has been not been a discernible impact in the investment grade segments of the SEC-registered and Rule 144A markets, concerns have been raised in the Rule 144A market for high yield bonds and the US private placement market has been impacted. Alerted by a risk factor regarding the *Sons of Gwalia* decision that was contained in the offer document for a high yield bond offer, a few investors in the Rule 144A market for high yield bonds have asked about the High Court decision.[71] While surprised and concerned, they believe the Parliament will reverse the effect of the *Sons of Gwalia* decision.

Investors are concerned about the *Sons of Gwalia* decision because it departs radically from their expectation (based on US law and, until the *Sons of Gwalia* decision, Australian law) that shareholders should only be paid from a bankrupt estate after creditors have been paid.

US private placement investors have a particularly keen understanding and appreciation of the risk that the *Sons of Gwalia* decision poses because they have suffered losses as a result. It is the US private placement market that Sons of Gwalia tapped in 2000 and 2001, raising a total of US$170 million, some of which may not be repaid due to shareholder claims against the company.

Some US private placement investors have decided to no longer purchase bonds of Australian companies until the effect of the *Sons of Gwalia* decision is reversed by the Parliament.

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[71] The risk factor reads, in part, as follows: 'the Australian High Court recently ruled that shareholders may rank alongside unsecured creditors in a winding-up where shareholders have an independent damages claim against the debtor company arising out of the purchase of their shares'.

Many other US private placement investors have decided to only invest in bonds of (1) private Australian companies because there is not a risk of public shareholders bringing claims against such companies or (2) ASX-listed companies of strong credit quality due to the lower risk of bankruptcy associated with such companies. Of the 13 private placements completed in 2007, three issuers were not ASX-listed companies and the remaining ten issuers were S&P/ASX 300 companies and, we understand, viewed as investment grade by investors.

Of course, confining investment to bonds of Australian companies perceived as investment grade does not fully insulate investors from the ramifications of the *Sons of Gwalia* decision. Even investment grade companies can, over time, become insolvent and be subject to shareholder lawsuits. For instance, one investment grade issuer that tapped the US private placement market in July 2007 suffered liquidity problems five months later and newspaper articles suggest shareholders may bring a class action lawsuit against the issuer. If shareholders were to sue and the issuer were to become insolvent with the *Sons of Gwalia* decision still in effect, then all Australian companies could find it much more difficult and expensive to access the US debt markets.

Even without this development, Australian issuers of debt in the private placement market have already been subject to heightened scrutiny since the lower court decision in *Sons of Gwalia* as investors perform greater due diligence to decide whether or not to invest. Some investors have dedicated legal personnel who are versed in the *Sons of Gwalia* decision and are involved in any decision to invest in an Australian issuer. With this raised bar, there will be fewer Australian companies, particularly those of lesser credit quality, that will pass muster.

The decision by some US investors to refrain from investing in Australian companies may result in less demand (ie, ‘price tension’) and, hence, higher cost for their debt. While it is difficult to fully assess the impact of the *Sons of Gwalia* decision on pricing, assuming identical issuers in the United States, the United Kingdom and Australia, investors would likely offer better pricing to the US and UK companies due to the higher risk associated with Australian companies arising from the *Sons of Gwalia* decision.

Taking some guidance from other jurisdictions, the *Sons of Gwalia* decision may be treated by investors as a ‘country risk’ that will add to the pricing of debt for Australian issuers. For instance, US investors add approximately 15 to 25 basis points to the coupon on debt issued by Italian companies due to unfavourable treatment received by US creditors in Italy following the bankruptcy of Italian dairy company Parmalat. A similar premium could apply to Australian companies. This would result in a significant amount of capital that would be taken out of the Australian economy and paid by Australian companies to US investors to compensate them for the risk imposed by the *Sons of Gwalia* decision.

While CAMAC notes in section 6.2 of its Discussion Paper that the ‘position in the United Kingdom is consistent in effect with that in Australia as determined in the *Sons of Gwalia* decision’, US investors do not share that perception. We understand that US investors believe UK law is comparable to US law in its treatment of a shareholders claim in the event of insolvency. Until a UK court decides a case similar to *Sons of Gwalia* involving US bondholders, some US investors will continue to prefer UK companies over Australian companies. While Australian companies raised more debt in the traditional private placement market than UK companies in 2004 and

2005, the opposite was true in 2006 and the first half of 2007. In the first six months of 2007, UK companies raised US$3.1 billion in the US traditional private placement market, compared to US$2.5 billion by Australian companies (albeit we cannot conclude that this turnaround is a result of the *Sons of Gwalia* decision).

Finally, a complete assessment of the impact of the *Sons of Gwalia* decision on the ability of Australian companies to access the US debt capital markets cannot be made at this time as some investors have delayed a full response, awaiting and expecting action from the Parliament. If the Parliament does not reverse the effect of the *Sons of Gwalia* decision and legislate claims of shareholders to rank junior to creditors, fewer US investors are expected to purchase debt from ASX-listed companies, particularly those of lower credit quality. For those investors who continue to invest, the debt of Australian companies may represent a decreasing percentage of their portfolio and they may demand changes to the deal structure (eg, security, tighter covenants and structural subordination of potential shareholder claims by requiring ASX-listed issuers and guarantors to be holding companies) to reduce the risk associated with the *Sons of Gwalia* decision.

IMF

Detrimental Effect on the Debt Market Argument

Some representatives of the debt markets have said the effect of the *Sons of Gwalia* decision will be detrimental to Australian company's capacity to obtain debt finance and the terms on which any finance may be obtained. This is addressed in section 5.1 and 5.3 of the Discussion Paper.

Before the High Court decision was handed down, academics were suggesting that credit spreads (the difference between the yield on a government bond and a company's bond, reflecting the risk of the company bond) might be affected by a finding for Mr Margaretic. For example, one article argued 'the resulting ambiguity with regard to the traditionally accepted investor hierarchy of claims in the event of corporate collapse has the potential to affect credit spreads in the market for corporate debt'.[72]

At a seminar hosted by the Investment & Financial Services Association on 8 March 2007, Stuart Gray, a senior credit analyst at Deutsche Asset Management, said that he and his colleagues had expected that Australian credit spreads would widen after the *Sons of Gwalia* decision. However, he clearly stated that 'this isn't happening'.

Mr Gray cited the 'benign credit environment' in support of this observation and said that 'investors directly affected by [the] *Sons of Gwalia* [decision] were limited' since there were only 30 to 50 US investors in the private placement market in which Sons of Gwalia issued its debt, and there were only seven investors in the Sons of Gwalia debt itself. Mr Gray said the US private placement market was dwarfed by the size of the investment grade market, which would not be affected by the *Sons of Gwalia* decision.

Since these comments were made in March, credit spreads have widened. However, this has largely been caused by a reassessment of risk globally in the wake of

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[72] Brown C and Davis K, 'Credit markets and the Sons of Gwalia Judgement' *Agenda* 13(3) (2006) 239 at 251.

concerns about the US economy and specifically the upheaval in the US subprime mortgage markets.

Any argument suggesting that the cost and availability of finance for Australian companies has been affected by the *Sons of Gwalia* decision would need to carefully explain how those increased costs have been caused by the decision, as opposed to other factors. It would be improper for the Parliament to consider changing the law until the persons raising concerns about the cost of debt can present tangible evidence to support their assertions.

We are not aware of any evidence in Australia that that the decisions in Sons of Gwalia of Emmett J, the Full Federal Court or the High Court caused any increase in credit margins or any difficulties for Australian companies seeking to raise debt finance.

In any event, you cannot generalise about the cost of debt and need to assess the provision of debt to a particular company on a case-by-case basis. Lenders will always assess the probability of default before estimating what losses will be if default does in fact occur. The High Court decision is not likely to influence lenders' assessments of the probability of default.

This point was clearly noted by Standard & Poor's which said the day after the High Court decision: 'For debt investors, it is Standard & Poor's view that this decision should have no impact on the probability of a default in debt payments in the ordinary course, so we do not anticipate credit ratings being affected.'[73]

Standard & Poor's director Anthony Flintoff was quoted in the same release, stating: 'In Standard & Poor's view, the case does not realign the debt-equity balance, rather it recognises that the market-protection laws are powerful and that absolute transparency in information flows is a key protection for companies and investors alike.'

The overwhelming majority of debt providers will not be affected by the *Sons of Gwalia* decision. In reality only a few reorganisations each year will be affected. This is because in order for shareholder claims to be viable:

- a listed company needs to have become insolvent;
- there must be sufficient assets to make distributions to unsecured creditors worthwhile;
- there must not be unpaid secured debt ranking in priority; and
- there must have been a reasonably clear breach of the market protection regime.

As stated previously, the legislature in the UK has allowed all shareholders, to claim in the situation of insolvency. Section 111A of the Companies Act 1985 (UK), which was inserted by the Companies Act 1989 (UK), provides that:

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[73] 'Gwalia Court Decision Is Credit Neutral For Australian Ratings, But Recovery Risks may Rise, Says S&P' Standard & Poor's Ratings Services, Press Release dated 1 Feb 2007. Another ratings agency, Fitch, said the decision 'is not expected to have any immediate major impact on Australian debt markets'. (See 'Fitch: Gwalia Shareholder Case Decision Unwelcome for Debt Markets; But No Major Impact Likely', Fitch Ratings, Press Release dated 1 February 2007.)

> *A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares.*

We are aware of no evidence from the UK that liquidity in the UK debt markets or the cost of debt finance has been affected by this provision. Moreover, there has been a relatively small number of shareholder claims against insolvent companies, and none that have adversely effected any significant administrations.

Harris & Hargovan

For debt capital markets

The *Sons of Gwalia* decision may have a dramatic impact upon the capital markets if it is not overturned by the High Court. The uncertainty caused by potential mass member class actions (seeking damages against companies for share losses) may make it more difficult for banks and other lenders to calculate their risk premium in advance when lending to companies. Consequently, it may become increasingly costly and difficult for Australian companies to raise funds from overseas bond markets, especially from countries like the United States, where the law expressly subordinates members' claims to creditors'. Rating agencies may decrease ratings for low-rated creditors, thereby increasing the cost of debt.

Although the removal of *Houldsworth* in the United Kingdom does not seem to have affected the availability of corporate debt in that country, Australian debt capital markets are not of the same scale as the United Kingdom and it should not be assumed that the lack of limitations on the availability of corporate debt in the United Kingdom will necessarily be replicated in Australia. However, ultimately, it remains to be seen if the *Sons of Gwalia* decision will have serious ramifications for Australia in global credit markets and whether lenders will develop new lending strategies to ameliorate the impact, if any, of the decision. That is an empirical question which will determine if this potential problem for Australia's debt market is overstated or not.

ABA

In paragraph 5.3.3 of the CAMAC paper it is suggested that the *Sons of Gwalia* decision may increase transparency for financial markets by placing greater pressure on disclosing entities, particularly when they are in financial difficulties, to keep the market fully informed and to thereby reduce the possibility of successful aggrieved investor actions against the company. The ABA does not consider the *Sons of Gwalia* decision will likely have this impact for the following reasons:

- If a company looks to trade out of its financial difficulties and the company does not enter into an insolvency process, the company is still liable for losses to shareholders on an unsubordinated basis arising from failure to comply with its disclosure obligations (in addition to other risks for failure to disclose); and in any event,
- if the directors have in fact formed the view that the company will likely enter into an insolvency process, they are likely to be less concerned about the risk of dilution to creditors from aggrieved investor claims arising from failures to keep the market informed, than they will be about their risk of personal liability both on the disclosure front and as a result of insolvent trading.

In those circumstances, the ABA does not consider that the *Sons of Gwalia* decision will likely have any real impact upon directors' behaviour in relation to corporate disclosure obligations.

AFMA

Possible Disclosure Benefit for Financial Markets

The Committee opines that there may be a 'transparency benefit for financial markets to the extent the *Sons of Gwalia* decision places greater pressure on disclosing entities, particularly when they are in financial difficulties, to keep the market fully informed, through continuous disclosure and other notifications, to reduce the possibility of successful aggrieved investor claims against the company.'

AFMA submits that this is highly unlikely for the reasons expressed by Brown and Davis at 3.1 above as to Board reaction.

Finally, it is AFMA's view that the corporate bond market would be unlikely to give any material weighting to any potential increase in disclosure.

6 Overseas law

The submissions in this chapter are summarised in Section 3.2.5 of the report.

6.1 General

Harris & Hargovan

In our view, Australia should be cautious about adopting the priority position given to aggrieved investor claims in other jurisdictions. Our markets and civil litigation systems are not identical to the UK, US and Canada. The absence of class actions and litigation funding is a notable difference between the Australian and UK markets. The Fair Funds for Investors provision in the US, together with substantially different litigation rules, make a simple adoption of the absolute priority rule difficult. Even in Canada, where the subordination rules are stricter than in the US, the investment market (i.e. strong cross investment between US and Canadian firms) and competition for restructuring work renders consistency with US laws a priority for their law. These factors are not as strong in Australia.

Duncan Brakell

As Justice Kirby notes, [at 128], in matters of basic principle in the law of corporate insolvency it is increasingly important to consider the legal provisions applicable in the major countries with which Australia conducts its trade. As set out in the Discussion Paper, [at paras. 6.2 to 6.4], it is relevant to repeat here the provisions as they stand in the United Kingdom, United States and Canada.

United Kingdom: The position in the United Kingdom is consistent in effect with that in Australia as determined in the *Sons of Gwalia* decisions. The UK *Companies Act* was amended in 1980 abrogating the rule in *Houldsworth*. It makes it clear that shareholders are not to be precluded from claiming against a company in their capacity as creditors. Section 111A of the UK *Companies Act 1985*, now s 655 of the UK *Companies Act 2006*, provides that,

> A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares.

Subsequently, in *Soden*, the House of Lords, in interpreting the UK equivalent of s 563A of the Act, concluded that claims such as the type brought by Mr Margaretic, ranked equally with conventional unsecured creditor claims.

United States: In the United States, s 510(b) of the US Bankruptcy Code specifically postpones claims arising from the purchase or sale of securities behind those of unsecured creditors in a liquidation. The relevant part of the provision states,

> For the purpose of distribution [in an insolvency], a claim … for damages arising from the purchase or sale of [securities] … shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security …

Canada: Corporate restructurings under Canada's insolvency regime are governed by the provisions of the *Bankruptcy and Insolvency Act*, however, there are as yet no statutory provisions dealing specifically with claims of the nature examined. As a matter therefore of general law, Canadian courts have adopted the approach of

subordinating such claims in an insolvency.[74] Amendments to the *Bankruptcy and Insolvency Act* and *Companies' Creditors Arrangement Act* have been proposed that would be consistent with the US position.

6.2 United Kingdom

Baker & McKenzie

We agree with the Committee's summary of the current law in the United Kingdom in relation to shareholder claims against insolvent companies.

However, the UK experience is of no assistance in the present context. Firstly, this is because the United Kingdom is in turn looking to Australia for guidance in relation to this issue.

More importantly, however, and as we have indicated, our discussions with market participants indicate that there is a general lack of appreciation in debt capital markets of the change in UK law brought about by section 111A of the Companies Act 1985 (UK) and the House of Lords' decision in *Soden v British and Commonwealth Holdings plc* [1998] AC 298. Our discussions indicate that US investors believe that the American 'absolute priority' principle is the law in the United Kingdom.

Finally, the Committee should note that the United Kingdom is not a jurisdiction in which class action litigation and litigation funding is as prevalent as it is in Australia or the United States. It is reasonable to expect that this combination of factors in the Australian jurisdiction will result in greater potential for large-scale litigation to arise from the decision in *Sons of Gwalia*.

AFMA

AFMA notes that the Davies Review of Issuer Liability has recommended a review of the law as applied in *Soden v British Commonwealth Holdings* plc 8 [1997] UKHL 41 in relation to the UK equivalent of section 563A, which review will take the Committee's findings into account.

It is entirely possible that the UK legal position may change to subordinate all shareholder claims after creditors. That result would have potentially negative implications for Australia's international competitiveness.

Furthermore, it is of little relevance whether the Soden case has had a 'demonstrated adverse effect on corporate financing'. Nor is the UK legal environment important in relation to the availability of litigation funders, class action proceedings and shareholder rights in comparison to Australian conditions. For the reasons stated at 5 above, offshore corporate bond markets have reacted adversely to the *Sons of Gwalia* and this has already had detrimental consequences for Australian markets.

Nehme and Wee

Did the Soden decision in the UK have a demonstrated adverse effect on corporate financing or on the conduct of external administrations?

The decision in *Soden* case has not, to our knowledge, affected the availability of corporate debt in the UK. However, it is important to note that Australian debt

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74 See, for example, *Re Blue Range Resource Corp* (2000) 15 CBR (4th) 169; 259 AR 30, *National Bank of Canada v Merit Energy Ltd* [2001] 294 AR 15. This decision was affirmed at [2002] 299 AR 200.

markets are not of the same scale as the UK and it should not be assumed that the lack of impact on the debt market in the UK may be necessarily replicated in Australia.

Are there material differences between the legal environment in the UK and Australia for instance to class actions and litigation funding, that need to be taken into account in considering the UK experience?

The UK system, like the Australian system, is not very litigious and does not strive on class actions like in the US. However, there seem to have been a shift to that regard in the last couple of years. For example, Allianz, Europe's largest insurer, is coming to London to set up a third party litigation fund. Furthermore, it has been noted that US style action litigation is set to take off throughout Europe, with the possibility that the UK would be Europe's class actions capital. A Legal Week/EJ Legal Big Question Survey revealed that it is likely that class actions in relation to shareholders' claims may be on the rise in the next few years.

6.3 USA

CSA

In short, CSA supports the rationale for the 'absolute priority rule' in the US Bankruptcy Code (as set out on page 53 of the discussion paper), which is based on the recommendations of a Commission on the Bankruptcy Laws which supported the postponement of claims arising from the purchase or sale of securities behind those of unsecured creditors in a liquidation on the argument that:

> allowing equity-holders to become effectively creditors by treating these two classes as though they were one gives investors the best of both worlds: a claim to the upside in the event the company prospers and participation with creditors if it fails. It also dilutes the capital reserves available to repay general creditors, who rely on investment equity for satisfaction of their claims.

CSA believes that shareholders should absorb the risk of insolvency as part of the risks they take in acquiring shares, which includes the risk of corporate fraud, misconduct and the non-disclosure of price-sensitive information as well as company failure. That is, shareholders should be liable for their equity investment if a company fails for whatever reason. CSA notes that shareholders have existing rights to raise claims against the directors in relation to their actions in the event of default.

ABA

In paragraph 6.3, the paper addresses the position under section 510(b) of the US Bankruptcy Code. The ABA wishes to draw to CAMAC's attention to some other characteristics of this provision which should be considered in relation to any reform proposal.

- **Subordination of security holders generally -** Section 510(b) is expressed to apply not only to shareholders, but to any 'claim arising from rescission of a purchase or sale of a security of the debtor'. Accordingly, if a creditor of the company in another part of the capital structure (for example subordinated debt investors) pursued an aggrieved investor claim, then section 510(b) will apply to ensure that such a claim does not elevate the investor in the capital structure by virtue of establishing that claim.

- **Derivative claims -** As we understand the operation of section 510(b), it would also act to subordinate any claim that was a derivative action. For example, if shareholders sued a third party (i.e. an auditor, promoter, director) for an aggrieved investor claim, and that third party then cross claimed against the insolvent company for contribution, then that contribution claim by the third party would be caught by section 510(b). We note however that the proportionate liability legislation, introduced by CLERP 9 in part 7.10 - 2A, may be relevant to whether such a situation would now be likely to occur in an Australian context.
- **Capturing an affiliate -** Section 510(b) purports not only to attach to claims against the company in which the claimant is a shareholder, but also any such claim against an affiliate of that company. As we understand it, this would for example subordinate claims of shareholders against an operating company which is a subsidiary of the listed entity, in circumstances where a claim is made against that subsidiary that it participated in the provision of misleading information which is said to have caused the shareholder loss.

Each of these characteristics of the US Bankruptcy Code should be carefully considered in relation to any reform of the Australian position. They are all aimed at enshrining the position that an investor stays in their section of the capital structure of the company notwithstanding claims they may have for being mislead into acquiring (or even holding) those securities or shares. So the effect of these provisions is that a shareholder remains subordinated to claims of unsecured creditors and cannot elevate their claim through derivative claims or other tactics. Such a legislative approach is founded on a risk/reward analysis of investing. In addition, it effectively limits the cost, expense and practical difficulties for insolvent estates associated with investors attempting to jump up the capital structure by asserting such claims.

AFMA

The ‘absolute priority’ rule in section 510(b) of the US Bankruptcy Code in favour of secured and unsecured creditors ahead of all shareholders, whether aggrieved or not, has entrenched this as a general expectation in US unsecured debt capital markets. As mentioned at 5 above, the effect, according to AFMA members, has been a 10 to 15 percent reduction in the corporate bond market investors who are prepared to invest on an unsecured basis.

6.4 Canada

AFMA

AFMA notes that since the Committee’s report was released, Canada has adopted the US ‘absolute priority’ rule which was passed as legislation in Bill C-12 before the House of Commons on 29 October 2007 and which is now in committee pending the Senate third reading speech. This development can only operate as a further detriment to Australian markets by reducing the availability of unsecured debt capital investment in Canadian bond markets.

Depending on the outcome of the UK review, Australia could be facing a situation where local legal conditions will be different from three of its major financial market counterparts.

7 Retain or change the law

The submissions in this chapter are summarised in Section 3.3 of the report.

7.1 Option 1: maintain current legal position

7.1.1 Support Option 1

Law Council – Insolvency Committee: minority view (for majority view, see Option 2)

The minority view: shareholders should be able to bring such claims

Those members of the Committee who support the ability of shareholders to bring claims maintain that it is not part of the implicit bargain made when investing that one may be misled. With the proliferation of share ownership, shareholders should be entitled to be recompensed by the company. Leaving shareholders with a remedy against the directors or advisors may not prove adequate as those persons may not be able to satisfy any judgment. There is also no reason in principle to distinguish between trade creditors and shareholders.

Further, corporate structures have become far more complex since the time of joint stock companies. Today, publicly listed companies are managed by professional managers and overseen by professional company directors. The average shareholder is not aware of the strategic direction of, or day-to-day decision-making within, such companies, and is forced to rely upon information given to him or her by the company. Where that information is false or misleading and the shareholder suffers loss as a result, he or she should have a remedy against the company.

Recognition of the need for shareholder protection resulted in changes to company law in Australia with the enactment of the Financial Services Reform Act 2001 in two relevant respects:-

- the enactment of Part 6CA of the Corporations Act/Law which created an obligation upon publicly listed companies to give continuous disclosure; and
- the enactment of section 1041H which created a statutory cause of action for misleading and deceptive conduct with respect to financial products with the Corporations Act.

The effect of both of these provisions was to create statutory duties between a company and any person who traded in their securities. Such duties did not exist at the time the decisions in *Houldsworth* and *Webb Distributors* were decided.

A person's ability to prove as a creditor should not depend upon issues of luck or timing, which would be the consequence if shareholder were unable to prove. For example, Mr A and Mrs B are both shareholders in and sellers of shares in X Ltd. At the same time, they place sell orders for their shares. X Ltd has failed to inform the market that six months ago a major contract had fallen through and it is likely to become insolvent unless the contract is replaced. Had they known this, both A and B would have cancelled any reserve on their shares in X Ltd. Shares in X Ltd are the subject of a trading halt and the company is subsequently placed into voluntary administration. Prior to the trading halt, Mrs B's sell order is satisfied, but Mr A's is

not. Why should A not he able to seek compensation for the loss which Mrs B, by luck alone, has been able to avoid?[75]

IMF

Executive Summary

- 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.

Submissions

IMF (Australia) Ltd supports Option 1 as described in section 7.3 of the Discussion Paper – that the current law, as determined by the High Court's decision in *Sons of Gwalia*, be retained.

Furthermore, IMF submits:

- that the legislature clarifies that proof of reliance on misleading statements or omissions is not necessary in order to prove casually connected loss for a breach of the market protection laws; and
- that the legislature stipulates a method for quantifying loss that is easily understood, enables enforcement and gives effect to the overriding principle that investors receive compensation for losses arising from breaches.

Investor protection

The timely disclosure of material information is critical to the confidence of market participants to ensure the market can maximise the capital available to it and that the capital in the market is allocated effectively.[76] As the Minister noted in the Second Reading Speech of the Corporate Law Reform Bill (No 2), which introduced the continuous disclosure regime:

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75 Those supporting the majority view would maintain that neither A nor B should be entitled to seek compensation from X Ltd.

76 Capital in this context is intended to cover all forms of capital, including debt and equity and all other forms of finance, including trade credit.

In essence, a well informed market leads to greater investor confidence and in turn a greater willingness to invest in Australian business.[77]

The Minister also noted in that speech that the continuous disclosure regime would have an important regulatory function by acting as a check on corporate misconduct:

An effective disclosure system will often be a significant inhibition on questionable corporate conduct. Knowledge that such conduct will be quickly exposed to the glare of publicity, as well as criticism by shareholders and the financial press, makes it less likely to occur in the first place.[78]

The Government has recognised this benefit by increasing penalties and widening the scope of the continuous disclosure regime since its introduction in 1994.[79] As noted by French J:

The importance attached to the continuous disclosure provisions of the Act by the legislature is emphasised by the penalties for their contravention which have recently been significantly increased and their widened scope since 2002 which is now not limited to intentional reckless or negligent non-disclosure.[80]

Importantly, market protections have not only been put in place to protect shareholders. In deciding whether to lend or provide trade credit, and if so at what price and under what terms, lenders and trade creditors also rely on the market protections. The principal cause of the Sons of Gwalia creditors' loss was the same as the cause of the shareholders' loss: a misinformed market.

To subordinate defrauded shareholders from claiming damages against a company, even though it is under external administration, would be to eschew the purpose for which the market protections were designed.

Chief Justice Murray Gleeson noted in the High Court of Australia's decision in *Sons of Gwalia* (the '*Sons of Gwalia* decision'), at paragraph 18, that the need for shareholder protection often only occurs when a company becomes insolvent and those protections may become 'illusory' if shareholder claims were subordinated:

Corporate regulation has become more intensive, and legislatures have imposed on companies and their officers obligations, breach of which may sound in damages, for the protection of members of the public who deal in shares and other securities. This raises issues of legislative policy. On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The spectre of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investors often arises only in the event of insolvency,

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77 Second Reading Speech of the Minister for Administrative Services introducing the Corporate Law Reform Bill (No 2) into the Senate, Parliamentary Debates, 26 November 1992 at p 3561.

78 Ibid.

79 Before 1994, the regime was contained in the ASX Listing Rules and thereby remained a contractual issue between the listed entity and the ASX.

80 *Australian Securities and Investments Commission, in the matter of Chemeq Limited v Chemeq Limited* [2006] FCA 936. The *Financial Services Reform Act* of 2001 removed the 'intentional, reckless or negligent' non-disclosure.

> *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.*

Since the High Court's decision in *Sons of Gwalia*, a number of valid concerns have been raised about possible delays and increased costs to external administrations. The implications of cost and delay are serious and the legislature's focus must be on an effective claims resolution process that resolves disputes fairly and quickly. At present, there are two barriers to affordable and speedy resolution of shareholder claims: the possibility that the circumstances of every shareholder be considered by the administrator adjudicating on the claims; and a lack of clarity as to the methodology to apply to calculate losses. Both barriers can be relatively easily overcome.

Should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct?

In answering this question, three presumptions will be made. First, 'misleading conduct' in this context is presumed to include a breach of the duty to provide continuous disclosure. Secondly, 'participation' is not presumed to mean participation at all, but rather participation pari passu with other unsecured creditors.[81] Finally, this submission presumes that 'shareholders' refers to shareholders on the register of the company at the time the external control commenced.[82]

Accordingly, this submission understands the question to be whether shareholders on the register of the company at the time external control commenced, who acquired shares as a result of a breach of section 674 or 1041 ('Shareholder Creditors') should have payment of their debt postponed until all other debts have been paid in full.

This submission argues that any possible unfairness to creditors consequent upon the reduction of capital in the case of a limited liability company is matched by the unfairness which would result to innocent victims of fraud perpetrated by a company or its representatives if no remedy were available.[83]

The market protections in the *Corporations Act, ASIC Act* and *Trade Practices Act* should be construed and applied broadly and the rights to damage should not be limited in relation to companies in liquidation.[84]

As noted by the Chief Justice in the *Sons of Gwalia* decision:

> *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.]*[85]

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81 It was not argued in the High Court in Sons of Gwalia that the respondent should not participate as a creditor, but rather that his rights were postponed pursuant to section 563A.

82 Clarity in respect of who is postponed and who is not will be a very difficult issue if legislative reform is considered appropriate.

83 *Re Pyramid* (1992) 10 ACLC 110 at 114 per Vincent J.

84 *Webb Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR at 15 per McHugh J.

85 *Sons of Gwalia (Subject to Deed of Company Arrangement) v Luka Margaretic* [2007] HCA 1 (31 January 2007) per Gleeson CJ at 31.

The Discussion Paper notes that reform to the Australian law would align Australia to the Federal Bankruptcy Code of the United States which subordinates Shareholder Creditors' debts to Other Creditors' debts (see Discussion Paper section 6.3).

On the other hand, the *Companies Act 1985* (UK) reflects a contrary policy and which expressly denies any such subordination of Shareholder Creditors' debts (see Discussion Paper section 6.2).

Accordingly, Australian law is currently consistent with the relevant UK law and inconsistent with the relevant law in the United States.

The Chief Justice in the *Sons of Gwalia* decision pondered if the Australian Parliament were to introduce a provision similar to the United States provision:

> *…it would need to consider what would be the practical effect upon the rights conferred upon people who deal in shares and securities by legislation of the kind relied upon by the respondent. One thing is clear. Section 563A does not embody a general policy that, in an insolvency, 'members come last'. On the contrary, by distinguishing between debts owed to a member in the capacity as a member and debts owed to a member otherwise that in such a capacity, it rejects such a general policy.*

Argument based on acceptance of risks invalid

It is argued by those seeking legislative change that there are good policy reasons why a shareholder attending an AGM who slips as a result of the negligence of the company and suffers damage should rank above a shareholder who is lied to by the company at the AGM and thereby suffers loss.

The policy consideration justifying the distinction, so the argument goes, is that the slip victim does not assume the risk of negligence whereas shareholders must, as a matter of policy, assume the risk that they will be lied to when making their investment decision as part of the trade off for a share of any profit and capital gain.

Law professors John Slain and Homer Kripke wrote the seminal article on the policy considerations behind the statutory subordination of shareholders in the US Federal Bankruptcy Code.[86] Slain and Kripke argued that it was justified for shareholders to bear the risk of a fraudulent or misleading conduct in relation to securities as they received the profits from a company's success.

However, the policy basis for this view seems increasingly anachronistic given the introduction in the US of legislation seeking to protect defrauded shareholders. As Hargovan and Harris note[87] 'the wisdom of the US legislation, it appears, has recently been doubted by Congress itself through its hasty actions in the aftermath of major US corporate scandals such as Enron and Worldcom. These events caused the US Congress to revise, whether intentionally or not, the importance of shareholder subordination in insolvency under the Sarbanes-Oxley reforms.' The authors state that the introduction of Sarbanes Oxley undermines the strong policy foundations of US subordination laws by allowing the SEC to distribute penalties for breaches of securities laws to defrauded shareholders.

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[86] Slain, J and Kripke, H, 'The interface between securities regulation and bankruptcy – Allocating the risk of illegal securities issuance between security holders and the issuer's creditors' (1973) 48 *NYULR* 261.

[87] Hargovan A and Harris J, 'Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience' (2007) 20 *AJCL* 265.

This submission supports the view of Hargovan and Harris, applying their analysis of the US position to Australia: 'The resultant outcome arising from blanket subordination, which eschews notions of fairness to shareholder interests…cannot be justified. The US approach to statutory debt subordination is premised on the belief that shareholders as investors should justifiably bear the risk of fraudulent or misleading conduct and does not accommodate shareholder interests in such circumstances which, in our opinion, is a flawed approach.'[88]

With respect, the argument that shareholders assume the risk of being lied to is cynical and debases our market protection regime. Shareholders, as with all other beneficiaries of the regime, should be able to expect the companies with whom they deal will comply with their market protection obligations and invest in and allocate capital within the market on that basis.

No policy can assume less, with any breach entitling compensation to rank equally with the slip victim and the other beneficiaries of the regime. Justifiable policy reasons to differentiate between and create priorities between beneficiaries of the market protection regime must be clearly articulated to justify legislative change.

For most shareholders who are still holding their shares at the time a company which has breached the market protection laws enters external administration, the first indication that the company is in trouble is typically an announcement to the Australian Securities Exchange that external administrators have been appointed.

This is because in the modern equity market, shareholders typically remain outside the company and have little influence on the company's operation, or insight into its performance, other than through the information which is publicly disclosed to the ASX.

As one commentator noted after *Sons of Gwalia* decision, 'in large listed companies, ordinary shareholders, even institutional shareholders, have only notional ownership rights in most circumstances. They have no real ability to direct the company, are rarely able to influence the composition of the board or strategies of their management and are in reality more like financiers receiving equity returns and accepting equity risk.'[89]

This is in contrast to trade creditors and unsecured finance creditors, who are typically much closer to the company. Many trade creditors would receive an indication that a company is in financial difficulty when accounts are overdue or not being paid. To continue to advance goods or services in this situation is to assume the risks that ultimately you will not be paid for those goods or services. Similarly, many unsecured finance creditors are in close contact with company management and some seek and receive access to the company's book and records to allow them to assess the risk of their loans.

Hence it is arguable that it is even more important that the investor protections are made available in the context of insolvency to protect shareholders who can prove their right to compensation, as it is the shareholders who practically have less opportunity to assess the company's performance when compared to the company's traditional creditors.

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[88] id at 294.

[89] Bartholomeusz S, 'Shareholders win at cost to creditors', *The Sydney Morning Herald*, 1 February 2007 at page 24.

Illusory Market Protections

Unless the law can actually protect, and ultimately provide compensation to, those victims of illegal conduct, the market protection regime risks becoming an irrelevancy, or, to repeat the words of the Chief Justice set out in paragraph 6 above, 'illusory'.

If the laws are not enforceable, then one of the main tools for preventing market misbehaviour is severely restricted.

Very few cases alleging breaches of continuous disclosure have been brought, either by the corporate regulator or by investors.[90]

The dearth of private actions is probably not illustrative of few companies acting in breach of their legal obligations to continuously disclose material information, but rather the access to justice barriers addressed later in this submission.[91]

ASIC

Should the current legal position be retained?

Recommendation: Retain the current legal position

ASIC supports the legal position reached in *Sons of Gwalia*, that aggrieved investor claims should not be postponed as member claims under s 563A of the Corporations Act 2001 (the Act), for the following reasons:

(a) The position reached in *Sons of Gwalia* reinforces investor protection provisions in the Act. The shareholder remedies in the Act for loss or damage resulting from market misconduct or misleading and deceptive conduct indicate that, while shareholders bear most of the risks of the company's performance, this should not include the risk of misconduct. Most shareholders today, particularly those of large publicly-listed companies that may be affected by *Sons of Gwalia*, are not privy to the internal decision-making of companies, and are highly reliant on companies' public disclosure. Facilitating the compensation of aggrieved investors in an insolvent company for damage suffered due to corporate misconduct gives meaning to, and is consistent with, investor protection provisions.

(b) The impact of *Sons of Gwalia* is likely to be limited. Aggrieved investor claims are likely to occur only in a narrow set of circumstances, namely, where a company that is a disclosing entity in financial difficulty fails to keep

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[90] There are only three court decisions on continuous disclosure of any substance. *Australian Securities and Investments Commission v Southcorp Ltd (No 2)* [2003] FCA 1369 and *Australian Securities and Investments Commission, in the matter of Chemeq Limited v Chemeq Limited* [2006] FCA 936 were actions brought by the Australian Securities and Investments Commission; *Kim Riley in his capacity as trustee of the KER Trust v Jubilee Mines* [2006] WASC 199 was brought by a shareholder (who successfully recovered damages).

[91] These include:
(a) lack of awareness of their rights;
(b) the costs and delays in our civil justice system;
(c) insufficient information about directors' capacity to meet any judgment;
(d) statutory restrictions on accessing other shareholder contract details to enable collective action; and
(e) the representative procedure created by Federal Parliament not being available for funded collective action.

shareholders informed of material price-sensitive information or makes false or misleading statements in disclosure documents, and subsequently goes into voluntary administration or liquidation and there are sufficient assets in the company to make bringing an aggrieved investor claim worthwhile.

(c) In light of the large number of listed trusts in Australia, it would be equitable for there to be homologous treatment of those unit-holders who have claims for non-disclosure or false or misleading disclosure by the responsible entity (RE) of an insolvent listed trust (who would rank as ordinary creditors of the RE in the event of that RE's insolvency), and aggrieved investors in insolvent listed companies. Any differentiation between the treatment of aggrieved investors in these two forms of structure within the listed environment would be undesirable.

Alternative options

While we support the *Sons of Gwalia* approach and consider that its impact is likely to be limited in terms of the number of listed company insolvencies affected, it is possible that in individual insolvencies a high proportion of shareholders may attempt to make out aggrieved investor claims. It may therefore be worthwhile considering some modification to the *Sons of Gwalia* approach to limit the circumstances in which aggrieved investor claims can be made. [See **7.5 Alternative 1** and **7.6 Alternative 2**, at the end of this chapter]

NSW Law Society Business Law Committee

COMMITTEE OPINION IN SUPPORT OF OPTION 1

The decision in *Sons of Gwalia Ltd v Margaretic*[92] has brought about much conjecture and excitement in the commercial community. It raises a number of implications, both legal and commercial.

The following opinion is not intended to address each and every aspect raised by CAMAC in its Discussion Paper. Rather, it chooses to specifically focus on understanding the High Court's reasoning and in doing so, presents an opinion on the decision as a question of law, and on arguments for legislative reform in light of commercial concerns.

The claim in context

Framing the issue

The essential issue presented by each appeal concerns the operation of insolvency provisions in the *Corporations Act 2001* (Cth) ('the *Act*'). The starting point of this examination is a clear appreciation that Mr Margaretic claimed SOG ('the company') was in contravention of s 52 of the *Trade Practices Act 1974* (Cth), s 1041H of the *Act,* and s 12DA of the *Australian Securities and Investments Commission Act 2001* (Cth). The basis of his claim therefore was that he was a victim of misleading and deceptive conduct and entitled to compensation.

The obligation Mr Margaretic seeks to enforce is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct; a contravention of federal consumer protection provisions. Any conclusions drawn on this issue depend on the meaning, operation, and interpretation of s 563A of the *Act*.

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92 [2007] HCA 1 ('*Sons of Gwalia*').

In doing so, it is shown by the court that such a claim is not a claim 'owed by the company to a person in the person's capacity as a member of the company'.[93]

A study of past decisions may be helpful, by analogy, to a court applying the relevant statutory provisions to the case in hand. However, it is necessary to distinguish *Sons of Gwalia* because the issue must be reframed in light of the reliance placed on past authority by the first and second appellants. The basis of the claim for damages in the present matter was not breach of contract for example,[94] but the company's breach of federal consumer protection provisions. The real point on appeal is whether Mr Margaretic's claim was brought in his 'capacity as a member' of SOG. When considering the issue in its reframed form, what is involved, as Kirby J states [at 117], 'is the unpacking of the meaning of s 563A of the Act and, in the end, nothing else.'

A statutory question

This opinion supports the view of the Court that the issue presented for decision was a matter of statutory interpretation. The purpose of the applicable statutory provisions must be interpreted in the context of the claim and a wider consideration of the purpose of s 563A is necessary. Relevantly, it is the duty of the High Court to give effect to the provisions of that section. As Kirby J states [at 109], 'The ultimate duty of a court in a case of this kind is to give effect to the meaning of the law as expressed by the Parliament'. The Court is firmly of the view that it is necessary to examine the words of s 563A in their context and, to give effect to their meaning the analysis must, as Kirby J notes, '…proceed, not only be reference to the words of the statutory provision but also by reference to the object and purpose of those words' [at 116].

Debt or claim

The focus for decision must be placed on the character of the 'debt' allegedly owed to the respondent. As Gleeson CJ notes, [at 6], 'The existence of a liability is the hypothesis upon which [s 563A] proceeds.' Standing alone, the phrase 'or otherwise' would be broad enough to include a 'debt' owed by a company pursuant to a claim for unliquidated damages upon proof of misleading and deceptive conduct giving rise to remedies under the specified federal legislation.[95] As an aside, it is important to also interpret (and apply) the wording of the Deed of Company Arrangement. Clause 1.1 defines 'creditor' to mean 'any person who has or asserts a claim'. The term 'claim' is defined in language based upon the provisions of s 553(1) of the *Act.* It includes a 'debt' and a 'claim' against the company, present or future, certain or contingent of sounding only in damages.

It was common ground that Mr Margaretic's claim fell within s 553 of the *Act,* which could be imported into the Deed and it follows that Mr Margaretic was a 'creditor'. This is a poignant distinction to make because Mr Margaretic had a provable 'claim' in damages as a member. It was not the case that a 'debt' was 'owed' by the company to him in his 'capacity as a member'. Mr Margaretic's claim was framed such that he never intended to seek recovery of any paid-up capital or to avoid any liability to make contribution to the company's capital. In this sense, his membership of the company was not, as such, definitive of the capacity in which he made his claim.

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93 Per Hayne J at [206].

94 See especially, *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1993) 179 CLR 15 ('*Webb*').

95 Per Kirby J at [124].

Abrogation of the Houldsworth principle

It follows that the rule in *Houldsworth* has been abrogated for subscriber claims against a company in liquidation given s 563A exhibits a legislative intention to exclude the rule in a winding up.[96] For the reasons established, this opinion is of the view it is necessary that this be the case.

Any presumed general subordination of shareholder claims on the assets of an insolvent company to the claims of general creditors, must give way to the true meaning of the legislation that actually governs the case.[97] The arguments advanced in support of, or in opposition to, the admissibility of such claims to proof were based on what was said to be the common law rule in *Houldsworth's* case, and whether that rule had received statutory recognition in the Companies (Victoria) Code.[98] The arguments of the appellants are by no means meritless, but it is interesting to note, notwithstanding the recognition *Houldsworth* attracted, that the parties in *Webb*, as was the case in *Sons of Gwalia,* placed *Houldsworth*, not the applicable statutory provisions, at the forefront of their arguments.

The asserted common law 'principle' could not deny the operation of the relevant federal consumer protection and investor protection provisions. Neither *Webb* nor *Houldsworth* established any common law 'principle' relevant to the present matter where there was no contract for subscription for the acquisition of shares made by the shareholder, Mr Margaretic, and the company, SOG.[99] As Gummow J remarked, [at 86], neither the 'principle' attributed to *Houldsworth*, nor *Houldsworth* itself, had anything to do with the presently relevant provisions of the Act and the Code. Because the statutory definition of claims admissible to proof on a winding up was changed in 1992, past authority decisions do not dictate the outcome in the present matter.

Legislative reform

Policy

CAMAC has invited respondents to comment on whether the rule in *Houldsworth* should be abrogated. On the reasons established, the question that arises is whether a change in the law should be supported to restore what was regarded as a settled position in respect of shareholder claims against companies in liquidation post *Webb*.

In acknowledging the call for reform it is important to carefully weigh up the appropriate balance between giving force to consumer protection provisions for shareholders and the practical implications for insolvency law.[100] If the Parliament concludes that the interpretation adopted by the Federal Court, now confirmed by the High Court, strikes the wrong balance, it can easily repair the defect by amending s 563A of the *Act*.[101]

As was argued in *Hodgson* it may be contended that the decision in *Sons of Gwalia,* in allowing shareholders to prove such claims in competition with conventional unsecured creditors, is inconsistent with the notion of limited liability. It also raises

96 Discussion Paper at [2.2.1].
97 Per Kirby J at [117].
98 Per Hayne J at [182], Kirby J at [104].
99 Per Hayne J at [190].
100 Discussion Paper at [2.2.2], cf Gleeson CJ at [18].
101 Per Kirby J at [133].

the notion of unfairness, not only as between shareholders and ordinary trade creditors but also, as Callinan J points out,[102] between shareholders themselves.

To deny the equality of a claim such as Mr Margeretic's, however, is to deny, in these circumstances, a rightful and certain claim under the *Act.* Recalling that the decision before the High Court was not one of common law principle, but one of statutory interpretation. Although the present claim was not found to be a conventional 'debt' owed by the company to Mr Margaretic, s 553 and s 563A of the *Act* do not operate to automatically preclude the claim. Here, we have the coexistence of two types of liability. Again, with reference to the Deed of Company Arrangement we have a 'claim' (for damages), and also a 'debt', admitted to proof in winding up SOG.

Nevertheless, the High Court found that Mr Margaretic was not claiming in his capacity as a member. This conclusion is critical to advancing the argument that the claim should not be subordinated. In this sense, while this opinion acknowledges arguments for the claim as being 'unfair', it does not think, for the reasons set out above, the argument is a persuasive one. With regard to the decision opening the flood gates, this opinion contends that the argument is not particularly convincing. When properly thought through, shareholders who have held their shares in ignorance of the true position of the company must, as did Mr Margaretic, prove that at the point in time the shares were acquired, reliance was placed on the information disclosed to the market.

They must be able to successfully prove, at that point in time, that the company was in contravention of the consumer protection and investor protection provisions and that they were a victim of misleading and deceptive conduct and entitled to compensation. Similarly, the decision before the Court would be one of statutory construction.

This opinion does not agree that the present matter should rest on the principle that the company's share capital represents a 'guarantee fund'[103] and protection to creditors which should not be returned to shareholders other than on a permissible reduction of capital. It is a basic policy objective of the insolvency laws in this country to comprehensively deal with *all* debts and liabilities of the insolvent company. As the Report of the Australian Law Reform Commission on the General Insolvency Inquiry ('the Harmer Report') sets out, '[i]n the case of a company, the aim is to deal with *all* the claims against a company so that its affairs can be fully wound up…', otherwise, 'if the creditors are unable to make their claims in the insolvency, they are unable to recover at all'.[104]

Despite a show of sympathy for the appellants' case, it was not the view of the majority of the High Court that the language of s 563A reflects an intention on the part of the Parliament to postpone *all* shareholder claims until the debts owed to creditors had been satisfied, only their claims in their capacity as 'members'. It can be assumed that the Act was intended to effect only a limited subordination of claims brought by people who happen to be shareholders.[105] In the present matter, these reasons favour the respondent.

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102 Per Callinan J at [256], Kirby J at [105].

103 *Webb* at [32-33].

104 Australia, The Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988), vol 1 at 315 [774 and 777].

105 Per Kirby J at [133].

As a question of law, and in keeping with the policy objectives of the insolvency provisions of the *Act,* this opinion argues that a claim of the nature of Mr Margaretic's should not be postponed, but recognised as a validly equal claim.

Reform

This opinion is of the firm view that the effect of *Sons of Gwalia* should stand and that the Parliament should not adversely amend it.

It was open to it to the drafters to have copied the drafting of the US Bankruptcy Code had it have been the purpose of Parliament to deal expressly with such claims, but it did not. Instead, as set out briefly above but in detail in Justice Hayne's judgment, s 563A derives its drafting from UK statutory provisions. Why would the Parliament now settle on US drafting?

This opinion does not favour the US position for several reasons. It is of the view that it is not in keeping with the policy objectives of Australian insolvency laws, it does not find favour with the reasoning on which its general law is premised, and it does not share the views of its legal commentators (which go to policy). In *In re Telegroup, Inc*, and in *In Re Worldcom*, for example, the courts seem readily apparent to conclude that shareholders should bear the risk of any illegality in the issue, therefore the acquisition, of their shares. This is at complete odds with the fundamental objective of Australia's federal consumer and investor protection laws; *justitia non est neganda, non differenda*.

This opinion acknowledges that neither should an unsecured creditor bear the loss in this instance, but why would the two competing claims not be regarded as equal? It does not accept the commercial arguments given in support as sufficient enough reason. US legal commentators for instance would have you believe that this gives investors, who should apparently bear the risk of illegal corporate conduct, the best of both worlds. Recalling that in *Sons of Gwalia* Mr Margaretic did not bring his claim in his capacity as a 'member' (and his action was for a breach of the consumer protection provisions). It was not a claim for unpaid dividends for example that would otherwise be postponed under s 563A.

This, we believe, sets his case apart from the assumption that he ought to be regarded as a longer-term shareholder waiting in the wings, so to speak, for a (retrospective) opportunity to file a claim which if successful would only serve to dilute the paid-up capital of the company in winding-up. If that were the case, then arguably his claim should not succeed and thus s 563A ought to be amended. However, this is not the case. Mr Margaretic's membership of the company was not definitive of the capacity in which he made his claim. In other words, mere membership of the company was not essential to the claim. The obligations he sought to enforce arose, by virtue of the company's conduct, under federal consumer and investor protection laws.[106]

In the present matter we are dealing with a case where a company, in liquidation, was in breach of federal law, and an injustice caused as a result of its unjust conduct. Mr Margaretic's claim was a present and certain claim, and ought to be recognised as an equally ranked liability alongside the claims of unsecured creditors. The governing reason of justice knows of its own disposition and what is material.

[106] Per Gleeson CJ at [31].

Conclusion

For these reasons, this opinion cannot set aside the principle of the matter and conclude that s 563A should be amended to favour the US position. It does not support Option 2 as proposed. It follows that it does not also favour the Canadian position.

Option 1, as proposed, should therefore be adopted.

Duncan Brakell

The decision in *Sons of Gwalia Ltd v Margaretic* has brought about much conjecture and excitement in the commercial community. It raises a number of implications, both legal and commercial.

This submission is not intended to address each and every aspect raised by CAMAC in its Discussion Paper. Rather, it chooses to specifically focus on understanding the High Court's reasoning and in doing so, presents an opinion on the decision as a question of law, and on arguments for legislative reform in light of commercial concerns.

In examining the issues raised in the Discussion Paper, this submission will have regard to the following question as its platform of debate:

Should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any [debt] that may arise out of that misleading conduct?[107]

In summary, the following conclusions are drawn:

- the issue presented for decision before the High Court is one of statutory interpretation. On this basis, the decision and reasoning of the majority is supported, and
- the principles in *Sons of Gwalia* should stand, and the effect should not be reversed.

I have endeavoured to explain that if one closely examines the High Court's reasoning, and fully recognises the principle of the matter as a question of law, policy, and ethics, then the conclusion reached is, for all intensive purposes, quite a logical and well reasoned one. In the end, it concludes that a claim such as Mr Margaretic's, against a company in liquidation, should not be subordinated but stand equal with conventional unsecured creditors.

Policy objective: In acknowledging the call for reform, it is important to carefully weigh up the appropriate balance between giving force to consumer protection provisions for shareholders and the practical implications for insolvency law.[108] If the Parliament concludes that the interpretation adopted by the Federal Court, now confirmed by the High Court, strikes the wrong balance, it can easily repair the defect by amending s 563A of the Act.[109]

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[107] As examined by the High Court, and discussed in this paper, a caution is issued to the reader such that the word 'debt' may be better substituted with the word 'liability'.

[108] Discussion Paper, para. 2.2.2; cf Gleeson CJ at [18].

[109] Per Kirby J at [133].

Policy concerns: A key commercial concern that arises out of the decision is that the ability to bring such claims is inconsistent with the policy objectives of Part 5.3A of the Act, which operates as a successful mechanism for reorganising insolvent companies. This concern is recognised by Justice Kirby [at 109] who, in obiter, remarks that if one were to give effect to a presumed general policy of s 563A of the Act, it would not be surprising to conclude, consistent with the language and purpose of the Act, that it operated to postpone claims such as the respondent's entitlement to recovery to those of general creditors.

On the one hand, for instance, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors, and legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up.[110] Two points are worth noting here. Firstly, the notion such claims as per the present case would be at the 'expense' of ordinary creditors and, secondly, the decision of the High Court, if not reversed, will open the flood gates to the number of potential creditors in a winding up. The key concern underpinning these arguments is the risk that, by allowing such shareholder claims, the pool of funds (albeit capital) available to firstly satisfy debt obligations owed by the company to ordinary creditors would be diluted.

As was argued in *Hodgson*, it may be contended that the decision in *Sons of Gwalia*, in allowing shareholders to prove such claims in competition with conventional unsecured creditors, is inconsistent with the notion of limited liability. It also raises the notion of unfairness, not only as between shareholders and ordinary trade creditors but also, as Callinan J points out,[111] between shareholders themselves.

To deny the equality of a claim such as Mr Margeretic's however, is to deny, in these circumstances, a rightful and certain claim under the Act. Recalling that the decision before the High Court was not one of common law principle, but one of statutory interpretation. Although the present claim was not found to be a conventional 'debt' owed by the company to Mr Margaretic, s 553 and s 563A of the Act do not operate to automatically preclude the claim. Here, we have the coexistence of two types of liability. Again, with reference to the Deed of Company Arrangement we have a 'claim' (for damages), and also a 'debt', admitted to proof in winding up SOG.

It may however be fruitful to further pursue narrow factual distinctions of this kind because, as Gummow J remarks,

> *Unless the means by which a person became a member (that is, by acquiring shares by subscription or by transfer) is relevant to the characterisation of the 'debt' owed by the company to the person as one owed to the person in his or her capacity as a member or not, the distinction is difficult to maintain as a matter of principle [at 52].*

Nevertheless, the High Court found that Mr Margaretic was not claiming in his capacity as a member. This conclusion is critical to advancing the argument that the claim should not be subordinated. In this sense, while I acknowledge arguments for the claim as being 'unfair', I do not think, for the reasons set out above, the argument is a persuasive one. With regard to the decision opening the flood gates, I also hold the opinion that the argument is not particularly convincing. When properly thought through, shareholders who have held their shares in ignorance of the true position of

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110 Per Gleeson CJ at [18].

111 Per Callinan J at [256]. See also Kirby J at [105].

the company must, as did Mr Margaretic, prove that at the point in time the shares were acquired, reliance was placed on the information disclosed to the market.

They must be able to successfully prove, at that point in time, that the company was in contravention of the consumer protection and investor protection provisions and that they were a victim of misleading and deceptive conduct and entitled to compensation. Similarly, the decision before the Court would be one of statutory construction.

I do not agree that the present matter should rest on the principle that the company's share capital represents a 'guarantee fund'[112] and protection to creditors which should not be returned to shareholders other than on a permissible reduction of capital. It is a basic policy objective of the insolvency laws in this country to comprehensively deal with all debts and liabilities of the insolvent company. As the Report of the Australian Law Reform Commission on the General Insolvency Inquiry ('the Harmer Report') sets out, '[i]n the case of a company, the aim is to deal with all the claims against a company so that its affairs can be fully wound up…', otherwise, 'if the creditors are unable to make their claims in the insolvency, they are unable to recover at all'.[113]

Despite a show of sympathy for the appellants' case, it was not the view of the majority of the High Court that the language of s 563A reflects an intention on the part of the Parliament to postpone all shareholder claims until the debts owed to creditors had been satisfied, only their claims in their capacity as 'members'. It can be assumed that the Act was intended to effect only a limited subordination of claims brought by people who happen to be shareholders.[114] In the present matter, these reasons favour the respondent.

As a question of law, and in keeping with the policy objectives of the insolvency provisions of the Act, I am of the view that a claim of the nature of Mr Margaretic's claim should not be postponed, but recognised as a valid claim against the company in winding-up and ranked equally with unsecured creditors.

Reform or not to reform?

I am of the reasoned opinion that Parliament should not amend the legislation, and that the effect of *Sons of Gwalia* should stand. I will briefly say why.

US drafting was not adopted: The issue brought to bear in *Sons of Gwalia* has not been examined by the High Court since its decision in Webb. Until this time, it was widely regarded that a claim such as Mr Margaretic's would be subordinate to conventional unsecured creditors. The High Court has now turned the page and decided otherwise, yet, all the while, had it been the purpose of the Parliament in Australia to adopt a general principle postponing, to the claims of general creditors, claims of the nature in the present case against a company which becomes insolvent, it would have been relatively easy for that purpose to be given effect in the Act.[115] This was not done.

Had it have been the purpose of Parliament to deal expressly with such claims, then it was open to it to the drafters to have copied the drafting of the US Bankruptcy Code, but it did not. Instead, as set out briefly above but in detail in Justice Hayne's

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112 *Webb's* case at [32-33].

113 Australia, The Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988), vol 1 at 315 [774 and 777].

114 Per Kirby J at [133].

115 Per Kirby J at [129].

judgment, s 563A derives its drafting from UK statutory provisions. Why would the Parliament now settle on US drafting?

Principles must be upheld: I do not favour the US position for several reasons. I am of the view that it is not in keeping with the policy objectives of Australian insolvency laws, I do no not find favour with the reasoning on which its general law is premised, and I do not share the views of its legal commentators (which go to policy). In *In re Telegroup, Inc*,[116] and in *In Re Worldcom*,[117] for example, the courts seem readily apparent to conclude that shareholders should bear the risk of any illegality in the issue, therefore the acquisition, of their shares. In other words, setting aside insolvency, this reasoning suggsets that a shareholder should suffer the injustice of a company's misleading corporate conduct affecting their shares (albeit though an action may be able to be brought against individual directions of the company). I am of the opinion that this is at complete odds with the fundamental objective of Australia's federal consumer and investor protection laws; justitia non est neganda, non differenda.

I acknowledge that neither should an unsecured creditor bare the loss in this instance, but why would the two competing claims not be regarded as equal? I do not accept the commercial arguments given in support as sufficient enough reason. US legal commentators for example would have you believe that this gives investors, who should apparently bear the risk of illegal corporate conduct, the best of both worlds. Recalling that in *Sons of Gwalia* Mr Margaretic did not bring his claim in his capacity as a 'member' (and his action was for a breach of the consumer protection provisions). It was not a claim for unpaid dividends for example as would otherwise be postponed under s 563A.

This, I believe, sets his case apart from the assumption that he ought to be regarded as a longer-term shareholder waiting in the wings, so to speak, for a (retrospective) opportunity to file a claim which if successful would only serve to dilute the paid-up capital of the company in winding-up. If that were the case, then I would argue his claim should not succeed and thus s 563A ought to be amended. However, this is not the case. Mr Margaretic's membership of the company was not definitive of the capacity in which he made his claim. In other words, mere membership of the company was not essential to the claim. The obligations he sought to enforce arose, by virtue of the company's conduct, under federal consumer and investor protection laws.[118]

In the present matter we are dealing with a case where a company, in liquidation, was in breach of federal law, and an injustice caused as a result of its unjust conduct. Mr Margaretic's claim was a present and certain claim, and ought to be recognised as an equally ranked liability alongside the claims of unsecured creditors.

Conclusion

For these reasons, I cannot set aside the principle of the matter and conclude that s 563A should be amended to favour the US position. I do not support Option 2 as proposed. It follows that I do not also favour the Canadian position.

Option 1, as proposed, should therefore be adopted.

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116 (2002) 281 F 3d 133 (3rd Cir, 2002).

117 (2005) 329 BR 10 (Bankr SDNY, 2005).

118 Per Gleeson CJ at [31].

However, as a derivation to Option 1, I suggest that if the Parliament were to consider redrafting s 563A of the Act so as to clarify its limits, then it should do so by giving further effect to the UK provisions.

Michael Duffy

Primary submission

On balance there is no compelling case for legislative intervention following the *Sons of Gwalia* decision.

Summary of points in support of primary submission

The various options for legislative intervention that appear in the Australian and United States literature – postponement, partial or selective postponement, tracing and discounting (see below) - are all potentially complex and confusing and likely to be onerous for liquidators. In many cases liquidators would need to investigate various substantive issues (which may overlap with issues in the shareholder proceedings themselves) and then refer matters to the court to seek guidance. This would have the effect of significantly increasing costs and delay in liquidations which would itself reduce returns for unsecured creditors.

Detailed submission

Possible resolutions

There are a number of positions between the two extremes of complete equality of shareholder creditors with other creditors, or on the other hand, complete subordination of one with the other. It is worth exploring these though it is submitted that each suffers from particular difficulties.

The following additional possibilities have been noted in the US literature:[119]

- Rescinding shareholder is preferred over general creditors to the extent he can trace the specific consideration representing his claim.
- Creditors whose claims arise subsequent to the share subscription have priority over the investors in that share subscription.
- Creditors have priority where their claims arise a reasonable time after shareholder becomes aware of his right to rescission and fails to exercise it.
- Creditors are entitled to a higher percentage of their claims than shareholders.

Further, in Australia the following options have been noted:

- Aggrieved investor claims rank behind creditors but ahead of any other shareholder claims.[120]
- Hargovan and Harris have proposed a resolution whereby only shareholders who purchased shares within a short time after misrepresentation will escape subordination.[121]

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[119] See Slain, John J and Kripke, Homer, 'The interface between securities regulation and bankruptcy – allocating the risk of illegal securities issuance between securityholders and the issuer's creditors' 48 N.Y.U.L. Rev 261 (1973) pp 286-287.

[120] CAMAC Discussion Paper p 68.

[121] Hargovan, A and Harris, J, 'Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience' (2007) 20 AJCL 265.

I will deal with each approach and analyse its implications.

Rescinding shareholder is preferred over general creditors to the extent he can trace the specific consideration representing his claim.

Davis indicates that this approach might be explained under the general theory of property transfers whereby in a transfer voidable by fraud, the transferee holds the property in constructive trust for the transferor.[122]

Slain and Kripke talk about the rationale for this as the court imposing a constructive trust or an equitable lien on assets where a transfer has arisen due to fraud, mistake or illegality or on the basis of unjust enrichment.[123] They also discuss assumptions that might be applied for tracing of the consideration for such issues such as first-in, first out (FIFO) or lowest intervening balance.

This option however does appear to create a significant administrative burden for liquidators in the tracing of assets and would increase the cost of liquidations to the detriment of unsecured creditors.

Only creditors whose claims arise subsequent to the share subscription have priority over the investors in that share subscription.

This is based on a theory of reliance by corporate creditors.[124] It makes an assumption that creditors have extended their credit aware of the equity holders' investment – for instance after viewing a financial statement which reflected the value of the shareholders' investment.[125] The creditor would further argue that the failure of the shareholder to rescind created a misleading appearance of regularity in the issuer's affairs whereas a shareholder's attempt to reclaim his investment by rescinding would have indicated a potential problem to credit suppliers.[126]

Given that many shareholder misrepresentation claims will arise in relation to non disclosures that are well subsequent to the original share issue and may be brought by transferee shareholders rather than original subscribers, this option may mean that most shareholder claims are postponed.

Creditors have priority where their claims arise a reasonable time after the shareholder becomes aware of his right to rescission and fails to exercise it.

The rationale for this view is based upon discouraging delay or laches by the shareholder to the detriment of the other creditors.[127]

This approach would require a liquidator to make enquiries about and formulate a view on whether a subscribing shareholder had a right to rescind, when she became aware of that right and what is a 'reasonable time' after that point. Apart from the fact that the argument again has no relevance to transferee shareholders it places a huge responsibility on a liquidator who in all probability would need to seek guidance from the court on all these issues. The problems are compounded when the claim is not by one shareholder but by many.

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[122] Davis, Kenneth B, 'The Status of Defrauded Securityholders in Corporate Bankruptcy' *Duke Law Journal*, Vol 1 1983 p 11, summarising Slain and Kripke.

[123] Slain and Kripke above n 119 pp 273-275.

[124] Slain and Kripke above n 119 p 288.

[125] Ibid.

[126] id p 289.

[127] id p 293.

<u>Shareholder-creditor claims are discounted</u>

The relativist view whereby senior interests such as creditors have been entitled to a higher percentage of their claims has been noted[128] and argued for.[129] Under such an approach shareholder creditor claims would be admitted equally with creditor claims but would be subject to a discount of their quantum. The level of such discount would be a matter for the legislature but would have to be at least 50 per centum to have an appreciable effect. Thus if the dividend were 20 cents in the dollar the shareholder creditor would receive 10 cents in the dollar. Such claims would be admitted to proof on this basis and voting rights in terms of value would therefore also be subject to the discount.

This approach has some merit but would likely create unfairness in relation to claims that are insured. In that situation the insurer rather than the creditors will receive the benefit of such discounting.

<u>Aggrieved investor claims rank behind creditors but ahead of any other shareholder claims</u>

This approach would postpone such claims behind other unsecured creditors though they would have a priority over any other claims by or residual rights of distribution to shareholders. CAMAC acknowledge however that this option may not give much practical assistance given that in the vast majority of liquidations unsecured creditors receive only a small percentage of the debt owed to them and shareholders rarely receive anything.[130]

<u>Only shareholders who purchased shares within a short time after misrepresentation will escape subordination</u>

Hargovan and Harris[131] argue for this option based upon at least three propositions. Firstly they argue that pre existing shareholders should be subordinated otherwise there will be an incentive for shareholders in a company approaching insolvency to improve their own position as creditors in an insolvency by attracting new capital. This would also include attracting capital through misleading information. It is argued that subordination of pre existing shareholders will remove this incentive. Secondly they argue further that both creditors and new shareholders may be subject to the same misleading non disclosure and therefore should rank equally. Lastly they suggest that shareholders who purchased a substantial time after the misrepresentation should be subordinated since they may have trouble establishing causation.

These views appear to presuppose both (1) a claim for damages for existing shareholders based upon a misrepresentation made subsequent to their share acquisition and (2) a claim for damages of those who purchased a substantial time after the misrepresentation. What is the first type of claim? It is clearly not a claim based upon purchase of shares in reliance upon a misrepresentation. Two possibilities suggest themselves as follows:

(a) A claim based upon a failure to disclose in a timely manner positive news. Thus if the shareholders sell at a time when the news should have been

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128 Slain and Kripke above n 119 p 262.

129 Swaine, RT, 'Reorganisation of Corporations: Certain Developments of the Last Decade', 27 *Colum.L. Rev*. 901 (1927).

130 CAMAC Discussion Paper p 69.

131 Hargovan and Harris, above n 121 p 157.

disclosed but wasn't, the news is later disclosed and the share price goes up, the former shareholder may argue that, but for the non disclosure they would have sold at a higher price. This sort of claim will not be without difficulty in any event. Firstly, there may be a problem with reliance as there cannot be reliance on non disclosure unless it is argued that there is a misrepresentation based upon earlier disclosures combined with the later silence. Otherwise it may require some alternative test of causation such as the US 'fraud on the market' theory.[132] Secondly in some situations it might be argued that earlier disclosure of positive news might cause the shareholder not to have sold because positive sentiment may have changed his mood (assuming that negative sentiment made him sell). As can be seen, the question is intimately bound up with the issue of causation and reliance (which is discussed in submission B).

(b) A claim based upon a misrepresentation or failure to disclose negative news. Here the claim would be that the shareholder held onto (rather than acquired) shares based upon a misrepresentation. But for the misrepresentation/non disclosure it is argued that he could and would have sold at a higher price. This type of claim has certain logical inconsistencies however as it is likely that the same misleading reassurance that caused the plaintiff not to sell also caused the share price to remain higher. If the reassurance had not been given the plaintiff may well have sold, but likely the market would also have responded and the more favourable sale price may not have been available.

In relation to the shareholders who purchased a substantial time after the misrepresentation it is argued that these should be postponed as they may therefore have trouble establishing causation. This appears to be an argument that they may not have a claim in support of the proposition that their claim be postponed. Clearly if there is no claim then there is no need to postpone anything. Conversely, if causation can be established then lack of causation cannot be an argument for postponing that claim. It may be therefore that the claims that this approach proposes to subordinate may not be viable claims in any event.

Conclusion

The effect of the *Sons of Gwalia* decision is undoubtedly good for shareholders however might be seen as somewhat harsh on small unsecured trade creditors. On the other hand a rule of absolute subordination of shareholder claims to the claims of unsecured creditors might be seen as neutering the recent blossoming of investor protection through civil suits and class actions.

On balance it is not clear that there is a compelling case for legislative intervention to overturn *Sons of Gwalia*. To the extent that the legislature wishes to be seen to provide some comfort for unsecured creditors there are various formulae available for a compromise position. Unfortunately these are generally burdensome and expensive for liquidators and claimants in relation to the tasks of tracing investor funds as well as determining issues of whether claims exist, how and when they arise, whether there is causation and so on. The only other compromise position – a general discounting of

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[132] Duffy, M, 'Fraud on the Market: Judicial Approaches to Causation and Loss from Securities Nondisclosure in the United States, Canada and Australia' (2005) 29 *Melbourne University Law Review* 621.

such claims – suffers from the fact that, in insured cases, the benefit of same will go to the insurer rather than to the unsecured creditors.

7.1.2 Oppose Option 1

Baker & McKenzie

As a result of the negative impacts of the decision in *Sons of Gwalia*, set out above at Chapter 5 [**Broader implications**], Option 2 identified in the Discussion Paper should be pursued in Australia by the Commonwealth government.

However, we discuss Option 1 below.

Option 1

The arguments advanced in section 7.3.1 of the Discussion Paper in favour of the retention of the effect of the decision in *Sons of Gwalia* cannot be sustained. In particular:

(a) Focused impact

Presuming that the impact of aggrieved shareholder claims will be restricted to listed, disclosing entities is not a good policy reason for maintaining the status quo.

(b) Investor protection

While protection of equity investors is an important policy objective, evidenced by the enactment of the continuous disclosure regime, sufficient incentives to comply with that regime are already in place. In particular, investor protection is secured by:

(i) the ability of the Australian Securities & Investments Commission (ASIC) to obtain civil compensation orders against companies and their former directors for contravention of the continuous disclosure regime, the proceeds of which are payable to those aggrieved shareholders who suffer loss as a result of the contravention;

(ii) the ability of ASIC to obtain civil penalty orders in relation to such contraventions; and

(iii) the possibility of criminal sanctions against directors.

It is not correct to suggest that companies and directors would become more relaxed about their disclosure obligations if they could not be sued by shareholders for losses. Additionally, ‘investor protection’ should not involve unsecured creditors underwriting the trading losses of others as would be the practical effect.

Moreover, it is fanciful to suggest that a putative investor in the Australian equity capital market would decide to proceed with an investment on the basis that if he/she is misled in making that decision it will be possible to agitate, at considerable expense, a claim against an insolvent company with a view to receiving some small dividend out of the insolvent estate.

(c) Fairness

There are several points to be made under this heading. First, shareholders as noted above, as a matter of course, are provided with considerable volumes of information before and during the period of their exposure to the risk of corporate failure. On the other hand, ordinary unsecured creditors such as trade creditors, however, receive no such information at any stage. It is difficult to see the ‘fairness’ in ranking trade

creditors, who have received none of the 'up side' of the company's activities, equal with shareholders who are at all times at a considerable informational advantage and who have previously participated in that 'up side'.

Secondly, shareholder claims have no upper limit. The 'loss' in *Sons of Gwalia* was, and probably in most cases will be, determined by reference to what the shareholder paid on market from another shareholder. That amount could be anything - the more wildly optimistic the investor, the higher his claim becomes. The total loss is therefore out of the company's control, and it becomes a function of trading volumes and speculative inflation in the share price more than anything else. Debt, on the other hand, is limited to the face value of the debt. It is finite, and can be controlled by the company. It does not present an unknowable claim amount to an administrator.

Thirdly, flowing from this, it is important to realise that the issue is not about shareholders claiming against the company - in reality they are claiming from creditors. A company in liquidation has a finite pool of funds. Any claim or preference is a classic zero sum game - $1 paid to a shareholder is $1 that a creditor does not get. This is unjust for two reasons:

(i) shareholders get all the upside if the company performs well, creditors get none. It would subvert the risk/reward balance if shareholders did not bear the downside. Who would want to be an unsecured creditor?

(ii) because the shareholder claim pool has no maximum limit (see above), while creditors do have a limited claim pool (ie. only the amount originally owed), unsecured creditors could easily be squeezed out of a fair return. For example, a highly speculative stock takes off, volumes are high, then it crashes. The shareholder claim pool is suddenly greatly inflated and may exceed the 'genuine' creditors who lent money or provided goods or services to the company. The shareholders would gain merely by swapping paper between themselves at increasing prices, without any benefit to the company (or, by extension, other stakeholders such as creditors and employees) from that activity.

(d) Acceptance of risks

Contrary to the Commission's statement, the risk of inaccurate or incorrect information being provided by an equity issuer in the course of soliciting equity investment is something capable of being factored into the price paid for that equity, much like any other investment risk.

(e) Promote market neutrality

As noted in (b), substantial protections for shareholders, and disincentives to corporate misconduct, are already a part of the Corporations Act and the Australian Securities Exchange Listing Rules. Those protections are, if anything, more heavily focused on equity, as opposed to debt, markets.

In any event, the inherently higher risk of equity investment, as opposed to debt investment, is reflected in the returns earned on equity investment when compared to debt investment.

(f) Corporate control

It is fair to say that modern corporate governance is such that control of companies now rests more with senior management and institutional owners than with retail

shareholders. If anything, however, this suggests that shareholders, the majority of whom are now large institutions, are more than capable of protecting their own interests when making an investment decision.

In any event, the focus of the law ought not be on comparing the degrees of control that the various stakeholders have over a company. Rather, the law's focus should be on:

(i) the comparative informational positions of those various stakeholders; and

(ii) the risk/return profiles of the stakeholders' various 'investments' in the company.

Plainly, shareholders are:

(i) in a position of informational superiority over unsecured creditors, particularly trade creditors; and

(ii) the returns earned by equity investors is considerably greater than the return earned by debt investors, reflecting the increased risk of equity investment.

(g) Corporate culture

Investigation and enforcement work undertaken by ASIC is considerably more effective and higher profile in deterring corporate misconduct than the possibility of aggrieved shareholder claims against insolvent companies; by the time that such claims are agitated, any incentive on company directors and senior management is passed, because shareholders are left to their remedy against the insolvent estate and have no additional remedy against directors or senior management that is not already available pursuant to, inter alia, section 1317HA of the Corporations Act.

(h) Private enforcement

We repeat the submission made at (g).

(i) Overseas markets

We repeat the submissions made in section 6 in relation to the relevance of the UK experience in relation to aggrieved shareholder claims. The Committee should also note that the House of Lords' decision in Soden does not appear to have been judicially considered since it was given in 1997.

We repeat the submissions made in [our comments on Chapter 5 [**Broader implications**] in relation to the costs and availability of finance in the US debt markets for Australian companies. The *Sons of Gwalia* decision has adversely affected the ability of Australian companies to access the US debt capital markets and they will be more adversely affected if the Parliament does not reverse the effect of the *Sons of Gwalia* decision and legislate claims of shareholders to rank junior to creditors.

(j) Administrative burden on insolvency practitioners

While we do not say that the argument is persuasive, it is important for the Committee to appreciate that the administrative time likely to be spent by a voluntary administrator in dealing with aggrieved shareholder claims [see Chapter 4 **Implications for external administration**] will detract from the pursuit by voluntary administrators of the central policy objective behind Part 5.3A of the Corporations Act, being resuscitation of companies for the benefit of shareholders and creditors alike.

AFMA

AFMA does not support retaining the law as propounded in the *Sons of Gwalia* decision.

Arguments in favour of no change

Focused impact of the decision and investor protection

The Committee notes that whilst aggrieved shareholder claims could be made against any company, it is likely that this would mostly occur in external administrations of disclosing entities. The Committee raises the importance of shareholders' need to rely on the company for accurate information affecting the value of investment.

However, Australia already has considerable regulation in the form of the Corporations Act 2001 and Regulations, ASX Rules and the Trade Practices Act 1974 which variously require continuous disclosure obligations by disclosing entities and penalties discouraging false and misleading conduct. On that basis, AFMA submits that shareholders are already well protected by such legislation.

It may also be the consequence of the High Court decision that unsecured trade creditors may impose more onerous conditions on companies in the form of contractual and payment arrangements, higher interest rates on overdue amounts and disclosure statements. This would have an uncompetitive and costly effect on corporate operations.

Further, for the reasons provided [elsewhere in the submission], AFMA regards it unlikely that reporting entities would tend towards greater disclosure in circumstances of financial difficulty simply to avoid potential aggrieved shareholder class actions.

Overseas markets

The Committee notes the argument that 'various broader economic implications, particularly in relation to possible reactions in the US market are speculative. Also, the UK market did not appear to be affected by the…decision in *Soden*…which is similar to that of…the *Sons of Gwalia*.'

For the reasons stated [elsewhere in the submission], it is AFMA's view that this is unlikely.

CSA

CSA supports the generally accepted principles of contemporary insolvency law, as identified in the Harmer Report (General Insolvency Inquiry ALRC 45, 1988, at para 5). These include provision for:

- a fair and orderly process for dealing with the financial affairs of insolvents
- the least possible delay and expense
- an impartial, efficient and expeditious insolvency administration
- the principle of equal sharing between creditors.

If aggrieved investors are given equal billing with creditors, CSA believes that there is a strong potential to disturb the application of these principles. In particular, CSA believes that the need for certainty of the resolution of claims, their efficient and prompt assessment and the payment of dividend returns to creditors will suffer.

CSA disagrees with the argument raised on page 64 of the discussion paper that 'making external administration simpler, quicker or more expedient does not justify postponing a category of shareholder creditors'. CSA believes that this argument undermines the principles of insolvency law as identified above.

CSA believes that each claim by an aggrieved investor may require separate adjudication, which would create undue delay and costs in an external administration. This in turn would reduce the return to general creditors.

CSA also believes that the uncertainty created for external administrators in adjudicating the claims of aggrieved investors would add further to the delays.

CSA recommends that certainty should be granted to creditors and shareholders that they need not wait many years for payment in the winding up of a company.

CSA also notes that the discussion paper puts forward the argument that '[a]ny procedural difficulties may be able to be ameliorated by appropriate administrative reforms' (page 64). However, CSA points out that any such administrative reforms may themselves take many years to develop and implement. CSA therefore doubts that any such hypothetical reform of procedural difficulties would compensate for the disadvantage to creditors and the whole body of shareholders that substantial delay in proceedings would give rise to.

The potential to split the rights of shareholders, favouring some to the disadvantage of others

CSA is concerned that privileging the claims of aggrieved investors over those of other shareholders would lead to ongoing uncertainty concerning shareholders' rights. The decision in *Sons of Gwalia* may afford recent purchasers of shares with a claim because of inadequate disclosure, when longer-term shareholders, who may have sold if such information was disclosed, may have no such claim.

CSA opposes the differentiating of shareholders and their rights based on how or when they purchased shares.

The potential to create a climate conducive to speculative claims

CSA is concerned that, if the law stands following the High Court decision in *Sons of Gwalia*, a shareholder can stake a claim to have equal billing with general creditors without having to prove their claim. It is left to the external administrator or liquidator to adjudicate the claim.

CSA believes that this will lead to speculative claims being lodged. Given that the potential in Australia for class actions and funded litigation is more closely aligned with practices in the United States than in the United Kingdom (as noted in the discussion paper), CSA believes that the UK precedent is not appropriate under Australian law.

The potential to create uncertainty for insurers

CSA is aware of concerns expressed by our members working in the insurance industry that there could be a detrimental effect on the recoveries that insurers would normally expect to receive via unsecured trade creditors' dividends if the present law is retained.

7.2 Option 2: reverse the effect of the law as determined in *Sons of Gwalia*

7.2.1 General

Law Council - Corporations Committee

In summary the Corporations Committee favours a legislative response along the lines of Option 2 as set out in section 7.4 of the Discussion Paper, for the reasons set out there. The Corporations Committee finds those arguments much more compelling than the arguments in favour of the other options set out in the Discussion Paper.

CSA

CSA is of the firm belief that it is in the best interests of providing an orderly market that Option 2 be implemented, that is, that the Corporations Act be amended to reverse the High Court decision in *Sons of Gwalia*.

Our reasons for this recommendation relate to the potential that the current law as determined in light of the High Court decision has to:

- diminish existing creditors' rights
- create uncertainty for external administrators in adjudicating the claims of aggrieved investors and risk substantial delay in distributions while those claims are adjudicated
- split the rights of shareholders, favouring some to the disadvantage of others
- create a climate conducive to speculative claims, which in turn could encourage class actions based on mere possibilities rather than substantiated claims
- create uncertainty for insurers, with a commensurate negative impact on insurance premiums
- create increased cost or reduced availability of finance for companies
- overturn the debt/equity distinction.

The potential to overturn the debt/equity distinction

CSA supports the maintenance of the debt/equity distinction in a limited liability company. Shareholders risk losing their equity investment but can participate in the distribution of dividends and capital gains, whereas creditors can only recover from the company their principal and any interest provided for in the contract. Moreover, shareholders have remedies for obtaining damages from a company for false or misleading conduct.

CSA believes it is important to maintain the distinction between those who deal with the company on a commercial basis, that is, creditors, and those who are members, that is, owners.

CSA supports the comments of Callinan J in the High Court decision of *Sons of Gwalia* as quoted in the discussion paper on page 66 that:

> *shareholders' statutory rights, their voluntary abdication of control over their investment in favour of the directors as their appointees (who have considerable statutory and constitutional discretions and obligations), their*

> *rights to proceed against the directors personally as well as the company in some circumstances, their limited liability, and their rights to participate in any successes, sit uncomfortably with the notion that they should have equal billing, on the failure of the company, with ordinary unsecured creditors.*

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, that is, they should be liable for their equity investment if a company fails for whatever reason. Companies fail for multiple reasons, including fraud, corporate misconduct, currency collapses and changes in markets. CSA does not believe that non-disclosure by directors of price-sensitive information should be singled out as requiring creditors to underwrite investors' speculative risks.

Conclusion

CSA supports taking the approach of subordinating the rights of shareholders to those of creditors in the event of company failure, which is aligned with the US approach.

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, which includes the risk of corporate fraud, misconduct and the non-disclosure of price-sensitive information as well as company failure. That is, shareholders should be liable for their equity investment if a company fails for whatever reason.

CSA strongly recommends that Option 2 be implemented, that is, that the Corporations Act be amended to reverse the High Court decision in *Sons of Gwalia.*

QBE

QBE supports policy option 2 as referred to on page 61 of the paper, i.e. to amend the Corporations Act 2001 to reverse the effect of the *Sons of Gwalia* decision.

Debt/equity distinction

Further from an insurance perspective, we support the comments in CSA's submission that if the present law is retained, it could have a detrimental effect on the recoveries that insurers would normally expect to receive via unsecured trade creditors' dividends. Again ultimately this could lead to increased premiums to address this shortfall.

The basic concept of investment and return involves a certain amount of risk.

In this respect, we note the comments in the 3rd bullet point on page 66 of the paper referring to the distinction of debt/equity in support of option 2. It states:

> a distinction should be drawn between those who have commercial dealings with a company in the ordinary course of business and those who invest equity in the company. The acceptance of risk is inherent in the investor relationship. While the possibility of obtaining damages from a company for false or misleading conduct should remain as a remedy for shareholders, in any competition between shareholders and non-shareholder creditors for the assets of an insolvent company, the burden should fall on the shareholders as part of the risk they subscribe to when purchasing shares. Part of that equity-linked risk includes the prospect of corporate fraud and other misconduct.

Baker & McKenzie

We agree with the arguments set out by the Committee in section 7.4.1 of the Discussion Paper. Without wishing to repeat those arguments verbatim, the key arguments for statutory reversal of the effect of the decision in *Sons of Gwalia* may be summarised as follows:

(a) Capital maintenance

The fundamental principle of maintenance of capital by companies, as illustrated by the rule in *Houldsworth's Case*.

(b) Debt/equity distinction

The desirability of the maintenance of the distinction between debt and equity capital as a means of corporate finance.

(c) Capital markets ramifications

The likelihood that the breaking down of the distinction referred to in (b) leading to:

- Decreased willingness to lend on an unsecured or negative pledge basis;
- Decreased liquidity in the Australian debt capital market;
- Increased costs of both debt and equity capital in Australian capital markets;
- Decreased ability of Australian issuers to raise debt in the United States;
- Decreased willingness of distressed debt investors to participate in the market for the distressed debt of Australian debt issuers.

(d) Comparative risk/return

In return for the increased risk accepted by equity investors, those investors have historically received increased returns on their investment and, most importantly, the opportunity to participate in the 'up side' of a company's success. The decision in *Sons of Gwalia* shifts some of that risk onto unsecured creditors of companies. In the case of debt investors, this shift will result in increased costs of raising debt. In the case of other unsecured creditors, this will likely result in a decreased inclination to provide companies with credit.

(e) Informational advantage

Equity investors have available to them very considerable volumes of information in support of their decision to make an equity investment. That information is not available to ordinary unsecured creditors, such as trade creditors, in making their decisions to advance credit to a company.

(f) Consistency with United States law

The US debt capital markets are a important source of capital for Australian companies. For that reason alone, it is highly desirable that Australian law be consistent with US law on this issue.

(g) Class action litigation

Like the United States, Australia is a jurisdiction where class action litigation is frequently used in the context of corporate failure, often with the assistance of litigation funding. Lengthy and costly trials of such large-scale litigation will not

promote the objects of Part 5.6 of the Corporations Act, being the prompt and cost-effective winding up of insolvent companies.

ABA

Introduction

The ABA strongly advocates legislative reform in consequence of the *Sons of Gwalia* decision in order to return to the legal position that was generally understood to be applicable prior to the decision, namely that the claims (broadly defined) of equity participants rank behind debt in an insolvency.

For convenience, the claims by shareholders identified by the High Court of Australia as falling outside s 563A will be referred to in this submission as 'aggrieved investor claims'.

Principal reasons justifying equity subordination

There are two principal reasons why it is inappropriate for aggrieved investor claims to rank pari passu with general creditors. The first is the fundamental distinction to be drawn between debt and equity, and the wholly different expectations, risks and anticipated returns that pertain to these two types of involvement with a company. Secondly, and just as importantly given its effect on the external administration of an insolvent company, there are significant practical implications associated with permitting aggrieved investor claims to participate for distribution. Permitting the pari passu participation of such claims has a fundamental effect on the ability of Australia's insolvency scheme to enable the affairs of an insolvent company to be addressed in an expeditious and cost-effective manner, and importantly, materially reduces the prospects of effecting a rehabilitation. These two points are elaborated upon below.

Debt versus equity

Debt and equity represent fundamentally different participations in the affairs of a company. A shareholder will obtain all of the upside returns associated with the success of the company in which they have invested. However, in seeking this 'equity return', the shareholder assumes the corresponding risk that, for whatever reason, a company is not as successful as they might wish, or indeed that the company may fail.

A debt participation is fundamentally different. The party extending credit to the company, whether it be a bank, trade creditor or other contracting party, shares none of the upside of the company's success. When credit is extended, the return to the creditor is simply repayment of the debt, in some cases accompanied by the payment of interest. There is no 'upside return', but there is a lower risk profile when compared with equity - parties extending credit do so on the basis that the company's capital base is available for the discharge of those debts.

For the many decades before the *Sons of Gwalia* decision, investors and financiers had proceeded on the basis of the fundamental distinction referred to above between debt and equity. Banks, trade creditors and other providers of credit had assumed that shareholders ranked after them for aggrieved investor claims. The *Sons of Gwalia* decision represents a very significant and fundamental change to the expectations of creditors in an insolvency context.

This fundamental distinction between debt and equity was observed by Justice Kirby in the *Sons of Gwalia* decision, who made the observation that, as a matter of

principle, there ought to be greater sympathy for general creditors in an insolvency compared with misled shareholders. His Honour stated [109]:

> *One can readily conceive why, as a matter of policy, strong arguments can be mounted that claims by persons such as the respondent should be postponed to claims made by the general creditors of the insolvent company. Putting it broadly, most general creditors, although not all, will be innocent of the business and entrepreneurial decisions of the company that led to its insolvency. Most will have dealt with the company as outsiders in good faith on the basis of its incorporation and, where applicable, its listing on the stock exchange and its subjection to regular and rigorous legal obligations. On the other hand, persons such as the respondent are investors. As such, they are not involved in the provision of goods and services to the company, as ordinary creditors generally are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks, albeit risks increasingly informed by mandatory disclosures. In particular, where, as here, the company was involved in the extraction of gold, the acquisition of which notoriously and historically involves substantial risks and a significant degree of chance, the purchase of shares will commonly entail a measure - even a high measure - of speculation. Such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risks.*

There are four further dimensions to the policy question as to whether aggrieved investor claims should be subordinated to general creditors:

- First, the grounds for complaint underpinning an aggrieved shareholder claim (for example, non-disclosure) should be seen as no different in principle to other grounds for complaint by a shareholder who has lost the value of its investment. A company can become insolvent for many reasons. In addition to poor (albeit honest and lawful) management and bad fortune, a range of unlawful activity by a company's directors and officers can lead to insolvency - for example, dishonest conduct by directors, unlawful reduction in capital, and other breaches of directors' duties. These breaches of the law can result in a shareholder losing the value of its shareholding, and in such cases the shareholder, although they may have claims against the directors, will have no rights to participate in a liquidation of the company pari passu with general creditors. Misconduct of these types by company officers is simply one of the many risks assumed by a shareholder in his pursuit of profit through his shareholding. Except for any remedies that shareholders may have against directors or third parties arising from such misconduct, it is equity risk. In principle, why ought the risk of mis-disclosure or non-disclosure at a time when the shareholder is acquiring his shares (i.e. aggrieved investor claims) be treated any differently? The ABA submits that such circumstances are similarly part of equity risk. Why should it be different in principle that the directors commit the misconduct after acquisition of the shares rather than before?

- Secondly, non-disclosure or mis-disclosure of the company's position may in fact result in its assets or business prospects being understated, so that the shares being purchased are undervalued and a person acquiring the shares later obtains unanticipated upside from having purchased the (under-valued) shares. Again, this is part and parcel of equity risk/return and, logically, obtaining the benefit of the upside should be coupled with an assumption of the corresponding downside risk.
- Thirdly, the ABA endorses as fundamental the following principle identified in the Harmer Report on Australia's insolvency laws:

  > *Central to modern commerce is the ability to honour the promise to pay.*[133]

  By permitting shareholders with aggrieved shareholder claims to participate pari passu with ordinary creditors, this fundamental principle is eroded. As Callinan J observed in the *Sons of Gwalia* case, it is not difficult to imagine a situation in which claims of a large body of shareholders dilute the company's ability to pay its debts to its creditors to less than a trickle.[134]
- Fourthly, the *Sons of Gwalia* decision has implications for the longstanding principle of company law that companies must operate with sufficient capital to enable their debts to be paid. If, in accordance with the *Sons of Gwalia* decision, the company's capital base might be matched in value by the measure of the claims of aggrieved investors, the existence of a company's capital will be illusory. As was observed in the 1973 academic paper on which the present US policy of shareholder subordination was founded:

  > *The exception [ie the then existing legal position enabling aggrieved investor claims to rank pari passu with creditors] does not acknowledge the fact that the general creditor relies on the existence of an equity cushion in case of his debtor's bankruptcy. The exception allows a shareholder with a known recision claim the option of retaining his interest if an enterprise prospers or reclaiming his investment if it fails, but neglects the interest and expectations of labourers, lenders and trade creditors.*[135]

The importance to company law of a company's capital base is reflected in the scheme of regulation set out in the Corporations Act regulating the limited circumstances in which a company's capital base can be reduced. To allow aggrieved investor claims to rank with general creditors is to permit a depletion of the company's capital base in a manner neither sanctioned by, nor regulated in the provisions of, the Corporations Act. The irony here is that the regime for regulation of reductions of capital set out in the Corporations Act has as its raison d'etre the protection of creditors in a prospective insolvency - the very circumstance identified as requiring protection is now (ie. post *Sons of Gwalia*) the trigger for avoidance of that legislative protection. Compounding this irony is the very real prospect, as

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133 The Law Reform Commission Report No. 45, General Insolvency Inquiry, vol 1, para 1 (Harmer Report).

134 Callinan J at para 256.

135 John Slain and Homer Kripke, 'The Interface Between Securities Regulations and Bankruptcy' (1973) 48 NYU L Rev 261 at 298.

identified by Justice Callinan in his judgment in *Sons of Gwalia*,[136] that general creditor claims could end up being swamped, with the company's capital being almost completely depleted by aggrieved investor claims.

Practical implications arising out of Sons of Gwalia decision

The ABA strongly recommends that CAMAC take steps to inform themselves in two areas regarding the practical implications of the *Sons of Gwalia* decision. First, CAMAC should consult with the appointed insolvency practitioners administering the affairs of publicly listed companies that are the subject of aggrieved investor claims - for example ION (where thousands of shareholder claims have been filed) and Sons of Gwalia itself. In this way, CAMAC can review the practical issues by reference to first-hand informed accounts of the impact of the *Sons of Gwalia* decision.

Secondly, CAMAC should inform itself regarding the Ingot litigation,[137] these proceedings providing a useful case study regarding an aggrieved shareholder claim advanced in relation to a publicly listed company. In that case, one aggrieved investor in a publicly listed reinsurance company claimed relief for having invested in a capital raising. The reinsurance company was placed in provisional liquidation within a matter of months of the capital raising in 1999. The investor commenced proceedings in 2001, including claims against parties involved in issuing the prospectus. CAMAC's attention in particular is drawn to the following aspects of Ingot proceedings:

- The proceedings were filed in 2001, but only reached a hearing in the Supreme Court that commenced in 2005.
- The investor's claims led to multiple cross claims being issued. In all, around 15 parties participated in the proceedings, with no fewer than 37 cross claims.
- The hearing took 108 sitting days.
- Judgment was issued in 2007.
- While the company issuing the rights, notes and shares to the investor was in liquidation, as was one of its subsidiaries, leave was granted by the court to proceed against both companies notwithstanding that they were both in liquidation. That then burdened the liquidator of those companies with the choice of either not participating in the proceedings (and thereby risking substantial additional claims being established against the company by default), or participating in the proceedings (so as to ensure general creditors of the companies did not have their dividend diluted) at the cost not only of engaging lawyers to conduct the proceedings, but the risk of adverse cost orders. Costs incurred by the subsidiary in defending the proceedings amounted to many millions of dollars, in addition to the risk of adverse costs orders.
- The investor lost the proceedings, principally on the basis that he did not demonstrate reliance.
- The investor has appealed to the New South Wales Court of Appeal, and further years of delay are likely to be encountered before the claim is finally

136 Callinan J at para 256.

137 See judgment of McDougall J in *Ingot Capital Investments Pty Limited v Macquarie Equity Capital Markets Limited*, Supreme Court of NSW, 30 March 2007.

> resolved. There is also the prospect of other aggrieved investors lodging proofs of debt in the liquidation should the investor ultimately be successful, or should other investors consider they can overcome the reliance impediment that defeated (at first instance) the plaintiff investor's claim.

AFMA

It should be noted at the outset that the timeframe between the handing down of the High Court's decision and the release of the Committee's Report has been relatively short to make a full assessment of its impact.

However, there are already indications of negative changes in financial market practices, particularly in the US corporate bond investment market.

While the *Sons of Gwalia* decision may be correct in terms of statutory interpretation, the practical consequences and policy outcomes are far reaching, potentially creating increased financial costs, reductions in the available capital and inequitable relationships between competing interests.

AFMA submits that the Committee needs to be mindful of the fact that the availability of unsecured debt capital is based on risk appetite which is to a large extent dictated by cyclical financial market trends. Currently there is a degree of uncertainty prevailing in international financial markets and, in these circumstances, the *Sons of Gwalia* decision is added element of concern.

AFMA supports Option 2 as the preferred response to the *Sons of Gwalia* decision for the reasons provided in this submission.

AFMA supports the modification of section 563A designed by Mr. Justice Michael Kirby in His Honour's judgment by deleting the words 'a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise' and replacing them with 'a debt owed by a company to a person who is a member of the company'.

Debt/equity distinction

AFMA agrees with the argument that there is an important distinction between equity and debt in the context of a corporation.

In the event of corporate insolvency, shareholders' liability is limited to their equity interest, but in the event of corporate growth, shareholders enjoy unlimited gains.

While it may be said that aggrieved shareholders should not make equity investment decisions in a company based on false and misleading information issued by the company and it may be unreasonable that they suffer loss as a result, the equity investment decision itself is nevertheless motivated by the potential of a capital gain.

Unsecured creditors are not in the business of investing and are not so motivated, being the suppliers of goods and services to companies without any prospect or expectation of a capital gain, but are exposed to loss of unpaid goods and services upon corporate insolvency.

Investors, both large and small have a natural ability to assess corporate performance through access to advice and information. However, creditors and in particular the small business sector, do not have the same natural capability or access to information and may be even more exposed to corporate risk. This is also reflected in the structure of the Corporations Act 2001 in Chapters 6 and 7 where greater protections are

afforded to the most vulnerable in terms of their capability to access and process information in an efficient way.

In that regard, it is unreasonable and inequitable to treat equity investment decisions which carry inherent elements of risk and reward in the same way as the supply of goods and services in the ordinary course of business and which are expected to be paid for.

AFMA also agrees with the following arguments that:

- Shareholders have statutory rights with respect to company directors as their appointees and against whom they have personal rights of recovery in the event of misconduct. Conversely, creditors have no such rights;
- Equity investors manage risk through the freedom of diversification, whereas creditors may not have such choice and be exposed to greater risk in the event of corporate failure;
- The increased administrative burden of corporate insolvencies inherent in aggrieved shareholder claims will increase costs, create delays and reduce remaining capital available to meet creditors' exposures;
- Efficient markets involve 'expeditious and cost-effective administration of insolvent companies' and this would be detrimentally affected by aggrieved shareholder claims;
- 'Prices offered to unsecured creditors seeking to transfer their rights in the secondary or distressed debt market' would be detrimentally affected by aggrieved shareholder claims;
- Changing the law would create certainty, consistency between Australian, US, Canadian law and competitive equality with these and other markets;
- All aggrieved shareholder claims, either arising as a result of *Sons of Gwalia* or from fraud on the market, should be subordinated to secured and unsecured creditor claims.

Law Council – Insolvency Committee (majority)

Members of the Law Council Insolvency and Reconstruction Committee do not have a unanimous view concerning whether shareholders should be able to bring claims against the company of which they are members. However, the vast majority of members of the Committee support a change in the law to restore what was thought to be the position in respect of shareholder claims after the decision in *Webb Distributors*, consistent with Option 2 in the Discussion Paper.

Debt/equity distinction

Shareholder should not be entitled to prove shareholder claims in competition with creditors

A United States commentator has noted '[a]n almost axiomatic principle of business law is that, because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the businesses' collapse up to the full amount of their investment.'[138]

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[138] Warren E, *Bankruptcy Protection* (1987) 54 U Chi L Rev 775 at 792.

A similar point was made by the Canadian Parliament's Standing Senate Committee on banking, trade and commerce in November 2003,[139] which stated (at p 159):

> *... in view of the recent corporate scandals in North America, the committee believes that the issue of equity claims must be addressed in insolvency legislation. In our view the law must recognise the facts in insolvency proceedings: since holders of equity have necessarily accepted – through their acceptance of equity rather than debt – that their claims will have a lower priority than claims for debt, they must step aside in a bankruptcy proceeding. Consequently their claim should be afforded lower ranking than secured and unsecured creditors, and the law – in the interests of fairness and predictability – should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full.*

Consistent with this logic, the Canadian companies legislation has been proposed to be amended, specifically to postpone the claims of shareholders behind those of general creditors (see paragraph 6.4 of the Discussion Paper).

To allow shareholders to prove claims of the kind considered in *Webb Distributors* and *Sons of Gwalia* – in competition with ordinary unsecured creditors – is inconsistent with the whole notion of limited liability and the unavoidable risks of investing in shares. The explosion in popularity of listed companies as an investment class (whether by individual investors or through superannuation funds and the like) should not be allowed to obscure two fundamental facts, namely that:

- buying shares with a view of profit carries concomitant benefits and risks of a character entirely different to those assumed by a trader expecting payment from a company for the supply of goods and services; and
- a company is an artificial creation of which all the shareholders are owners and therefore, in that sense, not in an external relationship with the company.

fairness

Allowing shareholder claims is unfair. The unfairness is not only as between shareholders and ordinary trade creditors (who are not taking risks in order to make capital profits) but also, as Callinan J pointed out in *Sons of Gwalia* [140] as between shareholders themselves. As Callinan J pointed out, purchasers in Mr. Margeretic's position were not the only ones to have suffered by reason of the company's failure to comply with its continuous disclosure obligations. If claims of the type allowed in *Sons of Gwalia* are to be allowed, where is the line to be drawn? What is the difference between a person in the position of Mr. Margeretic who purchases his shares soon before the appointment of administrators, and long term shareholders who have held on to their shares in ignorance of the true position? If all such shareholders can claim, corporate cannibalism will be the consequence: shareholders suing the company – in ultimate effect, themselves – to obtain compensation for a 'loss' which they have all suffered.

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[139] Debtors and creditors sharing the burden: *A Review of the Bankruptcy and Insolvency Act* and the *Companies Creditors Arrangement Act*.

[140] At para [256].

administrative burden

In addition to the point already made concerning relative assumption of risk, a compelling reason for preventing shareholder claims is that the delays, increased complexity, increased costs and increased Court involvement, which are their inevitable consequence, are antithetical to the efficient administration of an insolvency regime. In particular, the bringing of such claims is inconsistent with the efficient working of Part 5.3A of the Corporations Act, which is almost universally regarded as a successful mechanism for reorganising insolvent corporations. The Committee submits that when Parliament enacted the corporate reconstruction regime which is now in Part 5.3A of the Corporations Act, it did so on the assumption that shareholder claims could not be brought. The ability to bring such claims is also inconsistent with the worldwide trend towards seeking to rehabilitate corporations, and the enactment of legislation to enable this to occur readily. The only people likely to benefit in practice from shareholder claims are lawyers and accountants, who will be able to generate considerable fees from prosecuting and dealing with them, to the detriment of ordinary trade creditors.

Although the issue of shareholder claims is in practice likely to be confined to listed companies (or at least corporations with many shareholders), these are also the types of insolvencies that tend to give rise to the largest losses. They also have the most scope for insolvency practitioners to be able to bring about a speedy reconstruction and rescue of the company's business in order to minimise creditor losses. Experience in the administrations of Sons of Gwalia Ltd and Ion Ltd show that shareholder claims are jeopardising these aims. Although not easily quantifiable or politically fashionable, an efficient, certain and workable insolvency reconstruction regime is of crucial importance in a market economy. Experience shows that compliance with the underlying purposes of Part 5.3A is severely compromised if shareholder claims are allowed.

In cases where a *Sons of Gwalia*-type claim is made, the cost and time involved in the process of assessing and admitting proofs of debt will increase, with a corresponding reduction in the amount available for distribution among creditors.[141] An administrator or liquidator is responsible for assessing and adjudicating upon creditors' claims. The scope of the duty extends beyond dealing with claims which are volunteered to the practitioner and requires him or her to invite proofs from persons who may have claims which have not been lodged.[142] The practitioner is duty bound to examine the books of the company and to notify creditors who otherwise come to his or her attention.[143] There is a boundary beyond which practitioners need not tread: an administrator need not take 'active steps to seek out non-obvious creditors … who had suffered economic loss only'.[144] As far as shareholder claimants are concerned, the register of members provides the obvious starting point for the practitioner's

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141 The Committee acknowledges the assistance of Stewart Maiden, Barrister, from whose unpublished paper on the implications of Sons of Gwalia this paragraph and paragraphs [11]-[13] have been drawn.

142 *Re Autolook Pty Ltd* (1983) ACLR 409; *Harry Goudias Pty Ltd v Port Adelaide Freezers Pty Ltd* (1992) 10 ACLC 499; *Re Graf Holdings Pty Ltd*; *Larking v Australian Securities and Investments Commission* [1999] NSWSC 217; *John Frederick Lord as Liquidator of Silver Line Technologies Pty Ltd* [2005] NSWSC 620, [32].

143 *Pulsford v Devenish* [1903] 2 Ch 625; *James Smith & Sons Ltd v Goodman* [1936] Ch 216; *Harry Goudias Pty Ltd v Port Adelaide Freezers Pty Ltd* (1992) 10 ACLC 499.

144 *Selim v McGrath* (2002) 47 ACSR 537, 571 [126].

inquiry, but how far back must he or she go in identifying shareholders who might assert a claim against the company? In what circumstances might it be said that such a duty arises? The individual circumstances of particular shareholders may give rise to a wide variety of dates at which the relevant cause(s) of action against the company arose.

The difficulties faced by practitioners in determining whether and in what circumstances there might be an obligation to notify potential claimants might be said to be minor compared to the task they face in assessing and determining claims once made. Once details of a claim are determined and a proof is lodged, the administrator's or liquidator's duty is to act 'quasi-judicially' and according to standards no less than those required of a court.[145] It is in the nature of the collapse of such companies that many such claims are likely to emerge. For example, as at June 2007, some 5,344 shareholder claims had been made in the Sons of Gwalia administration, claiming a total of $250.5 million.[146] The administrators of a deed of company arrangement in the administration of Ion Ltd have reported that more than 3,200 shareholder proofs have been lodged in that administration, totalling $122 million.[147]

The complexity involved in 'acting judicially' in determining each shareholder's claim imposes a heavy burden on practitioners. One practitioner has said that the burden 'threatens the objective' of s 435A of the Corporations Act of maximising the chances of the company or its business continuing in existence, and undermines speed, which is another of the foundational objectives of Part 5.3A.[148]

NSW Law Society Business Law Committee

COMMITTEE OPINION IN SUPPORT OF OPTION 2

Members of the Committee who share in this opinion, in principle, support Option 2 of the discussion paper, being to reverse the law as determined in *Sons of Gwalia*. The *Corporations Act* 2001 ('the *Act*') should be amended such that claims by shareholders that arise from circumstances in connection with their shareholding should be postponed until all other debts and claims have been satisfied.

Specifically, section 536A of the *Act*, which already postpones a debt owed by company to a person in that person's capacity as a member of the company, is the preferred statutory vehicle for achieving such an amendment. The phrase '*debt owed by the company to a person in the person's capacity as a member of the company*' could be defined on an inclusive basis to include claims arising from circumstances relating to the acquisition of shares whether by direct issue by the company, on the market, or by private treaty.

This involves a relatively simple amendment and would bring the current law in line with what was generally accepted commercial practice and understanding prior to the High Court's determination in *Sons of Gwalia*.

The benefits of reforming the existing law are:

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145 *Tanning Research Laboratories Inc v O'Bryan* (1990) 169 CLR 332, 338-40.

146 Ferrier Hodgson, *Deed Administrators' Report: Sons of Gwalia and Certain of Its Subsidiaries*, 14 June 2007, 25.

147 McGrath + Nicol, *Ion DOCA Group Deed Administrators' Update*, 20 September 2007, 2.

148 Mark Korda, 'Gwalia ruling creates need for new legal category of aggrieved shareholder', *The Age*, 1 February 2007.

a) The rights of shareholders who may have a claim against the company are preserved so they would be entitled to seek recovery from a solvent company;

b) Their claims are merely postponed in the case of an insolvent company and not extinguished in the event there is a surplus after paying other claims. This may be relevant where the extent of their claim exceeds their entitlement prescribed by their shares;

c) It acknowledges the principle that because equity owners stand to gain the most when a business succeeds they should absorb the costs of the businesses collapse up to the full amount of the investment;

d) The administration of insolvent companies is likely to be made significantly more difficult, subject to further delays, and become more costly if the *Sons of Gwalia* decision remains in place. This is because it could be argued that nearly every insolvent company, through its management or other sources, misled equity investors by omission or otherwise, resulting in them acquiring equity, or for that matter, not being given the opportunity to divest themselves of their equity in the company. Until these claims are resolved it would be imprudent for a liquidator or deed administrator to declare a distribution to creditors;

e) This becomes particularly problematic in the case of voluntary administrations and deeds of company arrangement. In order for an administrator to be able to recommend to creditors that a deed of company arrangement should be accepted or otherwise, and for creditors to be able to determine whether they will vote in favour of a deed of company arrangement, they need to know the extent of the claims upon the company and the likely distribution to creditors. The limited timeframe in which an administrator has to investigate the affairs of the company and report to creditors means that creditors cannot be adequately informed. Therefore creditors are less likely to support a reconstruction of a company through a deed of company arrangement due to this uncertainty; and

f) The Committee concurs with the comments in Chapter 5 of the Discussion Paper dealing with the broader implications of the *Sons of Gwalia* decision, in particular the implications for access to and the cost of debt finance.

Conclusion

This opinion concludes that proposed Option 2 should be adopted.

In the alternative, members of the Committee who support proposed Option 1 agitate that the principles of *Sons of Gwalia* decision should stand, and the effect should not be reversed.

IPA

Summary of the IPA submission

The IPA submissions are:

- The law should be changed to exclude shareholders' claims as creditors in the insolvency of a company if those claims are based on the purchase or retention of shares.
- This view is based on the general approach of corporate and insolvency law that shareholders are given a reduced status in an insolvency and can be liable to contribute to the assets of the failed company. This view is reinforced by particular issues that arise when aggrieved investors make claims as creditors that unduly add to the complexity, cost and time in finalising an administration. The IPA explains those issues.
- If the law is not to be changed, and shareholders are permitted to make claims as creditors, the IPA considers that a particular tailored regime should be introduced to clarify the obligations and position of an insolvency appointee. That regime would involve changes to the legislation and regulations.

Shareholders as creditors

The IPA considers that the law should be changed to exclude shareholders' claims based on the purchase or retention of their shares, such as applies in the US.

The IPA accepts that shareholders who have been misled by company mis-information are creditors under the current law. They are, as the High Court has found, creditors in their capacity other than as members: s 563A. Nevertheless, we consider that there are other reasons to exclude such shareholders as creditors. Unlike creditors, shareholders have the potential to participate in the dividends and share gains of the company, as owners of the company; they also take the risk of a loss in share value. In the absence of the company's insolvency, those shareholders may have a valid claim against the solvent company. However, once the company enters insolvency, we consider that the risk assumed by shareholders should be broadened to include the risk that the purchase or retention of their shares was based on company mis-information.

Although there is some distinction between existing company members who are misled into buying more shares or retaining existing shares, and new subscribers misled into buying shares, we do not consider that is a distinction that should remain in the context of the company's insolvency.

The reasons for this are that corporate insolvency law has historically regarded shareholders as part of the insolvent company. They become contributories and as such are liable to pay any amount unpaid on their shares: s 515. They are only entitled to share in the assets of the company in the event that surplus funds are available. These are aspects of the risk they take in becoming shareholders.

Non-member creditors are in a different category; they simply expect their debt to be paid. In an insolvency, they invariably receive a limited dividend return, shared pari passu with other like creditors. The inclusion of contributory claims would necessarily dilute the dividend return of those other creditors.

The IPA considers that such claims as 'creditors' in relation to the purchase or retention of shares falls into a sufficiently different category than a non-member creditor such that the law should exclude their claims.

This view is supported by the inherent difficulty in dealing with such claims in an insolvency administration. These difficulties – as to the holding of creditors' meetings, determining rights to vote, and other issues of time and cost - are discussed in the submission below.

If this view is accepted, there may be other existing or new legal avenues to allow aggrieved investors to seek recompense for their losses, for example against the company directors or management. Under existing insolvency law, personal liability can be imposed on directors, for insolvent trading and in relation to certain tax liabilities. Directors and others may be also liable under ancillary liability provisions, for example s 79 *Trade Practices Act*, despite the company's insolvency. The IPA does not address the policy issues involved in whether such liabilities should be extended in the case of share purchases.

We also clarify that shareholders should not be excluded in relation to all claims as creditors. A shareholder may also be a trade creditor, or have other claims against the company other than as a share subscriber, and these claims should remain. Such claims are not part of the following analysis.

Law Institute of Victoria

This Submission supports **Option 2: reverse the effect of the law** as determined in ***Sons of Gwalia***, for the reasons outlined in section 7.4 of the Discussion Paper.

However, this Submission seeks to add to the analysis and commentary outlined in these sections by emphasising the 'fairness' or 'relative merits' implications of the decision for creditors, aggrieved investors and other investors.

No further comments are made in respect of the other sections or topics dealt with by the Discussion Paper. Expressions used in the Discussion Paper have been used here, where appropriate. The decision of the High Court in the Sons of Gwalia case is referred to as 'the Decision'.

Context

The following aspects of the context of the issues raised need to be borne in mind:

- From a functional perspective, notwithstanding its separate legal entity status, a company is an aggregation of assets and liabilities (or a fund) in which different classes of stakeholders have different economic interests. In an insolvency administration those interests are partially defined by the order of distribution of the realised proceeds of the administration.
- The Board and 'senior management' act effectively as the stewards of the enterprise on behalf of the various stakeholders. The ultimate accountability for the conduct and success or failure of a company rests with its Board of Directors and senior management. Fundamentally, all investment decisions by shareholders/investors are made on an understanding or expectation of the performance of the Directors and senior management.
- The only stakeholders who can influence the selection, composition, performance and activities of the Board and senior management are the shareholders/investors.

- The conduct of the company which is the basis for the claim by the aggrieved investors (the lack of or inappropriate disclosure or misrepresentation) was not, in all likelihood, the cause of failure of the enterprise. However, the Board and senior management are again ultimately accountable for the particular conduct the basis of the claim.
- This is a question of the order of priority of distribution of proceeds in an insolvency administration. So the issues of the fairness of the existence of the claim by the aggrieved shareholder are not relevant. Claims by aggrieved investors may be verified and sustained. But the question becomes whether the pool of funds available in insolvency should be available in such an order of priority that the aggrieved shareholders recover with the other creditors as opposed to with the other shareholders – which is the effect of the Decision.

Effect of Decision

The impact of the decision can be assessed at two levels. The effect on:

- the distribution of proceeds in an insolvency administration; and
- the resulting pattern of incentives relevant to decisions about entering into a relationship with a company that may become insolvent.

The Discussion Paper does a good job of describing these implications. This Submission would like to add to the 'relative merits' discussion and commentary.

Relevant Stakeholders

We consider the relevant stakeholders affected by the Decision are:

- unsecured creditors;
- shareholders who acquired shares prior to or without reference to the conduct that resulted in the aggrieved shareholders;

shareholders who acquired shares as a result of the relevant conduct and consequently became aggrieved shareholders.

There are other categories of stakeholders that could be discussed (directors, employees, secured creditors and so on), but these categories are sufficient for the purposes of the Submission.

Prior to Insolvency

Prior to insolvency if a claim by an aggrieved shareholder is sustained, the cost of the claim is borne by all shareholders at the time of payment. Essentially there is a redistribution of the residual assets of the company from the other shareholders to the aggrieved shareholders.

Because this is pre-insolvency, no value has shifted from the creditors and they can expect to be paid in the usual course, unless the company becomes insolvent. Of course, the net assets of the company may have been reduced, and this may affect the credit worthiness of the company and the likelihood of receipt of payment by the creditor.

Post Insolvency

Post insolvency, if the Decision is not varied, what was effectively a sharing of the proceeds of the company between shareholders (a distribution to the aggrieved

shareholders from the other shareholders) now becomes a contest between the aggrieved shareholder and the creditors. Other shareholders are further postponed.

Reason for Loss – Reliance upon Senior Management and Board

The aggrieved investors claim loss because of reliance upon the accuracy and trustworthiness of representations made by the company in assumed (but mistaken) compliance with responsibilities attaching to disclosure. Again, a company acts through individuals, and the 'reliance' ultimately is about reliance on the adequacy and performance of directors and senior management in fulfilling their disclosure responsibilities.

Similarly, other investors who retained or acquired their shares/equity but not in reliance upon a particular misrepresentation or disclosure failure, relied ultimately on the performance of directors and senior management, albeit in respect of their stewardship responsibilities generally. Aggrieved investors would have acted in making their investment decisions upon a similar basis.

Both classes of investors have acted upon and trusted the Board of directors and senior management.

Similar comments can be made about the position of creditors extending credit to the company.

Relative Merits of Priority of Distribution of Realisation Proceeds in Insolvency.

As can be seen from the foregoing discussion, the errors made by all stakeholders and the substantive cause of the losses were in respect of the activities of Directors and senior management.

On what basis can the merits of the stakeholder claims to the proceeds of an insolvency administration be distinguished? In our view the substantive difference is the responsibility of the shareholders for the selection and performance of the directors and senior management. Creditors cannot readily influence the selection and composition of the stewards of the organisation. The equity holders can so influence, and accordingly should shoulder responsibility for the appointment of directors and senior management.

In addition, equity holders have the prospect of enhanced returns. Associated with those higher expected returns, equity holders have accepted more readily the bearing of the higher risks. Creditors have not.

It is submitted that the foregoing is the correct basis for determining the relative priority of distribution of the proceeds of an insolvency administration between creditors, aggrieved investors and other investors.

7.2.2 Option 2 and other equity-linked interests

Baker & McKenzie

In response to paragraph 7.4.2 of the Discussion Paper, we agree that, in order to achieve consistency of approach, the subordination principle should also be applied to the holders of equity-linked derivatives such as options and warrants. Not only would this be consistent with proposed amendments to Canadian law, but it would also be consistent with the application of the United States 'absolute priority' principle to option holders: see *In re Enron Corp* 341 BR 141 (Bankr, SDNY 2006).

Law Council – Insolvency Committee

The Committee agrees that if option 2 were adopted, 'equity-linked claims' should also be subordinated.

IMF

It seems logically inconsistent that shareholder claims be postponed while investors other than those who become shareholders (for example, those that purchase options or convertible notes) are creditors whose claims have never been postponed. Moreover, it seems curious that the claim of one shareholder who sells all of his shares prior to the company entering external administration not be postponed, whereas the claim of another shareholder who is still holding his shares on the date of administration would be postponed. And if the same shareholder buys shares in an uninformed market and only sells some of them prior to the company entering administration, it seems an unusual result for him to have a full claim in respect of some but not all of the shares. These issues and others will need to be addressed if shareholder subordination is supported.

ABA

The ABA suggests that consideration to any reform should also consider encompassing the extension of the subordination principle from shareholders to subordinated debt.

7.3 Option 3: Option 2 with sub-category of aggrieved investor claims

7.3.1 Support Option 3

KordaMentha

Executive Summary

KordaMentha applauds the legislative reforms made by the Government, in particular those that:

- maximise the chances of the company, or as much of its business as possible, continuing in existence;
- ensure creditors receive the maximum possible returns from insolvent companies; and
- allow creditors to receive returns in the shortest possible timeframe (a recent example of this occurrence is the return of monies to the aged Fincorp investors).

It is abundantly clear that if aggrieved investor claims are elevated to rank equally with those of conventional unsecured creditors, the result would:

- reduce the chances of the company, or as much of its business as possible, continuing in existence;
- cause a decrease in creditors' returns because of the increased cost of the administration; and
- extend the time creditors must wait for a return for up to five years.

Accordingly, KordaMentha recommends legislation be amended to subordinate aggrieved investors claims behind unsecured creditors.

If shareholders with valid claims for misrepresentation are to be recognised in priority to the general body of shareholders, KordaMentha recommends that the Government introduce legislation to escalate their misrepresentation claims ahead of the general shareholder body, but behind those of unsecured creditors.

Thus, KordaMentha believes the current legislation should be amended to ensure the distinct treatment of aggrieved investors from general members that are captured by Section 563A of the Act.

However, these aggrieved investors should not rank equally with conventional unsecured creditors as they are a distinct creditor group with different incentives. That is, on exposing themselves to risk with the company, an unsecured creditor will largely be carrying on its ordinary course of business (including members that operate as traders) whilst an aggrieved shareholder will generally be looking at an investment to complement its current risk portfolio via applying its discretionary income to invest as a shareholder.

IPA

We note that one option is for shareholder claims to be ranked higher than ordinary member claims that are postponed under s 563A, with some possible variation between administrations and liquidations (7.2 of the discussion paper). The IPA would not support the differing priority of such claims between a liquidation and a deed of company arrangement, for the reasons given in the discussion paper, and as a matter of principle.

ABA

The ABA supports an amendment to the law along the lines of the proposed option 3. In addition, the ABA suggests that consideration to any reform should also consider encompassing:

- the subordination to equity-linked investors (as described in section 7.3.2);
- the extension of the subordination principle from shareholders to subordinated debt;
- the extension of the subordination principle to derivative actions (to the extent that this is necessary in light of the proportionate liability legislation); and
- the subordination of aggrieved investor claims against an affiliate of a listed company.

Nehme and Wee

General Observations:

The observations made in this submission can be summarised in the following manner:

- There is no direct evidence of Australian financial institutions changing their approach to providing corporate finance if the decision in *Sons of Gwalia* continues to apply. However, there is a high likelihood that credit would rise in such an instance due to the heightening of the risk for creditors.

- It is likely that in the near future, the cost and availability to Australian companies of US and other overseas finance are going to be negatively impacted.
- It is likely that there would be negative effect on the assessment of Australian companies by rating agencies if the High Court's decision on *Sons of Gwalia* is retained.
- Voluntary Administration should not take into consideration aggrieved investors' claims.
- The Corporations Act should be amended to reverse the effect of the High Court decision in *Sons of Gwalia*. There is a need for the establishment of a new internal ranking of shareholder claims.

Whether the current law should be retained or amended in regards to aggrieved investors' claims?

The Corporations Act should be amended to reverse the effect of the law as determined in the High Court decision, with an internal ranking of shareholder claims. We strongly believe that option 3 proposed in Chapter 7 [of the discussion paper] should be adopted.

Aggrieved investors should not be entitled to participate as creditors in a voluntary administration or liquidation and their claims should be postponed behind secured and unsecured creditors. Reasons (beside those already stated in our consideration in relation to the issues in chapter 5 [of the discussion paper]) for this suggestion are discussed below:

Debt/equity distinction

To attract foreign investment into Australia, it is crucial to have a very clear set of corporation law. Therefore, the debt-equity distinction is of utmost importance to be maintained if Australia were to continually attract foreign investment into the country.

Fairness

When deciding if aggrieved investors' claims should be subrogated to the creditors' claims or not, it is important to keep in mind the policy behind the introduction of the different legislations that apply today. When dealing with aggrieved investors' claim and the need for subrogation, two conflicting policies may appear and they are the following:

- Insolvency laws aim to foster strong economic market through certainty in the credit market. Accordingly, from the insolvency perspective, most creditors advance loans based on the certainty and the lack of risk regarding their claims and shifting the priority of payment may affect the availability of credit (see our consideration on the issues raised in Chapter 5 [of the discussion paper]).
- Securities Laws enhances global capital markets and develop confidence in the market through protection of investors. Accordingly, from the security law perspective, there should be meaningful remedies to deal with markets violation and protect the right of investors. A lack of protection may affect the confidence of the market and investors may not wish to continue investing in the market.

These two policies conflict in a scenario like the one in *Sons of Gwalia*: The creditors should be protected and the members who have been misled should also be protected. The case of *Sons of Gwalia* leans toward securities law aims by protecting the investors, leaving creditors in a vulnerable position. Finding a balance between these two policies in the case of *Sons of Gwalia* is difficult however we believe that option 3 may reach such a compromise by postponing the claims of shareholders.

In the US, absolute priority rule seemed to apply after a long debate over the position of creditors and members around the 19th century. However certain cases such as the *Northern Pacific Railway v Boyd* started emerging and the question of absolute priority reappeared again. The Securities and Exchange Commission (SEC) noted that rescinding members should share equally with general creditors rather than take after them. Accordingly the debate in relation to the subordination of such members claim intensified around the 1970's.

Slain and Kripke noted that there are two different risks that may appear: The risk of business failure and the risk of being misled into buying shares in a company. Both creditors and shareholders have the first of these risks, but the investors accept a greater exposure in return for their greater opportunity to participate in the business success. Slain and Kripke noted that this allocation of risk should remain the same and should not be altered because:

- The capital provided by the members motivates creditors to loan money to the corporation.
- It is 'difficult to conceive of any reason for shifting even a small portion of the risk [risk of being misled into buying the shares in the company] from the stockholder since it is to the stockholder, and not to the creditor, that the stock is offered'.

This argument of risk allocation convinced the Bankruptcy Commission to support subordination of members' claims and led to the introduction of mandatory legislation into the statute on 6 November 1978.

As a matter of fairness, creditors should rank before shareholders – since shareholders are entitled to unlimited upside benefits if the corporations perform well financially; while debt-holders are only entitled to the face value of their debt instrument plus interest regardless of how profitable the business performed. Kirby J noted that in the case of a conflict between the claims of creditors and the claims of aggrieved investors 'it is not difficult (at least for me) to feel a greater sympathy for the general creditors and their claim to priority in the recovery of their claims.' Furthermore, Callinan J observed that in such cases 'it is not difficult to imagine a situation in which claims of a large body of shareholders, perhaps most of them, would dilute the creditors' rights to less than a trickle'. Callinan J continued by noting the unfairness of such a tendency'.

Administration burden

Two administrative burdens come to mind:

- Administrative burdens generated by the involvement of aggrieved investors' in the voluntary administration (see our considerations in relation to the issues raised in Chapter 4 [of the discussion paper]).
- Litigation: Allowing the members' to claim damages for misrepresentation in relation to the acquisition of their shares at the same level of creditors may

lead to the rise of class actions. If the relevant sections in the Corporations Act are to remain as it is, the hope to recover parts of the investment would undoubtedly trigger hopeful shareholders to approach or be approached by litigation funders, whom would act in behalf of shareholders seeking claim as creditors in company administration. Though litigation funders have provided fair-play opportunity to small investors that do not have sufficient money to take action against large corporations when the companies are in liquidation, there are several issues that litigation funders themselves pose.

There are only a few litigation funders operating in Australia, due to the small size of the potential market. These litigation funders typically do not represent investors that lost money in companies with less than $2m capital ; otherwise it would not be profitable for the funders. Hence, small investors from small companies would not be able to take action against the companies, if they could not raise sufficient fund to do so themselves. The inability of small companies' investors to find a litigation funder to represent them has counteracted the whole idea of 'fair-play'.

Representation by some litigation funders would involve an up-front fee typically ranging between $100 - $550; though some litigation funders do not charge any up-front fee. This is somehow unfair to small and uninformed shareholders: on one hand, they do not want to miss out on any chance of recovering parts of their investment; on the other hand, to pay an upfront fee does not provide any sort of guarantee towards the recovery of their investment especially because they have to prove reliance and causation to be able to have a successful claim (see Chapter 3 [of the discussion paper]).

Another issue regarding litigation funders is their incessant attempt to use companies' register for the purpose of contacting shareholders as potential litigants. IMF (Australia) Ltd had tried ceaselessly to use Sons of Gwalia company register for this purpose, despite the fact that section 177 of the Corporations Act 2001 has explicitly prohibit any use of information obtained from a register to contact or send material to the shareholder except in certain circumstances. In May 2005, the Federal Court has ruled against IMF (Australia) Ltd's attempt to use the Sons of Gwalia Ltd share register to contact shareholders for an invitation of class action against the company. Nevertheless, on 16 March 2006, ASIC has accepted an enforceable undertaking from Shareholder Advocacy Pty Ltd in relation to their prohibited use of shareholders' information on company registers to issue unsolicited mailouts offering to lodge proof of debts and offer certain services to shareholders, for a fee, with three companies in administration – ION Ltd, Sons of Gwalia Ltd and Henry Walker Eltin Ltd.

Furthermore, litigation funders might not be acting ethically while they are in the race of recruiting clients from the pool of 'potential aggrieved investors' from companies that go into administration. For example, Shareholder Advocacy Pty Ltd, in the letters they sent to shareholders from company under administration, has failed to inform shareholders that shareholders themselves can lodge a proof of debt with an administrator without the assistance of professionals, and without any cost involved; and uninformed shareholders might be misled and under the false impression that all shareholders are

entitled to lodge proofs of debt in company administration, even if they did not satisfy the pre-requisite such as purchasing the shares on the open market.

If litigation funders were to take a more active role in the events of company liquidations, there are a few things to note: (1) More competitions among litigation funders need to be encouraged to avoid an oligopolistic market and to create a more efficient funding environment; (2) Litigation funders need to be closely monitored to ensure compliance to the law and so that small and uninformed investors' welfare are taken care of as well.

Efficient markets

An efficient financial market requires a set of clear and easily executed corporation law, stable political and economics platform, and high level of competition among all market participants. If Australia were to retain the High Court decision on *Sons of Gwalia*, it would have negatively impacted upon the efficiency of the Australian market – in terms of the ambiguity of the debt-equity distinction; and the prolonged period of liquidation settlement. The delay in liquidation settlement will make the market less liquid, hence less efficient.

Consistency with North American law

Option 2 would not necessarily make Australian Laws consistent with the US laws. Neither would option 3. Even though the principle applied in the US is the subordination of members' claims to creditors' claims, this principle has been tempered by the introduction of the Sarbanes-Oxley Act of 2002. Section 308(a) of the Sarbanes-Oxley Act allows the SEC to place a civil penalty obtained from the company for violations of the federal securities law into a disgorgement fund to be distributed to injured investors. Maybe an introduction of such a section in the Australian legislation may be desirable in Australia because it may add a protection to investors. Instead of the pecuniary penalty going to the Commonwealth, ASIC may have the discretion to give such a pecuniary penalty to the investors.

Argument relating to class actions

See comments on Litigation funders in the paragraph on administrative burden.

Conclusion:

Though aggrieved investors are ranked after all creditors, their claims should rank above member claims that are postponed by s 563A. Hence, the order for recovery in liquidation, in line with option 3, would be:

- Secured claims
- Priority secured claims
- Ordinary unsecured claims
- Aggrieved investor, and other equity-linked, claims
- Remaining shareholder claims.

Duncan Brakell

If, in the event, the Parliament determines that s 563A is to be amended such that it favours US drafting, then I would support proposed Option 3.

AFMA

AFMA is generally in favour of Option 3 as an alternative to the preference expressed for Option 2 for the reasons expressed at 7.4.

Law Institute of Victoria

If [Option 2] is not acceptable for whatever reason, this Submission supports Option 3, (Option 2 with sub-category of aggrieved investor claims) for the reasons set out in section 7.5 of the Discussion Paper.

7.3.2 Oppose Option 3

Baker & McKenzie

We agree with the Committee's position that a statutory elevation of aggrieved shareholder claims to a position ranking after ordinary unsecured creditors' claims, but before members' claims of the nature captured by section 563A of the Corporations Act, would produce little advantage to aggrieved shareholders.

Moreover, Option 3 implicitly requires that aggrieved shareholders be able to participate in the external administration process as creditors. For the reasons set out in section 4, such participation ought not be permitted.

NSW Law Society Business Law Committee

The Committee does not, however, support Option 3 in the Discussion Paper which involves reversing the law and creating a subcategory amongst shareholder claims for aggrieved investor claims which would take priority over other shareholder claims. This would create its own set of uncertainties as it could be argued by some investors that they would have avoided or reduced their loss had they been fully informed and divested themselves of their equity, although at a reduced value.

7.4 Variation of Option 3

Arnold Bloch Leibler

1 Introduction

1.1 This submission is in response to the Australian Government, Corporations and Markets Advisory Committee's (**CAMAC**) request for submissions in response to CAMAC's Discussion Paper, 'Shareholder Claims Against Insolvent Companies - Implications of the *Sons of Gwalia* Decision' (September 2007).

1.2 The purpose of this submission is to demonstrate by practical example in the current environment how the High Court's decision in *Sons of Gwalia* (**SOG Decision**)[149] may have the affect of forcing large publicly listed companies into a formal insolvency administration (with all the concomitant loss of employment, disruption to and loss of confidence in the market, as well as costs and expenses) when, but for the SOG Decision, it could have been avoided. This result is contrary to the underlying rationale of corporate reconstruction. And will inevitably result in the cost of capital increasing.

[149] *Sons of Gwalia Ltd & Anor v Margaretic* (2007) 60 ACSR 292

1.3 This submission recommends subordination of shareholder claims[150] in an insolvency administration by legislative amendment to section 563A of the *Corporations Act 2001* (the **Act**) as the appropriate balance between responsible insolvent corporate re-organisation, maintenance of good corporate governance standards and consumer protection.

1.4 All of the criminal and quasi-criminal preventative legislative provisions in the Act, the *Australian Securities and Investments Commission Act 2001* (**ASIC Act**) and the *Trade Practices Act 1974* (**TPA**) need not be modified. They act as the most significant deterrent to errant corporate conduct in their present form. Class proceedings do not.

2 Objects of Corporate Reconstruction

2.1 The objects of corporate reconstruction in Australia are to provide for the business, property and affairs of an insolvent, or near insolvent, company to be administered in a way that:

(a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or

(b) results in a better return to the company's creditors and members than would result from an immediate winding.[151]

2.2 Corporate rehabilitation is also designed to be:

(a) swift;

(b) uncomplicated and inexpensive; and

(c) flexible.[152]

2.3 There are important social goals underlying these objects of corporate reconstruction law, including:

(a) maximising the chances of employees retaining their jobs and minimising social dislocation;

(b) preserving the ability of other businesses to continue trading with the distressed company in the future (thereby avoiding 'domino' insolvencies); and

(c) maintaining as much of the 'going concern' value of the company as possible. This final consideration is of direct benefit to the company's members, those said to benefit from the SOG Decision.

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150 The expression 'shareholder claims' used in this submission has the meaning given by Hayne J in the SOG Decision at (2007) 60 ACSR 292, 328: '*A person who buys, or subscribes for, shares in a company, relying upon misleading or deceptive information from the company, or misled as to the company's worth by its failure to make disclosures required by law, may have a claim for damages against the company. That claim may be framed in the tort of deceit but, more probably than not, will now be framed as a claim under consumer protection provisions of the Trade Practices Act 1974 (Cth) or investor protection provisions of the Corporations Act 2001 (Cth) (the 2001 Act) or the Australian Securities and Investments Commission Act 2001 (Cth) (the ASIC Act).*'

151 Section 435A of the Act.

152 Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45* 1988, Vol 1 [53] to [54] (**Harmer Report**).

3 The SOG Decision as Deterrence?

3.1 Supporters of the SOG Decision assert that shareholder class actions deter corporate misconduct. For example John Walker, Managing Director of IMF (Australia) Ltd, states:

> *Enforcement* [of shareholder claims] *is a valuable deterrent and capable of materially effecting behavioural change across the market.*[153]

3.2 Consumers and investors are adequately protected against corporate misconduct by provisions in the Act, ASIC Act and the TPA.[154] There is no need to supplement these provisions with the additional spectre of class suits by aggrieved investors against distressed or insolvent companies.

3.3 In Arnold Bloch Leibler's experience the single biggest deterrent against misconduct by company directors is the risk of criminal and quasi-criminal sanctions under the Act, ASIC Act and TPA. Prosecutions may result in jail terms, pecuniary penalties, loss of reputation and loss of qualifications.

3.4 In our submission, these consequences are far more powerful deterrents than the prospect of litigation (including class actions) against an ailing company.

3.5 The real issue for the legislature is to determine the correct balance between corporate reconstruction law and consumer protection.

4 Serious Problems arising from the SOG Decision - the Centro Example

4.1 The SOG Decision generally affects publicly listed companies that do not have securities granted over the whole of their assets.

4.2 One such group that falls into this category is the Centro group. The Centro group is a stapled structure consisting of a publicly listed holding company and a registered managed investment scheme. Centro has no secured lenders over the whole of its assets and a vast number of retail shareholders and investors.

4.3 Centro is distressed and is currently attempting to re-finance short term debt reported to be about $3.9 billion.[155] And Centro is facing shareholder class actions of the type faced by Sons of Gwalia for allegedly misleading the market by the wrong classification of long term debt that should have been classified as near term.[156]

Injection of Capital Impaired by the Sons of Gwalia Decision

4.4 The obvious commercial solution to any company in Centro's current difficulty is an injection of capital. The prospects of successfully achieving a capital injection are materially lessened by the existence of the substantial unknown liability represented by the shareholder claims, which, by reason of the SOG Decision, rank pari passu with all other creditors and in priority to equity.

4.5 These threatened litigation claims are of unknown quantum, severely harmful to the reputation of the Centro group and driven by reputable class litigation lawyers or litigation funders. And unlike ordinary creditors who supply goods, services or

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153 John Walker, 'Sons of Gwalia - Shareholders as Creditors' (2005) *Australian Insolvency Journal* 4 at 10.

154 See for example Chapter 6CA and Part 7.10, Div 2 of the Act and Part 2, Div of the ASIC Act.

155 See for example *The Age*, 'Centro hopes to Extend Refinance Date', 15 January 2008.

156 See, for example, *The Age*, 'Centro's new chief in the hot seat as investors seek answers' 18 January 2008.

finance, they may not have an indirect interest in Centro remaining in existence. They may well prefer lodging a proof of debt in an insolvency administration.

4.6 An injection of capital is far more achievable if shareholder claimants are subordinated in an insolvency administration. That subordination presents a commercial opportunity to extinguish or settle those claims prior to or by a formal insolvency. This could be achieved by private treaty, settlement of ‘opt out’ class proceedings or a creditors solvent scheme of arrangement. And if these shareholder claimants achieve a better return than that which they would receive in an insolvency administration which would otherwise follow, then courts could play an active role in sanctioning such arrangements.

Other Adverse Consequences of the Sons of Gwalia Decision

4.7 The SOG Decision has a number of other adverse consequences on distressed companies apart from limiting its ability to raise equity, including:

(a) The board of a distressed company, such as Centro, may decide to place the company into a formal insolvency process when considering the company’s solvency having particular regard to threatened class proceedings and a perceived inability to meet those claims let alone the costs of defending them. If those claims are subordinated in an insolvency administration they would be considered as such in the board’s deliberations;

(b) When a company is nearing insolvency its directors must have regard to the interests of its creditors (including shareholder class claimants) and in doing so may be inhibited from making commercial decisions which are in the best interests of the company as a whole but prejudicial to the interests of contingent creditors; and

(c) In large corporate insolvencies creditors divide into differing groups. For example, in Centro there are three (3) distinct creditor groups namely Australian bankers, US bankers and US Noteholders. Each group has a different financial interest from the other. The task of the distressed company is to manage its groups of creditors in a transparent and fair process to ensure that it can continue as a going concern and pay all creditors 100c in the $, maintain employment for the employees and preserve equity for the shareholders and investors. In all large work outs this seemingly easy task is exceedingly problematic. The more sophisticated the corporate group the more difficult it is to manage. The capital expenditure requirements of a group create severe tensions in the process as do asset realisations. For instance:

- How are surpluses to be disbursed to creditors with differing interests?
- How can a distressed company disburse surplus funds from assets sales to certain classes of creditors if it does not know if it can meet shareholder claims? The creditor receiving any such payment will also be concerned that the payment may be subsequently ‘clawed back’ as preferential and it may drive the shareholder claimants to drive the company into an insolvency process to preserve the ‘relation back’ day;
- What should a board of a company do if suppliers and financiers will only continue to provide support or extend finance if granted security which elevates all those creditors over say all contingent claims?

If the board provides the security to survive as a going concern contingent creditors may seek to impugn it and (again) seek to force an insolvency process to protect their position at law. And if the board does not provide such security the company will be forced into an insolvency administration;

(d) The impediments to a capital raising by the threatened class proceedings, the likely unforeseen diminution of returns and the continued adverse press all threaten the likelihood of a successful work out;

(e) The 'shareholder' creditors are themselves disparate. Those shareholder creditors who have shares in the company will logically support its work out provided they are rewarded as creditors and members by doing so. But those former shareholders who have sold their shares when say, in relation to Centro, they became informed of its true financial position and thereby realised losses, have no interest in the company continuing as a going concern. Those former shareholders may be better served by an insolvency administration in which they prove as creditors ranking pari passu with all others and receiving a rateable return for their claims. In that context they will, on advice, lodge the largest possible claims for damages which may include expectation losses, interest, loss of opportunity and other damages;

(f) The pari passu ranking of shareholder claims creates a window of commercial opportunity for a sophisticated financial entity to acquire more shareholder claims or utilise its own shareholder claims to force an insolvency administration for some collateral purpose; and

(g) The shareholder claims are driven by class litigation law firms or litigation funders all of whom are paid from proceeds of settlement or court determinations. Consequently, they cannot be settled without a significant payment to their effective funders. This also increases the cost of resolution to the distressed company.

4.8 These consequences are destructive of the objects of corporate reconstruction in that they erode the possibility of corporate rehabilitation outside the context of formal procedures with their associated costs, delays and damage to goodwill.

5 Solution - Subordination

5.1 The difficulties presented by the SOG Decision can be solved by a simple amendment to section 563A of the Act along the lines suggested by Kirby J in his judgment in the SOG Decision.[157]

5.2 Such an amendment ought to specifically subordinate shareholder claims to the claims of non-shareholder, ordinary unsecured creditors.

5.3 Further, the legislative amendment should provide that shareholder claimants be admitted to proof in a formal insolvency procedure for the notional sum of $1. This would afford shareholder claimants with creditors' statutory rights including voting rights and the right to apply to terminate a deed of company arrangement under section 445D of the Act while at the same time providing the commercial certainty as to the value and status of the claims thereby enhancing the prospects of a successful reconstruction.

5.4 We appreciate that the proposed solution of an arbitrary subordination of consumer rights in an insolvency administration is just that. This in our submission represents the correct balance. Solvent companies that mislead the shareholders will face all the current civil, quasi criminal and criminal consequences of doing so. However only in circumstances where the company is insolvent will the civil claims be subordinated to those of other creditors and then only in circumstances where shareholder claimants will remain as creditors with all the current protections concerning the reconstruction process. But corporations are man made. The legislature can draw and re-draw the

[157] (2007) 60 ACSR 292 at 327.

boundaries as and when it regards it as necessary and appropriate to do so. This proposed subordination is a measured and necessary response.[158]

6 Benefits of Subordination

6.1 Subordinating shareholder claims in the manner we suggest would promote the objects of corporate reconstruction. It would also restore an appropriate balance between the objects of the consumer protection laws, deterring corporate misconduct and maximising the chances of distressed companies being rehabilitated.

6.2 First, such amendment would immediately place limits upon and define the scope of shareholder claims in situations such as the Centro scenario. This would vastly enhance the prospects of reorganising distressed public companies as management would be able to conduct negotiations with a defined class of creditors with ascertainable claims.

6.3 Second, subordination would remove from a corporate reconstruction the layer of cost introduced by shareholder class actions;

6.4 Third, shareholder claimants who continue to hold their shares and those who have sold their shares would be more likely to support an informal reorganisation as this will represent the best possible outcome for both classes of shareholder claimants. This is because the shareholder claims are only subordinated in a winding up (or under a Deed of Company Arrangement that incorporates the subordination provision). Consequently, the former members with shareholder claims would have better prospects of redress in respect of their claims if the company remains solvent. This is not the case under the SOG Decision.

6.5 Fourth, subordination will maximise the possibility of achieving early settlements with shareholder claimants without the need to engage in protracted litigation or the expensive and time consuming task of estimating the value of each and every claim.

7 Conclusion

7.1 Centro is one example of how the SOG Decision is already impeding corporate reconstruction in Australia. In the current volatile market conditions, the ramifications of the SOG Decision are likely to be further manifested.

7.2 We submit that legislative amendment subordinating shareholder claims will give distressed companies a more realistic opportunity of rehabilitation. This is in the interests of all stakeholders of distressed corporations (including members).

7.5 Alternative 1: limited subordination: subordination of existing but not new investors

ASIC

A legislative amendment could introduce subordination of certain aggrieved investor claims, so that:

- only aggrieved investors whose claims relate to corporate misconduct (e.g. misleading or deceptive conduct) that occurred before their shares were purchased would be allowed to bring their claims as unsecured creditors.
- on the other hand, those members whose claims relate to misconduct occurring while they are members, for example, in relation to the loss of the

[158] As an insolvency practitioner my view is that all shareholder claims should be subordinated to creditors. However this submission advocates a more balanced approach.

> chance to sell at a certain point in time for a certain price based on all relevant information, would be postponed. This would include cases where an ongoing failure to disclose was alleged, so that members would be precluded from making out a claim in relation to shares held at the date the non-disclosure commenced.

Dividing aggrieved investor claims in this manner can be justified on the principle of achieving fairness between debt and equity holders. At all times before they actually purchase shares, aggrieved investors are in the same position as other unsecured creditors. In deciding whether or not to purchase, they have only the same publicly available information at their disposal as other unsecured creditors. If a misrepresentation is made to them at this stage, they are not members at the time that the wrongdoing occurs. Therefore, these aggrieved investors should be treated in a similar manner to other unsecured creditors, rather than as members. On the other hand, existing members have available to them rights and powers that creditors do not have, for example, the power to call meetings. Allowing these members to seek to change their position, yet also enjoy the same rights as other unsecured creditors, is arguably unfair.

Arguably, this approach has two main advantages:

(a) it ensures fairness as between member and creditor claims; and

(b) it places some limitation on the number of aggrieved investor claims that would be brought.

Harris & Hargovan

We reject all 3 options outlined in the Discussion Paper. We advocate an alternative approach of limited subordination. This would involve subordinating claims by existing members including retention claims (which have been a problem in the US) and allowing claims by new investors to stand alongside creditors. This position provides 2 main benefits. Firstly, it protects investors who have relied on defective information disclosure by companies by allowing those induced to become members to take part in the company's insolvency administration. This position addresses the problems identified by Kirby and Callinan J in Gwalia regarding the unease in allowing existing shareholders (who have extensive rights and powers) to take on the role of creditors. Secondly, this position effectively reduces the likelihood of any flood of claims in insolvency as only new investors (such as Margaretic in the Gwalia case) could take part in the insolvency. These are likely to be much smaller in number compared with allowing all shareholder (new and existing) to take part. This position is consistent with the arguments raised by influential US professors Slain and Kripke (whose work was the impetus for the US laws). Our proposal could be achieved by amending s 563A to clarify that claims 'in the capacity as a member' only apply to members who are not registered as shareholders when they purchase their shares on the basis of defective disclosure by the company.

Appendix 2[159]

Should Australian law adopt blanket subordination?

The US position on the treatment of shareholder and creditor claims upon insolvency is open to criticism on the basis that it adopts the blunt instrument of blanket shareholder subordination, which, as discussed above in Parts 2 and 4, results in inflexibility, unfairness and judicial tension. In recent times, it appears that the limitations of this approach have been recognised by Congress in enacting the Fair Funds for Investors Provision. It is submitted that law reform in Australia, if any, should not follow the US position and reform the Corporations Act to introduce a blanket subordination of all members' claims. The resultant outcome arising from blanket subordination, which eschews notions of fairness to shareholder interests discussed earlier, cannot be justified.

The US approach to statutory debt subordination is premised on the belief that shareholders as investors should justifiably bear the risk of fraudulent or misleading conduct and does not accommodate shareholder interests in such circumstances which, in our opinion, is a flawed approach. In the authors' view, any law reform in Australia needs to take a more targeted, distinctive and, consequently, limited approach to subordination.

The adoption of blanket subordination would, in our opinion, frustrate the purpose of consumer protection laws in favour of non-shareholder creditors; ignore the risk of moral hazard created by blanket subordination and fail to recognise the informational disparities between certain shareholders and the company's creditors. These concerns are addressed, in turn, below. We then advocate a statutory rule that would subordinate existing shareholders from claiming misrepresentation damages in insolvency, but would allow new 'outside' shareholders to maintain those claims as unsecured creditors in the company's insolvency. However, before explaining why we advocate limited subordination, it is important to examine why blanket subordination is not a preferred option.

Consumer protection laws

The legal treatment of shareholders in modern Australian corporate law has undergone significant change and is unrecognisable from the legal position of shareholders at the time of *Houldsworth* and *Salomon*.

The past century has seen an increasing focus on investor protection, initially through market disclosure documents such as annual reports and prospectuses. In more recent times, there has been judicial recognition of the 'substantial revolution' relating to modern corporate responsibility. With the focus on investor protection, federal parliament has created continuous disclosure laws that are widened in scope and, more significantly, offer substantial compensatory remedies for use by market participants where companies make misrepresentations to the market or fail to provide market-sensitive information in a timely manner. Continuous disclosure is fundamental to the integrity of the Australian securities market and therefore a key factor for investor protection. In the second reading speech introducing the Corporate Law Reform Bill (No 2) in the Senate on 26 November 1992, the Minister offered the following policy considerations as underpinning the continuous disclosure regime:

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[159] Hargovan and Harris, 'Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience' (2007) 20 *Australian Journal of Corporate Law* 265 at 293-300.

> *An effective disclosure system will often be a significant inhibition on questionable corporate conduct. Knowledge that such conduct will be quickly exposed to the glare of publicity, as well as criticism by shareholders and the financial press, makes it less likely to occur in the first place.*
>
> *In essence, a well informed market leads to greater investor confidence and in turn to a greater willingness to invest in Australian business.*

Chapter 6CA of the Corporations Act, in particular s 674, reinforces the continuous disclosure obligations within the ASX Listing Rules by providing for criminal and civil liabilities for non-compliance. The significance, and impact, of reforms to continuous disclosure laws in 2002 has received judicial recognition. In *ASIC v Chemeq Ltd*, Justice French commented:

> *The importance attached to the continuous disclosure provisions by the*
>
> *[Corporations] Act by the legislature is emphasised by the penalties for their contravention which have been recently significantly increased and their widened scope since 2002 which is now not limited to intentional reckless or negligent non-disclosure.*

Justice Kirby recently acknowledged the increasing importance of investor protection measures in Australia and, principally, the role served by continuous disclosure laws and its preventative and compensatory function.[160] Similarly, the modern trend towards enhanced investor protection has also been recognised by the Chief Justice of the High Court in *Sons of Gwalia*:

> *modern legislation . . . has extended greatly the scope for 'shareholder claims' against corporations, with consequences for ordinary creditors who may find themselves, in an insolvency, proving in competition with members now armed with statutory rights. Corporate regulation has become more intensive, and legislatures have imposed on companies and their officers obligations, breach of which may sound in damages, for the protection of members of the public who deal in shares and securities.*

The protection of investors, in the manner described above, creates a tension with the notion that shareholders (ie, investors) should always finish behind non-shareholder creditors, which would be the position if a rule of US-style blanket subordination were adopted.

In our submission, based on the importance attached to consumer protection laws, it is necessary to adopt a policy of limited subordination of shareholder claims in insolvency. A rule of limited subordination has twin benefits—it not only recognises and respects legitimate creditor interests upon insolvency, but strikes a balance that accommodates and values existing shareholder protection rights. In fashioning such a policy choice, we are influenced by the contemporary Australian corporate landscape with disclosure and the prevention of deceptive practices and other forms of market misconduct now a central feature.

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[160] *Sons of Gwalia* at [106].

A central feature of these protective statutory provisions, discussed above, is the need to compensate shareholders from losses that might be suffered from undisclosed facts and the need to reduce the incidence of such losses.

In circumstances where shareholders and creditors have equally been defrauded or misled by the deceptive practices of the insolvent debtor company, why should creditors receive favourable treatment over such misled shareholders? If the true position in Sons of Gwalia had been disclosed to the market, the availability of credit would have been restricted (through higher interest rates or more restrictive loan covenants) and the demand for shares in the company would have decreased. Neither shareholders nor creditors bargain for the risk of being deceived by misleading statements to the markets.

It should be remembered that the original rationale for shareholder subordination in the United States was the reliance by creditors on the equity cushion provided by existing shareholders. Slain and Kripke expressly disfavoured subordinating claims by shareholders who purchased their shares after creditors had lent money to the debtor company. The learned authors advocated evaluating each claim to determine whether each creditor could maintain a detrimental reliance, which they argued should be established by a reverse onus of proof imposed on the shareholders (ie, to require shareholders to prove an absence of detrimental reliance by creditors). In the end, Congress adopted the simpler and more administratively workable solution of subordinating all claims for rescission or damages arising from the purchase or sale of securities. That does not mean, of course, that the US position is the only workable solution to the tensions between protecting and promoting equity investments and protecting the bargained expectations of contractual creditors.

Moral hazard

A further problem that may be caused by blanket subordination involves the moral hazard that arises in the following manner. A rule of blanket subordination will prevent both inside shareholders and new shareholders from bringing their claims against the company until all non-shareholder creditors have been paid in full.

Consider this hypothetical, dealing with a marginally solvent company, to demonstrate why limited subordination is a better policy choice than blanket subordination. By marginally solvent, we mean a company that currently has sufficient assets to satisfy all of its non-shareholder creditors, but no more. Thus, if such a company were to be wound up voluntarily, the creditors would be fully repaid but there would be no residual assets to distribute to shareholders. Such a precarious position poses the risk that any additional debt will render the company insolvent. However, given that the company’s current financial status will not generate any surplus for the shareholders, there is an incentive for current shareholders to attract new capital through a share issue. Under a rule of blanket subordination, there would be an incentive for the company to attract new capital by any means, including misrepresentation or other deceptive practices, because any claim by the new shareholders (induced to subscribe for shares by the misrepresentation) will be subordinated. Thus, blanket subordination creates the risk of moral hazard. On the other hand, limiting subordination to pre-existing shareholders creates no such moral hazard.

Limited subordination

Having rejected the US position on blanket subordination, this then raises a further and important question as to whether all shareholders are equally innocent and therefore deserving of equal protection and entitlement to misrepresentation damages upon corporate insolvency? We do not believe so, for reasons that follow below.

In advocating a limited approach to subordination, we favour an approach which recognises the informational disparities between certain shareholders and the company's creditors.

It is submitted that shareholders who purchase shares in the company due to a misrepresentation by the company are in a similar position to contract creditors. When an investor (large or small) is deciding whether to purchase shares in the company (either by way of prospectus or through the secondary market), that investor will rely upon the information that the company has disclosed to the public. However, creditors also rely upon this same publicly available information. Prior to the acquisition of shares, the investor is not in a superior position to the general creditors. Thus, if the investor suffers a loss because of a misrepresentation inducing the initial purchase of shares, the creditors will also suffer a loss because they would not have provided credit to the company either on those terms, or perhaps not at all, if they had been aware of the true state of affairs. Therefore, we argue that new shareholders who claim misrepresentation damages should have parity in insolvency with general unsecured creditors and should not be subordinated.

However, the same cannot be said for pre-existing shareholders and therefore their legal treatment for misrepresentation damages upon insolvency should differ from that of new shareholders. As noted by Callinan J (albeit in dissent) in *Sons of Gwalia*, shareholders have extensive rights and powers that creditors do not have (such as the right to attend meetings and the ability to sue for oppression). This supports the view that it is unfair for those same shareholders to seek to change their position by standing as creditors and thereby to recover (at least part of) their investment. After all, the quid pro quo of limited liability is the risk of losing the full price of the shares owned by each member. To allow shareholders to claim back their investment, allows shareholders the rights, powers and benefits of investment, without the concomitant risks. Creditors bargain for a fixed return, while shareholders bargain for variable (but hopefully higher) gains through increases in capital value or by dividend payments. Thus, as also recognised by Justice Kirby and Justice Callinan in *Sons of Gwalia*, it is arguably unfair to allow all shareholders to stand as creditors.

It should be noted though that the rights, powers and benefits of shareholding only arise when the investor is a 'member' of the company (ie, when they are registered shareholders). A prospective investor is not a member of the company (either in law or equity) prior to the purchase of shares. This means that when a misrepresentation is made by the company to the market, the existing shareholder has a power and informational advantage over both the company's general creditors and the prospective investors. In our view, it is this advantage that justifies subordination, not the mere fact of membership. Thus, unlike the US position, we advocate subordinating only the claims of existing shareholders and allowing investors induced to purchasing shares in the company (either directly or indirectly) to claim in the company's liquidation as they were equally as vulnerable and innocent as the company's general creditors.

Apart from notions of fairness, this approach would also answer many of the concerns regarding the impact of the decision in *Sons of Gwalia*. It is unlikely to result in large numbers of shareholders making claims, because only those shareholders who purchased shares in the company within a short time after the misrepresentation would escape subordination. All existing shareholders would be subordinated and investors who purchased shares long after the misrepresentation would have difficulty establishing a casual nexus between the misrepresentation and their purchase under current law, and could be denied proof by the liquidator. Thus, the only situation where shareholders would not be subordinated would involve a company making a misrepresentation to the market which induced at least some new investors to purchase shares in the company, and where the company then entered insolvency administration soon after, similar to the circumstances of Mr Margaretic. In such situations, shareholder success is still not guaranteed as evidenced by the outcome in *Johnston v McGrath*. Causation, however, is an evidentiary matter separate from the issue dealing with shareholder classification as a creditor and their equal ranking with unsecured creditors.

Despite the risk of the defrauded investor not being fully compensated, either through failure to prove causation or through lack of funds by the insolvent debtor company, this policy approach is still capable of promoting investor confidence which is an important policy goal of modern securities legislation. The policy approach advocated recognises the importance of promoting new investment in equity capital markets while balancing the responsibilities of existing shareholders to use their extensive powers to better monitor management and enhance corporate governance.

Conclusion

This article has attempted to add value to the debate surrounding the subordination of shareholder fraud and misrepresentation claims against insolvent companies. Canada and the United States were chosen as points of comparison with Australia because they either contemplate, as in Canada, or have statutory provisions that provide robust subordination.

The Canadian provision provides, arguably, a clearer and stricter form of subordination because of the broad definition of 'equity claims'. As noted above, this accords with Canada's common law position of steadfastly refusing to allow shareholders in insolvent companies to block reorganisation attempts or to receive a distribution out of the reorganisation. This refusal by the Canadian courts is also consistent with the US position under the 'absolute priority rule'. The United States and Canada provide two interesting examples of different paths reaching the same destination — the priority of debt over equity in insolvency administrations.

Plainly, there is a clear tension between the conferral of rights to investors during solvency and the seeming disregard of those rights in insolvency due to subordination rules.[161] The immediate future brings hope, through CAMAC's involvement, that Australia may be ready to address this tension by making a policy choice between shareholder subordination and shareholder parity or, more appropriately and justifiably, a combination thereof as advocated in this article.

In forging Australia's insolvency law policy, we should learn from the North American experience. As part of that lesson, we should be cautious in transplanting a

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161 *Sons of Gwalia* at [18] per Gleeson CJ.

foreign model, with warts and all, into our corporate milieu.[162] As demonstrated in this article, the policy objective in the United States of treating shareholders last under the principle of blanket subordination is problematic and should be rejected in Australian insolvency law.

In particular, s 510(b) of the US Bankruptcy Code has generated considerable conflicting case law concerning the meaning of 'arising from' the purchase or sale of securities. Controversially, recent appellate court decisions have interpreted these words to include post issuance conduct by the debtor company. This paradigm shift, as demonstrated in Part 2, represents an unsettled area of law deserving of future attention by the US Supreme Court. The haphazard dent in the 'shareholder comes last' principle under the Sarbanes Oxley reforms, which previously enjoyed almost three decades of unrivaled supremacy in US law, is also testament to the need for caution. Furthermore, as appraised in Part 4, fundamental objections against the US policy objective of blanket subordination can be raised on grounds of fairness, public policy and moral hazard.

Australian insolvency law needs to find an appropriate balance between encouraging investor confidence in the equity markets and maintaining certainty in the debt capital markets. In our view, that balance should be found in a rule of limited subordination that recognises and protects the reliance interests and, simultaneously, recognises the informational asymmetries that exist between existing and future shareholders and general unsecured creditors.

Appendix 3[163]

Rejection of Blanket Subordination

We have argued elsewhere that a policy of blanket subordination of shareholder interests, modelled on §510(b) of the US Bankruptcy Code, is undesirable from a policy perspective. It is a blunt instrument that would, inter alia, frustrate the raison d'être of consumer protection laws and ignore Australia's modern corporate milieu with its increased focus on investor protection. There is a real risk, as recognised by Gleeson CJ in *Sons of Gwalia*, that current investor protection laws may be 'illusory' if the claims of those who are given the apparent benefit of legislative protection are subordinated to the claims of ordinary creditors. A policy of blanket shareholder subordination would make a mockery of the importance of our continuous disclosure laws, with their emphasis on a preventative and compensatory role. Blanket subordination of shareholder interests, cautions Davis, would strike at the heart of the compensatory objective embodied in the various securities remedies. Furthermore, a policy of blanket subordination would make insolvent companies judgment-proof in respect of securities claims, as demonstrated by the Enron and WorldCom experiences in the US, and increase the risk of moral hazard through deceptive and misleading practices.

By the same token, an unfettered policy of shareholder parity with creditors' claims in insolvency would unjustifiably give shareholders the best of both worlds — gains

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162 For discussion on current Australian corporate milieu, see *Sons of Gwalia*, at [18] per Gleeson CJ; [214]–[221] per Callinan J. For the importance attached to Australia's continuous disclosure laws, see *ASIC v Chemeq Ltd* (2006) 58 ACSR 169 at [46]; *Sons of Gwalia* at [106] per Kirby J.

163 Hargovan and Harris, 'The Shifting Balance of Shareholders Interests in Insolvency: Evolution or Revolution?' (2007) 31(2) *Melbourne University Law Review* 26-31.

when the company prospers and participation with creditors if it fails. Kirby J appropriately recognised the resultant unfairness in transferring shareholder investment risks to creditors in the following observation:

> *investors ... are not involved in the provision of goods and services to the company, as ordinary creditors generally are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks ... [and] the purchase of shares will commonly entail a measure ... of speculation. Such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risks.*

Limited Shareholder Subordination

Between the two extremes of blanket subordination and total shareholder parity discussed above, we see a viable middle path which adopts a more nuanced approach to subordination that combines features of both policy options. In addressing the future shape of Australia's insolvency laws, we advocate the need for a targeted, distinctive and consequently, limited approach to shareholder subordination.

In advocating this policy option, we distinguish clearly between two types of risk. It is readily accepted that the risk of business failure not involving misleading conduct falls on the shareholder as the quid pro quo for limited liability. To that extent, we agree with the general remarks made by Callinan and Kirby JJ on the unfairness for creditors to underwrite the shareholders' speculative investment risk. In such instances, the case for shareholder subordination is justified. However, we draw a line at the risk of shareholders being misled into purchasing their shares and the policy of blanket subordination in such instances.

Within this model of limited shareholder subordination, we draw a further distinction. In particular, we advocate that newly defrauded shareholders, as opposed to existing shareholders, should not have their claims subordinated. At first blush, this model appears to be inconsistent and unfair in its treatment of defrauded shareholders. The justification for this distinction, however, arises from the informational asymmetries that exist between existing and future shareholders and general unsecured creditors. As we note elsewhere, new shareholders investing in the company do not, ex ante, have the rights and powers of existing shareholders and depend upon publicly available information to price their risk in purchasing shares. In this regard, they are in a similar position to small contract creditors (such as trade suppliers) who are unable to bargain for security rights and must rely upon publicly available information to price their risk in providing goods or services on credit.

We therefore advocate the formulation of a statutory rule that would subordinate existing shareholders from claiming misrepresentation damages in insolvency, but would allow new 'outside' shareholders to maintain such claims as unsecured creditors. Such an approach, we believe, has the added benefit of striking an appropriate balance between encouraging investor confidence in contributing additional capital to equity markets, and allaying some of the concerns in the debt capital markets because the large number of existing shareholders will be subordinated to their position.

The current law under-deters securities fraud in the following way. A breach of s 764(2A) by a director attracts the financial services civil penalty provision. In turn,

this means that a defaulting director may be subjected to either a pecuniary penalty order under s 1317G or a compensation order under s 1317HA. Crucially, notwithstanding the director's involvement in the breach of the Act and subsequent defrauding of innocent shareholders who may have purchased securities, the director still enjoys the freedom to manage the corporation. Remarkably, from a deterrence perspective, the Corporations Act 2001 (Cth) offers no protection against future fraudulent conduct for this offence through a disqualification order. The court may only disqualify a director from managing a corporation if they have breached a 'civil penalty/scheme provision'. Continuous disclosure provisions, however, are 'financial services civil penalty provisions' (under s 1317DA) which means a disqualification order could not be made. Furthermore, statutory misleading or deceptive conduct provisions are neither civil penalty nor financial services civil penalty provisions. Their remedies are restricted to damages, which whilst offering a compensatory remedy, provide inadequate protection against future breaches.

In this way, current regulatory policy undermines the deterrence objective against fraudulent conduct by directors and consequently, to some degree, blunts the effectiveness of the model we propose. To fulfil the deterrence promise and threat, the way forward is to refocus the statutory liability provisions onto directors and other culpable insiders.

This reform would go some way to ensure that the costs of fraudulent conduct in securities actions do not fall on innocent shareholders via large penalties being imposed on corporations. Instead, ideally, the cost of such fraudulent conduct, both through court penalties and also through the business cost of increased directors' and officers' insurance premiums in securities claims, should fall primarily on the perpetrators to promote a sound policy result. In advancing these views, we do not reject the role of corporate liability. It has a residual role to play in a scheme which shifts the primary liability on managers and insiders.

Evolution or Revolution?

The surprising lack of judicial consideration of the rationale of s 563A (and its predecessors) prior to the High Court decision in *Sons of Gwalia* does not necessarily mean that the judicial interpretation afforded by the High Court is revolutionary. The conclusion reached by the High Court in *Sons of Gwalia* was not written from a clean slate. It is based on existing precedent (particularly the House of Lords' decision in Soden) and reflects, rightly or wrongly, a particular view of the implicit parliamentary intention regarding the intersection between shareholder and creditor rights in insolvency.

The majority decision in *Sons of Gwalia*, through principles of statutory interpretation, construed s 563A in a way that does not cut down or reduce the availability or effectiveness of consumer protection remedies conferred by statute. Whether intentional or not, the majority decision maintains the practical efficacy of these provisions. Viewed in this context, devoid of the hysteria, the decision in *Sons of Gwalia* is far from revolutionary. It is underpinned by protective statutory provisions which, as observed by Gleeson CJ, have now armed investors with statutory rights. Significantly, there has been judicial recognition of this trend since at least 1991.

Based on the authoritative decision in *Sons of Gwalia*, and subject to CAMAC's law reform recommendations, it appears that Australian company law is evolving to a

position where shareholders' protective rights are valued and enforced, albeit at the expense of unsecured creditors, in corporate insolvencies. This raises the pertinent question of whether such values are, or ought to be, permissible.

Elizabeth Warren, a respected US bankruptcy scholar notes that, '[b]y definition, the distributional issues arising in bankruptcy involve costs to some and benefits to others.' It is trite to observe that enforcing the collection right of secured creditors often comes at a cost of defeating the collection rights of unsecured creditors whose claims are discharged without payment. Similarly, a priority payment to one unsecured creditor, such as an employee, necessarily leaves less for remaining creditors. Such values exist in the Corporations Act 2001 (Cth) distributional scheme and have been given credence by Parliament. Should Parliament take the next step by explicitly endorsing the value espoused by the majority judgment in *Sons of Gwalia*?

On one hand, it is arguable that the High Court's decision in *Sons of Gwalia* is sufficiently clear to render legislative amendment aimed at clarifying the position of shareholder claims unnecessary, as they currently fit within the broad notion of a 'contingent creditors' for the purposes of the Act. However, on the other hand, it may be advisable (at least for the purposes of greater legislative certainty) that s 563A be amended for two reasons.

First, to explicitly confirm that the focus of shareholder subordination under s 563A is on the nature of the claim rather than on the person bringing the claim. The seeming acceptance by the majority of the position taken in Soden, as well as the general tenor of the majority judgments, lends support for the view that the only claims subordinated by s 563A are those that are exclusively given to shareholders either under the Act or by the statutory contract embodied in the corporate constitution. Secondly, in support of the limited subordination model we propose, to draw a further distinction in the compensation claims between new and existing misled shareholders for the reasons advanced earlier.

CONCLUSION

Sons of Gwalia goes to the heart of the different philosophies underpinning risk allocation in insolvency law. The judicial uncertainty on the interpretation of s 563A has now been resolved by the High Court in favour of limited subordination of shareholders claims in insolvency. The majority High Court decision, whether intentionally or not, has exposed the hitherto buried legal path towards a legislative policy of limited shareholder subordination. Uncertainty, however, remains in some quarters of the commercial community as to whether the decision in *Sons of Gwalia* represents a sound legislative policy outcome.

We have argued for legislative amendment to ensure an appropriate balance in the allocation of risk between investors and creditors and the priorities between them upon insolvency. The approach advocated here, and elsewhere by the authors, in the treatment of defrauded shareholders' claims adopts this yardstick for law reform. In advocating a policy of limited shareholder subordination, a variant on that in *Sons of Gwalia*, we aim to strike a delicate balance without resulting in a massive shift of power from creditors to shareholders in insolvencies. Simultaneously, we acknowledge the serious role that the current statutory landscape and public and private remedies, discussed earlier, serves for investor protection. This is particularly significant in light of the fact that Australians have among the highest recorded levels of share ownership in the world.

For the law reform model advocated to be viable and efficient, however, it must be accompanied with two other reforms. First, 'process' reforms dealing with administrative burdens and procedural matters in external administration are essential. This must be done to resolve current uncertainty and efficiency concerns, discussed above in Part IV. Until then, the absence of clear legislative intent on how to deal efficiently with the intersection of creditor and shareholder rights upon insolvency will remain problematic for all stakeholders (shareholders, the credit market and insolvency practitioners). Secondly, to achieve the optimal deterrence value of the policy objective advocated in this article, it is essential for law reform to go further in transferring the burden of damages claims for fraudulent conduct from the company, and in effect its shareholders, onto the managerial actors who are truly culpable.

Appendix 4[164]

Defrauded or Misled Shareholders: Blanket vs Limited Subordination?

The arguments discussed above have traditionally been raised in the context of prohibiting the competition between shareholder and creditor claims. However, no subordination statute or common law rule supports true blanket subordination so as to deprive a person of an independent right to claim against the company merely because he or she happen also to be shareholders. Shareholders, as individual entities, may interact with the company in different capacities and shareholders may be owed money by the company in different capacities, both as shareholders and as creditors. For example, a shareholder may be owed money because of an unpaid dividend, but may also be owed money through an unpaid loan made by the shareholder to the company. In this simple example, most would accept that the claim of the shareholder as lender (and therefore as an outsider of the company) is qualitatively different from the shareholder's claim for the dividend that arises because of his/her status as a shareholder.

Whilst it may be accepted that a monetary claim that does not arise because of the person's shareholding should not be subordinated, what of a statutory claim for damages arising directly because of the purchase of shares? The use of a tortious action to claim damages for misrepresentation inducing the purchase of shares, particularly when the misrepresentation involves the factual substratum giving rise to the company's insolvency, allows shareholders to convert themselves into creditors at the point of insolvency and thereby avoid traditional subordination rules. Should this be permitted? Should insolvency subordination rules triumph over non-insolvency securities law rights? There is a range of diverging views on this vexed issue.

On the one hand, the often-cited article by U.S. law professors Slain and Kripke (which influenced the introduction of statutory subordination in the United States) argued that shareholder misrepresentation claims should be subordination on the basis of the differing bargaining and reliance interests of shareholders and creditors. They argued that shareholders, as investors, should bear the risk of fraudulent or misleading conduct in relation to securities as they had the most to gain from the company's success. Investors share in the profits of the business, a benefit not accorded to creditors, who bargain for a fixed return. Accordingly, the authors found it 'difficult to conceive of any reason for shifting even a small portion of the risk of illegality

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[164] Harris & Hargovan, 'The Intersection Between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective' in Sarra J (ed) *Annual Review of Insolvency Law* (2008, Carswell) 726-730.

from the stockholder, since it is to the stockholder, and not the creditor, that the stock is offered'. In other words, the shareholders had knowingly bargained for their subordinated position. Equal treatment to shareholder fraud claims, in their opinion, gives investors the best of both worlds: a claim to the upside in the event that the company prospers and participation with creditors if it fails. This was also recognised by Justice Kirby of the High Court of Australia in the recent *Sons of Gwalia* case:

> *. . .investors. . .are not involved in the provision of goods and services to the company, as ordinary creditors are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks . . . [and] the purchase of shares will commonly entail a measure . . . of speculation. Such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risk.*

Slain and Kripke provided further support for subordination by asserting that creditors had priced their provision of credit to the company on the basis of, at least partially, a particular level of capital provided by the shareholders (the 'equity cushion'). Thus, it is unfair on creditors for shareholders to seek, in effect, to rescind their shareholdings in insolvency by claiming damages for the costs of their shares and thereby removing their capital from the equity cushion.

On the other hand, arguments have been made that the subordination of securities misrepresentation claims by shareholders unjustifiably undermines the policy of market disclosure laws. This argument is supported by several points. Firstly, neither shareholders nor creditors agree to bargain on the basis of misleading information. Secondly, allowing shareholders to maintain monetary claims in insolvency creates stronger enforcement of disclosure laws which will enhance the efficiency of capital markets, providing benefits for both shareholders and creditors (who also rely on publicly disclosed information to price their credit). Lastly, the increasing use of capital reduction techniques to increase share prices and reward shareholders (driven partially by tax considerations) has also called into question the reality of a meaningful equity cushion upon which creditors rely in pricing their credit.

Rather than advocating blanket subordination or parity between shareholders and creditors, we argue that corporate insolvency law may pursue a policy of limited subordination. In advocating a limited approach to subordination, we favour an approach which recognises the informational disparities between certain shareholders and the company's creditors.

It is submitted that shareholders who purchase shares in the company due to a misrepresentation by the company are in a similar position to contract creditors. When an investor (large or small) is deciding whether to purchase shares in the company (either by way of prospectus or through the secondary market), that investor will rely upon the information that the company has disclosed to the public. However, creditors also rely upon this same publicly available information. Prior to the acquisition of shares, the investor is not in a superior position to the general creditors. Thus, if the investor suffers a loss because of a misrepresentation inducing the initial purchase of shares, the creditors will also suffer a loss because they would not have provided credit to the company either on those terms, or perhaps not at all, if they had been aware of the true state of affairs. Therefore, we argue that new shareholders who

claim misrepresentation damages should have parity in insolvency with general unsecured creditors and should not be subordinated.

However, the same cannot be said for pre-existing shareholders and therefore their legal treatment for misrepresentation damages upon insolvency should differ from that of new shareholders. As noted by Callinan J (albeit in dissent) in *Sons of Gwalia*, shareholders have extensive rights and powers that creditors do not have (such as the right to attend meetings and the ability to sue for oppression). This supports the view that it is unfair for those same shareholders to seek to change their position by standing as creditors and thereby to recover (at least part of) their investment. After all, the quid pro quo of limited liability is the risk of losing the full price of the shares owned by each member. To allow shareholders to claim back their investment, allows shareholders the rights, powers and benefits of investment, without the concomitant risks. Creditors bargain for a fixed return, while shareholders bargain for variable (but hopefully higher) gains through increases in capital value or by dividend payments. Thus, as also recognised by Justice Kirby and Justice Callinan in *Sons of Gwalia*, it is arguably unfair to allow all shareholders to stand as creditors.

It should be noted though that the rights, powers and benefits of shareholding only arise when the investor is a 'member' of the company (i.e., when they are registered shareholders). A prospective investor is not a member of the company (either in law or equity) prior to the purchase of shares. This means that when a misrepresentation is made by the company to the market, the existing shareholder has a power and informational advantage over both the company's general creditors and the prospective investors. In our view, it is this advantage that justifies subordination, not the mere fact of membership. Thus, unlike the U.S. position, we advocate subordinating only the claims of existing shareholders and allowing investors induced to purchasing shares in the company (either directly or indirectly) to claim in the company's liquidation as they were equally as vulnerable and innocent as the company's general creditors.

Apart from notions of fairness, this approach would also answer many of the concerns regarding the impact of the decision in *Sons of Gwalia*. It is unlikely to result in large numbers of shareholders making claims, because only those shareholders who purchased shares in the company within a short time after the misrepresentation would escape subordination. All existing shareholders would be subordinated and investors who purchased shares long after the misrepresentation would have difficulty establishing a casual nexus between the misrepresentation and their purchase under current law, and could be denied proof by the liquidator. Thus, the only situation where shareholders would not be subordinated would involve a company making a misrepresentation to the market which induced at least some new investors to purchase shares in the company, and where the company then entered insolvency administration soon after. In such situations, shareholder success is still not guaranteed as causation is difficult to prove in the absence of a rule similar to the fraud on the market rule that operates in the U.S. Causation, however, is an evidentiary matter separate from the issue dealing with shareholder classification as a creditor and their equal ranking with unsecured creditors.

Despite the risk of the defrauded investor not being fully compensated, either through failure to prove causation or through lack of funds by the insolvent debtor company, this policy approach is still capable of promoting investor confidence which is an important policy goal of modern securities legislation. The policy approach advocated

recognises the importance of promoting new investment in equity capital markets while balancing the responsibilities of existing shareholders to use their extensive powers to better monitor management and enhance corporate governance.

7.6 Alternative 2: relation-back period

ASIC

A legislative amendment could specify that claims relating to alleged misconduct occurring within a certain period of time (2 months, for example) before the section 513C day in the case of a voluntary administration or the day on which the winding up is taken to have begun in the case of a liquidation,[165] would be postponed. A large number of claims may well be brought relating to non-disclosure about the insolvency of a company just prior to the company entering external administration, which may inflate the intended scope of the *Sons of Gwalia* approach.

This approach would clearly have the effect of disadvantaging aggrieved investors who bought within the relation-back period. However, the advantage of introducing a relation-back period is that it will limit the number of members with aggrieved investor claims.

7.7 Alternative 3: limited claim in liquidation and exclusion from voluntary administration

Evan Sylwestrzak

Introduction

This paper is a response to the call for submissions made by the Corporations and Markets Advisory Committee (CAMAC) in its discussion paper examining the issues surrounding the High Court's decision in *Sons of Gwalia Ltd v Margaretic* ('*Sons of Gwalia*'). More specifically, it is a response to the options proposed in Chapter 7 of CAMAC's discussion paper. For ease of reference, the term 'aggrieved investor' is adopted from the CAMAC discussion paper to describe shareholders 'who claim that they have suffered loss to the value of their shareholding in a particular company in consequence of misconduct of that company for which they have a legal remedy against the company'. In the discussion paper, CAMAC outlined three possible options for dealing with aggrieved investor claims. 'Option 1' would see the retention of the current law after *Sons of Gwalia* and allow aggrieved investors to rank equally with unsecured creditors in a liquidation. 'Option 2' would see law reform negate the *Sons of Gwalia* decision and subordinate aggrieved investor claims so that they rank equally with members. 'Option 3' would see aggrieved investors being ranked behind unsecured creditors but ahead of other members.

This paper proposes another option, 'Option 4', for approaching aggrieved investor claims. Essentially, Option 4 performs two functions. Firstly it allows an aggrieved investor to claim in a limited capacity as an unsecured creditor with the remainder of their claim subordinated with members. Secondly, it retains capital in order to reduce the impact of aggrieved investor claims on other unsecured creditors. Part 1 of this paper explains how Option 4 would operate and also provides a simple example of its application. In Part 2 two aspects of the rationale behind Option 4 are explored. The paper concludes that aggrieved investors should be given some protection from the

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[165] As determined under the rules in sections 513A and 513B of the Act.

risk that they may acquire shares on the basis of misleading information. This conclusion coincides with the continuing importance placed upon consumer protection by contemporary law and society.[166] However, this must be balanced with the impact of aggrieved investor claims upon unsecured creditors. The maintenance of capital principle is argued as being a justification for limiting the consumer protection offered under Option 4 to the difference between the price paid for the shares and the average amount of capital that those shares represent in the company. In summary, Option 4 is a compromise between the total subordination of Option 2 and the equal ranking of Option 1.

Option 4: Limited claims as unsecured investors

Explanation of Option 4

Option 4 would see aggrieved investors ranking equally with unsecured creditors and members. It would restrict the amount an aggrieved investor could claim as an unsecured creditor to the difference between the total loss that they have suffered and the capital represented by their shares (the 'limited claim'). The amount which an aggrieved investor could claim as a member would be the amount of their total loss less the amount of their limited claim.

The following formula would be used to calculate an aggrieved shareholder's limited claim:

$$TL - RC = LC$$

where:

- 'TL' ('Total Loss') represents the total monetary loss suffered by an aggrieved investor;
- 'RC' ('Retained Capital') represents the capital of an aggrieved investor's shares. In order to calculate the RC an administrator or liquidator would refer to the company's financial records to obtain the total value of capital raised from issuing a particular class of shares. The total value of capital is then divided by the number of shares the company has issued of that particular class: this answer is the average amount of capital each share in that class represents. Multiplying this average amount of capital per share with the number of shares the aggrieved shareholder holds in that class equals the RC;
- 'LC' ('Limited Claim') represents the total amount that an aggrieved investor can claim as an unsecured creditor.

Furthermore, under Option 4 aggrieved investors will not be able to participate in voluntary administration in the same capacity as other creditors. For example, they will not enjoy the voting rights which creditors have in the process of voluntary

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[166] An example of the importance of consumer protection in the stock market is the amendments made in 1990 to the insider trading provisions of the Corporations Act 2001 (Cth). This is evident from the speech made by Mr AG Griffiths when he presented the Standing Committee on Legal and Constitutional Affairs' *Fair Shares for All: Insider Trading in Australia* report to the Commonwealth Parliament on 28 November 1989: 'If Australia is to increase its levels of investment – the importance of which cannot be overemphasised – then potential investors among the public must have confidence in the integrity of the securities markets. That confidence can be guaranteed only if investors are sure that they will not be placed at a disadvantage by those who are in possession of inside information.' (from Hansard).

administration.[167] There are two reasons for this treatment of aggrieved investors. Firstly, it is a concession by aggrieved investors who will benefit from the elevated priority of their limited claim. Secondly, it will help reduce the administrative burden of implementing Option 4. For example, administrators will not need to decide which members might also be aggrieved investors for the purpose of giving notice to creditors about creditor meetings.[168]

Option 4 Example

Red bought two $1.00 shares in Blue Ltd at market. The original issue price of Red's shares was $0.40 and $0.60 respectively. The shares which Red bought were valued at $1.00 due to Blue Ltd providing misleading information to the market. The company is now insolvent and Red's shares are worth nothing. Red wants to sue Blue Ltd for misleading it into purchasing the shares. The unsecured creditors of Blue Ltd are owed $2.00. The liquidator has $2.00 to distribute pari passu to unsecured creditors.

Applying the above formula to the example:

$2.00 – $1.00 = $1.00

where:

- 'TL' ('Total Loss') represents the total monetary loss suffered by Red;
- 'RC' ('Retained Capital') represents the capital of Red's shares. Blue Ltd raised $1.00 of capital when it issued Red's two shares. Each share on average represents $0.50 of capital. Therefore, the retained capital represented by Red's two shares is $1.00.
- 'LC' ('Limited Claim') represents the total amount that Red can claim as an unsecured creditor.

Under Option 4 Red can claim $1.00 as an unsecured creditor and $1.00 as a member. Blue Ltd's unsecured creditors can claim $2.00. Table 1 shows the percentage of the unsecured creditors' total debt and the Red's total loss that is recovered under different policies. The policies of 'Subordination' and 'Unlimited Claim' equates to Option 2 and 1 respectively from the CAMAC discussion paper. The policy of 'Limited Claim' equates to Option Four.

TABLE 1: Percentage of Total Debt and Total Loss recovered in winding up

Policy	Unsecured Creditors			Aggrieved Investor		
	Total Claim	**Paid Pari Passu**	**% of Debt Recovered**	**Total Claim**	**Paid Pari Passu**	**% of Loss Recovered**
Subordination	$2.00	$2.00	100%	-	-	-
Limited Claim	$2.00	$1.33	66%	$1.00	$0.66	33%
Unlimited Claim	$2.00	$1.00	50%	$2.00	$1.00	50%

167 In a voluntary administration, creditors are granted the power to make the decisions listed in Section 439C(a) to (c) Corporations Act 2001 (Cth). Namely, creditors – and not members – can vote to implement a deed of company arrangement, initiate winding up proceedings or end the administration.

168 Section 439A(3)(a) Corporations Act 2001 (Cth). Also note that if Option 4 were implemented, the decision of which aggrieved investor claims to admit will be an added administrative burden on the administrator. The CAMAC discussion paper points out that 'depending upon how courts deal with the reliance issue...each claim by a mislead shareholder may require separate adjudication'. CAMAC, 67. This could be overcome by an adoption of a 'fraud on the market' approach. This approach will not be discussed here; instead see CAMAC, 81-3.

Under a policy of subordination Red would not be able to make a claim as an unsecured creditor and would not recover any money. This option is the best option for creditors. Under a policy of unlimited claim, Red's $2.00 total loss would rank equally with and be paid pari passu with the unsecured creditors. This is the worst option for creditors. Under a policy of limited claim, Red would be able to make a limited claim that would rank equally and be paid pari passu with unsecured creditors. For creditors, a policy of limited claim is better than a policy of unlimited claim but worse than a policy of subordination.

As this example indicates, by allowing an aggrieved investor to make a limited claim as an unsecured creditor, Option 4 is a compromise between the extreme of:

- total subordination of aggrieved investor claims (Option 2 and the US position); and
- allowing aggrieved investors to claim their total loss and rank equally with unsecured creditors (Option 1 and the UK position).

Option 4: Rationale

This section outlines two aspects of the rationale behind Option 4.

Acceptance of Risk[169]

Arguments based on acceptance of risk are justified by stating that members should be subordinated because, unlike creditors, they have the opportunity to share in the spoils of a company's success. This argument is sometimes accompanied by broad statements such as '[p]urchasing shares in a company is an inherently risky proposition which leaves the investor at the mercy of the vagaries of the market'.[170] In essence: the greater the risk, the greater the potential return.

Unfortunately, this point of view covers only half the story. Buying shares is a risky proposition. But investors are at the mercy of both market vagaries and companies who mislead the market. They are indeed two separate and very real risks.

By choosing to invest in equity, investors should be taken as automatically accepting market risk. The vagaries of the market can be understood as the fluctuating economic conditions that are part of the ordinary course of business. It is logical to assume that investors accept this risk because – unlike creditors who have a fixed claim against a company – investors have the opportunity to profit from a company's success. For example, if a company's shares increase in price, an investor may sell their shares at market for a profit. Conversely, the investor may make a loss if the economic conditions fluctuate in such a way that results in the shares decreasing in price. The risk posed by the vagaries of the market is the risk that investors accept for the opportunity to buy and sell their shares at market for profit.

However, in principle, investors should not be taken as accepting the risk of being misled by a company if they have no knowledge of or reason to suspect that a company is misleading the market. There are two justifications supporting this conclusion; one practical reason and one theoretical reason.

Firstly, investors must be able assess the risk of investing. But how can investors make an investment decision if they have to accept the risk that the company might be

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169 This section expands upon 'Argument based upon acceptance of risk invalid' in CAMAC, 63.

170 Hargovan, A and Harris, J 'Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies' (2007) 25 C&SLJ 7.

misleading the market? Investors use, amongst other things, market information provided by companies to make an assessment of its market risk. Take, for example, a company who has been reporting to the market that it profits have been steadily increasing over the last few years. An investor may use this information to predict that the company's profits will continue to increase and so will its share price. By buying shares in that company, the investor accepts the market risk that the shares might not increase in value as much as expected or that they may even decrease in value. However, it would be impossible for the investor to predict with any confidence if they also had to factor in the possibility that market information is incorrect. The very nature of misleading conduct is that there is no evidence to suggest that market information is incorrect. Without evidence of the company's true business situation, any investment decision calculated on the assumption that a company is misleading the market would be arbitrary at best.

Secondly, unlike market risk's opportunity to make a profit, there is no corresponding reward for accepting the risk of being misled by a company. If there is no corresponding reward, why should an investor be taken held as having accepted that risk when purchasing shares? Risk and reward are two inseparable concepts; you cannot have one without the other. However, the reward for accepting the risk of being misled by a company is that the company has not actually misled the marketplace. In other words, an investor may be rewarded by investing in an honest company. As a matter of principle, honesty should not be treated as a reward. Investors should be able to assume that companies and the market are being conducted in honest manner if there is no evidence to suspect otherwise.

Sons of Gwalia can be used as an example to highlight the difference between the two risks. The risk realised in that case was that of being misled by a company. Market vagaries did not lead to the plaintiff shareholder's loss. The market priced the company's shares based upon, amongst other things, the information the company provided and upon the assumption that the information provided is correct. The plaintiff shareholder bought the shares on the same assumption. However, the company had provided the market with incorrect information. Consequently, the plaintiff shareholder's loss is solely attributable to the company's misleading conduct and not the vagaries of the market.

Aggrieved investors should not be held to have accepted the risk of being misled but should be held as accepting the risk of market vagaries when purchasing shares. This is why Option 4 allows aggrieved investors to claim in limited capacities as both an unsecured creditor and member. Granting unsecured creditor status on aggrieved investors acknowledges that they have been misled. Limiting this status to the difference between their total loss and the average amount of capital which their shares represent acknowledges that aggrieved investors chose to accept market risk by entering the market. It also has the benefit of allowing the company to retain the capital represented by those shares in order to pay its creditors.

Maintenance of Capital

The maintenance of capital principle restricts a limited liability company from returning capital to its shareholders before it goes into liquidation.[171] It has been described as a 'cushion of security' from which creditors can rely upon to be paid.

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[171] Nygh P and Butt P (eds), *Concise Australian Legal Dictionary*, 2nd edition, Butterworths 1998, 280-281.

> *The general creditor asserts a fixed dollar claim and leaves the variable profit to the [shareholder]; the [shareholder] takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim.*[172]

The maintenance of capital principle is one of the arguments advanced by US commentators in favour of subordination of aggrieved investor claims. It is argued that giving aggrieved investors the right to share pari passu with unsecured creditors negates or reduces this cushion of security by reducing the capital represented by their shares. As the example in Part 1 demonstrates, maintaining capital in an insolvent company is in creditors' best interests because they will be able to recover more of their total debt.

By limiting the amount that an aggrieved investor can claim as an unsecured creditor, Option 4 retains capital in the company. This protects unsecured creditors better than Option 1. However, under Option 4 aggrieved investors can also participate with unsecured creditors in the distribution of an insolvent company's retained capital. There are three reasons for allowing aggrieved investors to do so.

Firstly, the 'best of both worlds' argument is hard to reconcile with the reality facing aggrieved investors. The argument, originally used to support the US subordination doctrine, is that:

> *allowing equity-holders to become effectively creditors by treating these two classes as though they were one gives investors the best of both worlds: a claim to the upside in the event the company proposers and participation with creditors if it fails.*[173]

Reinforcing this reasoning is the fact that, generally speaking, members – and not creditors – stand to profit most from a company's success. But whilst the best of both worlds argument is sound in theory, it starts to break down in relation to aggrieved investors. When a company misleads the market only to enter administration or commence winding up procedures shortly thereafter, a stark reality faces aggrieved investors. This reality is that the opportunity for aggrieved investors to profit from the company's success – via dividends or profits from selling shares – is nothing more than an illusion. There is no 'best of both worlds' situation because the chance to make money is either not possible at all or the chance is limited at best.[174]

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172 Slain, J and Kripke, H, 'The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors' (1973) 48 New York University Law Review 286-287.

173 Slain, J and Kripke, H, 'The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors' (1973) 48 New York University Law Review 261.

174 Suppose Yellow bought shares in Green Ltd. The next day it is discovered that the company is insolvent and has been providing misleading information to the market for a month. The misleading information provided by Green Ltd had kept its share price from falling for that entire month. Trading in Green Ltd's shares is immediately halted. As a result Yellow cannot sell its shares and those shares are now worthless. The reality in this situation is that Yellow never really had the opportunity to make a profit: the opportunity was merely an illusion created by the company when it misled the market. Consider the same scenario except that Yellow had bought its shares two weeks earlier. Yellow would have had a limited chance of breaking even or making a profit by selling its shares within two weeks. But what if Yellow bought the shares as a longer term investment? Perhaps Yellow thought the company's share price would increase in the future; perhaps Yellow was interested in receiving dividends. In any case, Yellow's motivation for buying the shares would at least be partly based on the

Sons of Gwalia is a real world example of how the opportunity to make a profit can be illusionary where a company misleads the market. The plaintiff shareholder bought $26,200 worth of shares in the company 11 days before it appointed administrators pursuant to s 436A. There was no opportunity for dividends to be earned. This meant that the plaintiff shareholder had less than two weeks in which to sell his shares for profit. The misleading information created the representation that the company was in a better situation than it was in reality. The effect of this representation was the creation of an illusion that a profit could be made by investing in the company. As the opportunity to make a profit was illusionary or limited at best (11 days), the plaintiff shareholder cannot, in essence, be said to have enjoyed the best of even one of the two worlds.

The second reason why aggrieved investors are allowed to share pari passu with unsecured creditors under Option 4 is because of the fact that 'in the vast majority of liquidations, unsecured creditors receive only a small percentage of the debt owed to them and shareholders rarely receive anything'. If this situation is commonplace, than policies of subordination (Option 2) or partial elevation above members (Option 3) would almost guarantee that aggrieved shareholders receive little or no compensation for being misled. Conversely, if their claims were treated equally with unsecured creditors (Option 1) this will be to the greatest detriment of other unsecured creditors. This is undesirable as it would result in the entire market risk accepted by aggrieved investors being shared amongst all unsecured creditors. Option 4 acknowledges the reality that there is almost always not enough money to pay unsecured creditors in full. It is also a compromise between the consequences likely under Options 2 or 3 and Option 1. Whilst granting some relief to aggrieved investors, Option 4 also maintains capital in order to reduce the impact of these claims on the capital available for distribution to other unsecured creditors.

Recall the example from Part 1: Red, as an aggrieved investor, will be happier receiving 66 cents under Option 4 than receiving nothing if its claim is only as a member. Similarly, the unsecured creditors are going to be happier because they receive more money under Option 4 then if Red was able to claim its entire $2.00 loss as an unsecured creditor. It should be noted that both unsecured creditors and aggrieved investors would want the option that has the best outcome for them: unsecured creditors would want Option 2 or 3 and aggrieved investors would want Option 1. Nevertheless, the compromising nature of Option 4 acknowledges the reality that there is usually not enough money to satisfy both groups' claims and provides a solution where the impact of one groups' claim upon the other group's claim is minimal.

A third reason why aggrieved investors can claim in a limited capacity as unsecured creditors under Option 4 is because it will provide an element of consumer protection. It has been argued that there has been a historical decline in the reliance on the maintenance of capital doctrine.[175] The reasons forwarded in support of this theory are twofold. Firstly, that there has been a shift in the corporations law to impose liability on directors. Secondly, because a company limited by shares can now be started with an extremely insignificant amount of capital, creditors do not rely upon this 'cushion of security' as much as in the past. Rather, creditors are 'more interested

misleading information. In reality, the opportunity for Yellow to make a profit in the long term was also an illusion.

175 Austin, RP and Ramsay, IM at [20.160].

in a company's ability to pay its debts as they fall due.'[176] Although the extent of its importance may have declined, this paper argues that the maintenance of capital principle remains important today. This is especially the case for unsecured creditors and aggrieved investors. Unlike secured creditors, these groups are essentially unable to protect themselves from an insolvent company that is misleading third parties into thinking it is solvent. Under Option 4 the maintenance of capital principle could be seen as being given an additional purpose. That additional purpose would be to act as a limited 'cushion of security' for aggrieved investors. Under Option 4 the amount of capital that an aggrieved investor's shares represent is retained in the company. This retained capital can then be used to pay the aggrieved investor and other unsecured creditors. By adopting Option 4, the retained capital acts as a limited form of consumer protection which would not otherwise exist under a policy of subordination (Option 2).[177]

To summarise hitherto: Option 4 allows aggrieved investors to rank equally with unsecured creditors but limits this participation to the difference between their total loss and the amount of capital represented by their shares. There are three reasons for justifying this equal ranking. Firstly, the opportunity for aggrieved investors to make a profit from a company who misleads the market before becoming insolvent is an illusion. This is because it is either not possible or the chance is limited at best. Secondly, the reality is that in the vast majority of liquidations there is not enough money to satisfy the claims of unsecured creditors. Unless aggrieved investors can rank equally with unsecured creditors in some capacity, then they will be unlikely to receive anything. Thirdly, the maintenance of capital doctrine is still important today; especially for the protection of unsecured creditors and aggrieved investors who are victims of misleading companies. Option 4 relies upon these three reasons to justify a compromise that, firstly, allows aggrieved investors to claim in a limited capacity as unsecured creditors and, secondly, retains capital in order to reduce the impact of aggrieved investor claims on other unsecured creditors.

Conclusion

Option 4 is a middle ground approach to aggrieved investor claims. It is a compromise between the subordination of Option 2 and the equal ranking of Option 1. Part 1 of this paper dealt with the operation of Option 4. Under this option an aggrieved investor can claim in a limited capacity as unsecured creditor and a member. Capital is also retained in the company. Part 2 of this paper explored two aspects of the rationale behind Option 4.

Aggrieved investors should be given some protection from the risk that they may acquire shares on the basis of misleading information. This conclusion coincides with the continuing importance placed upon consumer protection by contemporary law and society. However, this must be balanced with the impact of aggrieved investor claims upon unsecured creditors. The maintenance of capital principle is argued as being a justification for limiting the consumer protection offered under Option 4 to the difference between the price paid for the shares and the amount of capital raised by those shares when they were issued by the company. In summary, Option 4 is a compromise between the total subordination of Option 2 and the equal ranking of Option 1.

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[176] Ibid.

[177] 'Retained capital' is used here with the same meaning as described in the formula from Part 1 (TL – RC = LC).

8 Possible reforms if law unchanged

The submissions in this chapter are summarised in Section 4.2 of the report.

8.1 General

IMF

There are several ways that shareholder claims in the insolvency context can be determined efficiently.

The market protections are clear in respect of duties companies have concerning their conduct. These submissions do not call for any changes concerning an external controller's capacity to efficiently determine whether the company has breached the market provisions and, if so, the period in which the breach was active.

As can be seen in the Sons of Gwalia administration, the fulfilment of the external controller's existing duties requires him or her to:

- report to ASIC in respect of possible offences in relation to the company[178]
- determine the reasons for the failure of the company;[179] and
- publish a Report to Creditors, which includes an analysis of the matters in (a) and (b), above.[180]

This existing process enables the external controller to form an opinion as to whether, on the balance of probabilities, there have been relevant breaches of the market protection provisions by the company and, if existent, when the breaches were operative.

If this is not possible, the issue could be resolved for the benefit of the Company and all creditors by an application to the Court for declaratory relief or a decision binding on a representative Shareholder Creditor.

Accordingly, examinations specific to identifying relevant breaches will rarely cause material additional costs or delays.

Baker & McKenzie

Subject to the position taken above in relation to reform of the law in this area, we support the suggestions made by the Committee in Chapter 8 of the Discussion Paper.

Form of proof of debt

Turning to how proofs of debt might best be dealt with by liquidators and deed administrators, if aggrieved shareholders were able to prove, a 'class' approach would plainly be preferable. To aid that approach, a special form of proof of debt would be appropriate, which would ask that aggrieved shareholder to set out the elements of his or her claim:

(a) What representation was relied on?

(b) How is it said that the representation was misleading?

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[178] Section 438D.

[179] Section 439A.

[180] Refer to Attachment "**A**" in respect of proving causation and Attachment "**B**" in respect of proving quantum of the loss.

(c) What action was taken following the making of the representation?

(d) How did the shareholder rely on the representation?

(e) What loss has the shareholder suffered?

8.2 Calling a creditors' meeting

IPA

Notice of meeting and communications generally

If the law remains unchanged, the IPA agrees with the suggestion at 8.2.1 of the discussion paper that the administrator does not need to provide specific notice of a meeting unless the administrator has received express notice of an aggrieved investor claim that identifies the claimant and supplies the claimant's address for service of notices. The reason for this is that the insolvency of the aggrieved investors' company will be a matter of record and within their knowledge. There are also general advertising requirements in respect of an insolvency in any event.

While we agree that the law does not oblige the administrator to actively seek out creditors, certainly at the stage of the initial meeting of creditors in a voluntary administration, we suggest there be a specific regulation excluding shareholder claims from normal notice requirements.

It is suggested that a process be considered in terms of the following in relation to any communications with aggrieved investors in any formal insolvency administration:

- external administrators are only required to communicate with an aggrieved investor where the external administrator has received express notice of an aggrieved investor claim that identifies the claimant and supplies the claimant's address for service of notices;
- where a group of aggrieved investors are being represented by one particular person (eg legal advisor in a class action), the information only needs to be provided once to this person for all claimants that person represents; and
- the external administrator should have the option of providing aggrieved investors with a one page notification of how to access a report or other information from the internet, rather than having to provide the full report or other information.

There would also be value in industry associations giving guidance or notice to aggrieved investors on their rights in that event (8.3.1 of the discussion paper).

CSA

As it is possible that CAMAC could recommend to the government that either Option 1 or 3 be implemented, we provide comments below on a number of matters that arise only in the event of either of these two options being implemented. Our comments on these matters are offered solely on the basis that Options 1 and 3 might be implemented. They are not to be read as weakening our support for Option 2.

CSA recommends an express statement be provided that, as set out on page 71 of the discussion paper, the administrator need not search the share register or take other steps to identify those who may have a claim against the company for possible misconduct relating to their shares, for the purpose of giving them notice of a creditors' meeting.

ASIC

We consider that the current creditor meeting rules are sufficient to deal with the location of and communication with large numbers of creditors.

Harris & Hargovan

In our view, administrators should not need to personally contact each member. Advertisement in a daily newspaper and on the company's website should be sufficient.

CSA

As it is possible that CAMAC could recommend to the government that either Option 1 or 3 be implemented, we provide comments below on a number of matters that arise only in the event of either of these two options being implemented. Our comments on these matters are offered solely on the basis that Options 1 and 3 might be implemented. They are not to be read as weakening our support for Option 2.

CSA recommends that insolvency practitioners should be required to hold the meeting at the place of incorporation of the company and that notice of such meeting should only be required to be given at the place of incorporation. In this way, the meeting is held in a place convenient to the majority, and the legislation relating to aggrieved investors would align with that relating to general creditors. CSA can see no reason for privileging aggrieved investors on this matter if they rank equally with general creditors.

IPA

Time and place of meetings

The IPA agrees that aggrieved investors are more likely to be spread geographically compared to the general body of creditors (8.2.2 of the discussion paper). For the smooth conduct of the engagement an administrator should only be required to have regard to ordinary creditors in determining the place and time of any meeting.

8.3 Determining aggrieved investor claims

IPA

For the purposes of determining voting rights

We suggest that the potential for undue cost and time being generated by aggrieved investors justifies some additional onus being placed on them to substantiate their claims. The IPA considers that there should specific requirements in respect of the information that needs to be provided by an aggrieved investor to enable the making of a just estimate of the claim by the external administrator for voting purposes.[181] The information to be provided should include:

- the date or dates of acquisition of securities;
- the number of securities acquired on each occasion;
- the consideration supplied for the acquisition of the securities;
- the dates and amounts of any dividends received in respect of the securities;

[181] See Corporations Regulation 5.6.23.

- in respect of the sale of any securities, the dates, numbers of securities and the amount sold for; and
- specific details of the corporate misconduct relied upon and how it was relied upon.

The IPA considers that such a requirement will serve a twofold purpose of:

- making the administrator's determination of the claimants' entitlement to vote easier, even if the claim is only able to be admitted for a nominal amount, and
- reducing the number of spurious claims, or claims that may be made merely as a matter of course, by virtue of the shareholder being a shareholder.

This requirement should apply to voting in voluntary administrations and liquidations.

IMF

An Efficient Method of Quantifying Loss

There are two kinds of loss that will be claimable by Shareholder Creditors, namely:

- direct loss, being the amount paid for shares purchased during the period in excess of their true value,[182] and
- consequential losses flowing from loss of use of the funds comprising the direct loss.[183]

Calculation of the direct loss suffered by each shareholder currently requires expert evidence concerning the true value of the shares during the period in issue.

An efficient method of identifying the true value of the shares would be the appointment by the company and the shareholders of one independent expert who could provide a binding expert determination.

Alternatively, loss might be defined in the statute as the difference between the price paid for the shares and the subsequent price received or receivable for the shares (which in the case of insolvency, is likely to be zero).

Whichever definition is chosen, the focus of the legislature must be on creating a compensatory rule that is easily understood and workable. As the High Court has noted, referring to a judgment of Lord Steyn in the House of Lords:

> *The fundamental rule was that the plaintiff should be compensated; that the rule which turns on an assessment of value is only a means of giving effect to the overriding compensatory rule.*[184]

Consequential losses could be calculated by reference to the average return on investment on shares included in the Australian All Ordinaries or some other index such as the ASX200, from the date of the breach until the appointment of the external controller to the company.

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[182] See *Potts v Miller* (1940) 64 CLR 282; *Smith New Court Securities Ltd v Citibank NA* [1997] AC 254.

[183] *Marks v GIO Australia Holdings Ltd* (1998) 196 CLR 494.

[184] *HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd* [2004] HCA 15 at par 63. The decision of Lord Steyn was in *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1997] AC 254.

Attachment "B"

Calculation of Loss

1. Calculation of Loss

1.1 Direct Loss

(a) direct losses will be incurred at the time the shares were purchased[185]

(b) 'the proper mode of measuring the damages …[is] to ascertain the difference between the purchase money and what would have been a fair price to have paid for the shares in the circumstances of the company at the time of the purchase'[186]

(c) 'the real value of what the plaintiff got must be ascertained in the light of the events which afterwards happened; because those events may show, for instance, that what the shares might have sold for was not their true value or that it was a worthless company'[187]

(d) what is recoverable is the price paid, giving credit for further benefits received as a result of the transaction, including the market value of the property acquired at the date of the transaction. This rule is not applied inflexibly so as to prevent full compensation being obtained. For example, it will normally not apply where the misrepresentation has continued to operate after the date of the acquisition of the asset so as to induce the plaintiff to retain the asset or where the purchaser is locked into a business that he has acquired[188]

(e) the High Court in *HTW Valuers (Central Qld) Pty Ltd v Astronland Pty Ltd*[189] referred to *Smith New Court Securities Ltd* with approval (see para 63) and said:

> *And Lord Steyn, who reached the same result, pointed out that the fundamental rule was that the plaintiff should be compensated; that the rule which turns on an assessment of value is only a means of giving effect to the overriding compensatory rule, and that the valuation of assets as at the date of the transaction is 'simply a second order rule applicable only where the valuation method is employed'. [81] He went on... 'If that method is in apposite, the Court is entitled simply to assess the loss flowing directly from the transaction without any reference to the date of transaction or indeed any particular date. Such a course will be appropriate whenever the overriding compensatory rule requires it'.*
>
> *The deduction of true value at the acquisition date from the price paid is no more than a guide to the assessment of damages under s 82. Section 82 does not in terms refer to that method, and the width of s 82 permits other approaches to the assessment of damages so long as they work no injustice. The alternative approach advocated by the plaintiff has particular appropriateness in the present circumstances. That is because a primary reason for the common adoption, in assessing damages in deceit, of the test of comparing the price paid for an asset with its true value when acquired is the desirability of separating out losses resulting from extraneous factors in the later history of the asset [83].*

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185 See *Potts v Miller* (1940) 64 CLR 282; *Smith New Court Securities Ltd* [1997] AC 254.

186 Dixon J in *Potts v Miller*.

187 Dixon J in *Potts v Miller.* See also *Tay v Koh* [1998] WASC 138.

188 See Lord Brown-Wilkinson in *Smith New Court Securities Ltd.*

189 [2004] HCA 54 (14 November 2004).

Here, the trial judge found that the decline in value of the Plaza had no cause other than the completion of the Beach Road Shopping Centre;

(f) the measure of loss for a shareholder who purchased shares on the market after a certain date (and who establishes causation) may be:

- the difference between the price paid and the true value of the shares at the time of purchase; and
- because the misrepresentations and non disclosure continued (and new misrepresentations were made or new acts of non disclosure occurred (or silence continued) until the shares were worthless, also the difference between the true value of the shares at the time of purchase and the present value (if still held) or the value at the time they were sold.

(g) the result would be that loss is the difference between the price paid and the present value (zero) or the value at the time the shares were sold;

(h) it may be that the shareholder will need to prove that the continuing misrepresentation or failure to disclose (or fresh misrepresentations or failure to disclose) caused the shareholder to hold the shares rather than sell them (or to hold them until they were sold) in order to obtain compensation as discussed in (g)(ii) above.

1.2 Consequential Loss/Loss of Opportunity

Loss of an opportunity to make a return by investing the money with which the Company's shares were bought (or for which they could have been sold) in another asset is likely to be capable of recovery.[190]

CSA

As it is possible that CAMAC could recommend to the government that either Option 1 or 3 be implemented, we provide comments below on a number of matters that arise only in the event of either of these two options being implemented. Our comments on these matters are offered solely on the basis that Options 1 and 3 might be implemented. They are not to be read as weakening our support for Option 2.

CSA recommends that, as set out on page 74 of the discussion paper, the regulation should require that a shareholder claim relating to the acquisition of shares in the company stipulate:

- the date or dates of acquisition
- the number of securities acquired on each occasion
- the consideration supplied for the acquisition of the securities, and
- the corporate misconduct relied upon (specifying, for instance, where an alleged misrepresentation is contained in a document, the precise misrepresentation relied upon and its location in the document).

CSA further supports the suggestion that there be a requirement that the particulars of the claim be verified by statutory declaration of the shareholder or (in the case of a corporate shareholder) a director of the shareholder.

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190 *Sellars v Adelaide Petroleum NL* (1994) 179 CLR 332.

ASIC

Practical procedural reforms

The *Sons of Gwalia* approach may place some additional administrative burden on external administrators (and thus increase fees and decrease recoveries for creditors). Any measures that reduce this possible increased burden are desirable. We therefore support the following practical procedural reforms to complement the current legal position on aggrieved investor claims:

'*Just estimates*': Regulation 5.6.23(2) of the Corporations Regulations should be amended to set out a standard procedure by which aggrieved investors would make out a claim, as proposed in section 8.3.1 of the Paper.

Harris & Hargovan

In our view, should the fraud on the market approach be adopted, this will then make assessing the value of aggrieved investor claims simpler.

If our proposal of limited subordination is adopted (see above submission to 7.3), then the issue of determining the payout to aggrieved investors will be relatively simple as only claims by new investors will need to be addressed.

IMF

Making Determination of Claims More Efficient

The Discussion Paper notes in section 8.3.2 that 'possible ways to expedite the claims procedure and make it more efficient' include providing for a single judicial determination for a common aggrieved investor issue, including through a single proof of debt, and having a rebuttable presumption that a court's determination of a common question of fact in one proceeding applies in all subsequent proceedings. These proposals are sensible given this submission's view that it is not necessary for each investor to prove individual reliance (and therefore there should be a sufficient commonality of claims).

If the legislature decides that shareholders are not entitled to rank with unsecured creditors, thought must be given to the suggestions in Part 2 above, namely by clarifying that a shareholder, in order to prove causation in any action that might be brought against the directors of a company under external administration, need only show that the shareholder:

- acquired shares in the company during a period in which the company and its directors were in breach of their legal obligations; and
- would not have purchased the shares at the price the purchase was made if the shareholder had known the true circumstances.

CSA

As it is possible that CAMAC could recommend to the government that either Option 1 or 3 be implemented, we provide comments below on a number of matters that arise only in the event of either of these two options being implemented. Our comments on these matters are offered solely on the basis that Options 1 and 3 might be implemented. They are not to be read as weakening our support for Option 2.

CSA recommends that, as set out on page 75 of the discussion paper, a single judicial determination for a common issue require aggrieved investors to lodge their claims by a certain cut-off date, with all appeals to the court from any decision of the external administrator on the proofs of debt being consolidated in a single action, rather than the external administrator being involved in multiple court actions on this matter.

ASIC

There is already a significant body of rules in place to encourage the bringing of representative or joint actions in relation to claims dealing with similar facts and questions of law. We consider this is sufficient to facilitate the consolidation of aggrieved investor claims.

IPA

For the purpose of distribution to creditors

If a fraud on the market doctrine, or its statutory equivalent, is not available, practitioners will be required to assess the liability in respect of each claim individually.

However, we consider that there is merit in the following:

- the introduction of a rebuttable presumption that a court's determination of a common question of fact in one proceeding applies in all subsequent proceedings. There may be instances where an administrator can group claimants in respect of common issues for determination by the court. A determination on a common issue may be presumed to apply in relation to others in the group. There is some parallel with such a process in s 588E of the Corporations Act;
- a requirement that aggrieved investors lodge their claims by a certain cut-off date; and
- all appeals to the court from any decision of the administrator on the proofs of debt being consolidated in a single action, rather than the external administrator being involved in multiple court actions. We do not agree with the suggestion of a single proof of debt on behalf of all aggrieved investor claimants as we do not believe that there would be a sufficient commonality of interests.

We also consider that there be introduced a different regime for determination of shareholder claims for the purpose of paying dividends. We think that the current regime in the Corporations Act for calling for proofs and paying a dividend[191] does not give practitioners dealing with aggrieved investor claims sufficient time within which to process these claims and still remain within the timeframes in order to obtain the benefits of the process.[192]

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[191] The liquidation process for paying dividends is often imported into Deeds of Company Arrangement to provide the structure for dealing with claims under the Deed.

[192] A benefit of the dividend process is that once the date for lodging proofs of debts passes, the creditor is excluded from participating in that dividend, providing the liquidator with certainty when distributing the dividend.

For example, under the current regime:

- regulations 5.6.54 and 5.6.65 to 5.6.69 provide for a process of calling for proofs, dealing with those proofs and then paying a dividend;
- notice has to be given to each person who, to the knowledge of the liquidator, claims to be, or might claim to be, a creditor of the company;
- if a person who claims to be a creditor does not submit their formal proof by the date specified then they are not to be permitted to participate in that dividend;
- for this limitation to apply, the liquidator has a window of two months from advertising the intention to declare a dividend to actually declaring and paying the dividend. This timeframe is unlikely to be able to be met when considering the number and complexity of aggrieved investor claims;
- if the timeframe expires without the declaration of the dividend, the process has to start again.

As an alternative to the current regime, the IPA considers that it would be of benefit to insolvency practitioners if a process along the lines of the following was provided to deal with aggrieved investor claims:[193]

- notice of intention to declare a dividend be advertised and notice posted to aggrieved investor claimants who have given written notice of their intention to claim but have not (in accordance with the communication framework detailed in our submission);[194]
- cut off date for lodgement of claims be specified at not less than 1 month to allow aggrieved investors sufficient time to lodge their claim (the timeframe under existing regime is currently 21 days);[195]
- one month be given to deal with claims, or longer if approved by ASIC or the Court[196] (currently 14 days applies under regulation 5.6.66 which is not long enough for these types of claims). The application to ASIC or the Court to deal with claims should be a single application to obtain a general extension to deal with all aggrieved investor claims;
- the administrator be only required to advise rejections or requests for further information, not decisions to admit the claim, by the end of this one month period or any extended period if one is granted;[197]
- rejection appeals have to be made by aggrieved investor claimants within one month;[198]
- depending on the grounds of the rejection appeals, these can be heard using the rebuttable presumption or the single hearing options mentioned above;
- there be a prohibition in place on the making of any further claims by aggrieved investors until the intended dividend is paid. To ensure that this

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193 Ordinary creditors could continue to be dealt with under the existing framework.
194 Equivalent to regulation 5.6.52.
195 Equivalent to regulation 5.6.65(2).
196 Equivalent to regulation 5.6.66(1)(a) and (b).
197 Equivalent to regulation 5.6.66(1)(c) and (d).
198 Equivalent to regulation 5.6.54.

does not extend indefinitely, there should be a time limit of one year or longer, if allowed, on application to the Court.[199] This aspect of the process is critical. The administrator must have certainty as to the creditors participating in the dividend and once the date for claims has passed, there can be no further claims on that dividend; and

- once all of the aggrieved investor claimants have been dealt with and resolved they are effectively on hold while the Practitioner follows the current regime for other creditors.[200] The fact that aggrieved investors have been dealt with and their position finalised should allow the rest of the process to proceed as normal.

The implementation of such a process as outlined above is not meant to limit the administrator's ability to process claims in the manner they deem appropriate to the administration (for example through the implementation of an agreed streamlined adjudication program for immaterial claims). The above process should complement the practitioner's process for claims adjudication.

The IPA suggests that such a process may be useful in other situations where there are large numbers of complex claimants; for example, long tail liabilities for insurance companies or personal injury claimants.

ASIC

Practical procedural reforms

The *Sons of Gwalia* approach may place some additional administrative burden on external administrators (and thus increase fees and decrease recoveries for creditors). Any measures that reduce this possible increased burden are desirable. We therefore support the following practical procedural reforms to complement the current legal position on aggrieved investor claims:

'*Rebuttable presumption*': The Act should be amended to introduce a rebuttable presumption that a court's determination of a common question of fact in one aggrieved investor proceeding applies in subsequent proceedings that involve a determination of the same question of fact, as proposed in section 8.3.2 of the Paper.

8.4 Exercising proxy votes

IPA

The discussion paper at 8.4 refers to a possible difficulty of law firms or litigation funders exercising proxies in circumstances where they have a financial interest, in breach of Corporations Regulation 5.6.33. We point out that regulation 5.6.33 was amended on 31 December 2007 to provide that only a person acting under a general proxy must not vote in favour of any resolution which would directly or indirectly place them in a position to receive any remuneration out of assets of the company. The exclusion in relation to specific proxies has been removed and this should address the issue the discussion paper raises.[201]

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199 Equivalent to regulation 5.6.65(3).

200 Regulations 5.6.54 and 5.6.65 to 5.6.69.

201 The reasons for this are explained in the Explanatory Statement to Select Legislative Instrument 2007 No 325 at item [35] which includes reference to CASAC's 1998 Report - *Corporate Voluntary Administration*. Footnote 161 of the discussion paper refers.

8.5 Court directions

IPA

Whilst a voluntary administrator can seek the court's assistance under s 447A in relation to any variations in the legal requirements as may be necessary, there are only limited avenues for this in a liquidation. The IPA suggests that there be a provision that allows a liquidator to seek specific orders, for example in relation to the process of determination of claims or meeting procedures. Such a provision would be preferable to a detailed legislative regime where all issues would need to be anticipated.

9 Possible reforms if law changed

The submissions in this chapter are summarised in Section 5.3 of the report.

QBE

We do not believe there is any sound justification for the introduction of a US style 'fraud on the market' theory in Australia, as it would make it easier for shareholders to claim damages without each having to prove reliance on misleading conduct by the company.

From the perspective of an international organisation operating in 45 countries, there are many factors which can affect the share price, some of which are out of our day to day control and are part of normal market fluctuations.

QBE (and we believe many other companies) is committed to full and frank disclosure to its shareholders, employees and other stakeholders. However, the honesty and quality of such disclosure must be judged in line with the prevailing market conditions at the time, in terms of available data and any commercial sensitivities which may be present.

Australia has a strong, practical regulatory framework for listed companies across various industries governing all aspects of business, including directors' duties. One core feature which all listed companies share and are guided by is a robust continuous disclosure regime via the Australian Securities Exchange, for which we believe the large majority of listed companies take seriously and make disclosures in good faith.

We consider CAMAC should ensure that not all listed companies are disadvantaged through the introduction of further regulation aimed at addressing the fraudulent or negligent conduct of a small minority of listed companies.

If 'fraud on the market' theory were introduced, this would not only potentially affect QBE as a listed company, but could have a significant impact on QBE as a large underwriter of directors' and officers' insurance (D & O), if it leads to a greater frequency and severity of claims.

Increased premiums will ultimately be borne by customers and shareholders, especially for those companies which pay claims via their D & O policy or the indemnity for officers in their constitution. In turn, this will impact investment returns. This is against the Federal government seeking Australians to self-fund their retirement.

We understand that 'fraud on the market' is an issue in the recently concluded trial of the Aristocrat Leisure case. We believe CAMAC should await the judgement and carefully analyse it before finalising its recommendations.

As 'fraud on the market' is essentially a US concept, we note with interest the 2005 US Supreme Court decision in the matter of *Dura Pharmaceuticals, Inc v. Broudo*, 544 U.S. 336 (2005), in which the Supreme Court found that if a shareholder purchased shares at an artificially inflated price because of a misstatement by the company, this was not sufficient reason to base a securities fraud suit. The Supreme Court said the shareholder needs to demonstrate a clear link between the misrepresentation and the actual reduction in the share price.

If 'fraud on the market' becomes of Australian law, then it should include the safeguard of the clear link above.

Law Council - Corporations Committee

In section 3.2 of the Discussion Paper, reference is made to the roles of principles of causation and reliance in the context of civil securities law actions under Australian law. In section 9 of the Discussion Paper reference is made to the possibility of the introduction of a fraud on the market rule for civil recovery in the Australian securities law context.

The Corporations Committee is strongly of the view that it is inappropriate to consider possible changes to Australian law in relation to these matters in the context of consideration of the *Sons of Gwalia* issue. In the Corporations Committee's view such a proposal is outside the reference to the Advisory Committee described in section 1.4 of the Discussion Paper.

Changes to the requirements of reliance and causation and, in particular, the introduction of a fraud on the market rule would have profound implications to the Australian securities laws that are much broader than the issues surrounding *Sons of Gwalia*. The Corporations Committee strongly submits that if the Advisory Committee wishes to enter into an analysis of these issues a much broader range of considerations need to be considered than those that are set out in the Discussion Paper.

IMF

Addressing the call in section 9.2 of the Discussion Paper regarding the introduction of a 'fraud on the market' approach, IMF submits that the approach to causation described in paragraphs 65 to 71 of this submission is consistent with established authority and that one does not require that adoption of any particular 'theory' to establish causation. (See Attachment "A")

Attachment "A"

Causation

The word 'by' in the context of the misleading and deceptive provisions requires that:

- the company's conduct must have materially contributed to the suffering of loss or damage; and
- the shareholder's loss be caused by the conduct of the Company in breach of the relevant legislation. Reliance per se is not required.[202]

The words 'resulted from' in s 1317HA(1) in the context of the material non disclosure provisions[203] result in the same approach to causation as for misleading and deceptive conduct.

Circumstances in Which Causation Can Arise

Causation can arise at a series of graduated levels:

(a) direct reliance on the Company's conduct - the shareholder is induced to buy or not to sell in reliance on the conduct of the Company;

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202 *Wardley v State of Western Australia* (1992) 175 CLR 514, 525; *Henville v Walker* (2000) 206 CLR 454.

203 *Adler v ASIC* [2003] NSWCA 131 re S1317H by analogy.

- the shareholder must currently be personally aware of the Company's conduct. If the misrepresentation was calculated to induce the shareholder to buy shares and the shareholder buys shares, an inference arises that it was induced to do so[204]
- the Company may attempt to rebut the inference of reliance by evidence (presumably after discovery from individual shareholders) to the effect that the shareholder did not rely on its conduct in making the purchase or hold decision

(b) reliance on another, who relied on the Company's conduct - the shareholder is induced to buy or not to sell as a result of the conduct of a third party, whose conduct was induced by the Company's conduct;[205]

- the third party might be a broker or it might be other shareholders or potential shareholders (ie the market);
- to raise the inference of reliance by the third party, it is necessary to show that the third party was aware of the Company's conduct (including silence). Where the third party is the market, this may be established by inference as it is likely to be accepted that announcements (or lack of announcements) come to the attention of the market. Therefore, an inference is raised of reliance by the market, resulting in the Company's shares trading at an inflated price;
- to raise the inference of reliance by the shareholder on the third party (being the market), the shareholder will need to have been aware of the prices at which the Company traded (at the time of the purchase and presumably through out the period if the case is one retention of shares);

(c) no reliance on another, but that other's reliance results in loss to the shareholder - the Company's conduct induces a third party to act (or not to act) and that of itself causes the shareholder to suffer loss;[206]

- this circumstance would arise where the shareholder bought shares and held them in a market which had not been properly informed or was misinformed (where the third party is treated as the market) and therefore the shares are trading in a false market;
- underlying this level of causation is the assumption (which may need to be proved by expert evidence) that purchasers of shares in the market rely on information disclosed by companies to make buy and sell decisions, which determines the prices at which the shares trade.

The last level of causation (ie (c)) is the broadest and encompasses the levels discussed in (a) and (b). It is the logical type of causation to arise where there is failure to disclose material information because the whole purpose of the continuous

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[204] *Gould v Vaggelas* (1985) 157 CLR 215; *Como Investments Pty Ltd (in Liquidation) v Yenald Nominees Pty Ltd* (1997) ATPR 43,617; *ACCC v Internic Technology Pty Ltd* [1998] 818 FCA; *Burg Design Pty Ltd v Wolki* [1999] FCA 388; *Blacker v National Australia Bank Ltd* [2000] FCA 681.

[205] *Hampic Pty Ltd v Adams* [1999] NSWCA 455; *Digi-Tech Australia Ltd v Brand* [2004] NSWCA 58; *Australian Breeders' Co-operative Society Ltd v Jones* (1998) 150 ALR 488.

[206] *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 37 FCR S26; *Ford Motor Company Australia Ltd v Arrowcrest Group Pty Ltd* [2003] FCA FC 313.

disclosure regime is to ensure (as much as possible) that market prices reflect true value of the company by requiring material information to be disclosed.

In the case of a material non disclosure, causation could arise where:

- immediately before the shareholder bought shares it checked the ASX disclosures to determine what announcements the company had made and bought in reliance on what the company had disclosed or that there were no negative disclosures; or
- the shareholder relied on the advice of a broker who had been monitoring the Company's disclosures or checked the prices at which the Company was trading and relied on the fact that those prices would reflect all material information publicly available about the Company; or
- the shareholder simply purchased shares in the Company and by virtue of the fact that others in the market relied on information available (or no negative information), which determined the price (which was a false price), suffered loss.

CSA

CSA is strongly opposed to the introduction of a fraud on market approach.

CSA believes that any person seeking to claim damages should be required to establish specific knowledge of and reliance on misrepresentations. CSA is also concerned that the introduction of this approach would facilitate shareholder class actions against solvent ongoing companies, which is not the policy objective of a fraud on market approach.

The policy objective would be to increase shareholder rights in rare cases where the company has become insolvent and the company was able to pay the claims of all creditors and had sufficient funds remaining to meet aggrieved investor claims. CSA is opposed to law reform that seeks to address rare cases, yet will have far greater effect on matters it was not designed to address than on those it was designed to address.

ASIC

Fraud on the market doctrine

The introduction of a 'fraud on the market' doctrine cannot serve as an alternative to the *Sons of Gwalia* position, as the two have different application and effect. Merely introducing the fraud on the market doctrine would not address the issue that, if the *Sons of Gwalia* position were reversed, then aggrieved investors would not be paid until after all other creditors. The fraud on the market doctrine merely assists investors to make out claims; it does not affect their priority in relation to other creditors in the distribution of funds of the insolvent company.

ASIC considers that the issue of whether a fraud on the market doctrine should be introduced in Australia warrants further, detailed consideration. The doctrine would apply to actions against both solvent and insolvent companies and its effects, especially in relation to claims against solvent companies, deserve careful analysis. CAMAC might wish to consider whether it would like to conduct a separate review on the potential introduction of the 'fraud on the market' doctrine into Australia on its

own initiative under its power in sections 148 and 154 of the *Australian Securities and Investments Commission Act 2001 (Cth).*

ABA

The introduction of a fraud on the market concept would clearly make it far easier for shareholders to bring aggrieved investor claims. Indeed, in the Australian context where class actions are increasing and litigation funders are extremely active, the introduction of a fraud on the market concept would, it is submitted, lead to a very significant increase in claims being brought in circumstances that give rise to aggrieved investor claims.

The ABA would be extremely concerned at the introduction of the fraud on the market concept unless it was done so in circumstances that made it abundantly clear that such claims were subordinated in every respect to claims brought by unsecured creditors. That subordination would need to extend to both direct and indirect or derivative claims so that the introduction of the fraud on the market approach did not, through an indirect route, elevate such claims to rank equally with the claims of unsecured creditors.

AFMA

While the criteria referred to by the Committee for founding an aggrieved shareholder claim based on the *Sons of Gwalia* decision [are] currently correct, there are other developments in the law. The case of *Dorajay Pty Ltd v Aristocrat Leisure Ltd* has raised the issue of importing the fraud on the market theory into Australian law. This would overcome the causation difficulties raised by the Committee for aggrieved shareholders establishing a cause of action against an insolvent company, with the consequence that such cases would become more frequent and increase the concerns expressed at 5 below in the case of corporate insolvencies.

Fraud on the market would not require aggrieved shareholders to establish causation. The United States Supreme Court decision of *Basic Inc v Levinson* (1988) 485 US 224 @ 248, provides the following criteria for fraud on the market claims which would not require proof of individual aggrieved shareholder reliance:

(a) the defendant made public misrepresentations;

(b) the misrepresentations were material;

(c) the shares were traded on an efficient market;

(d) the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and

(e) the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.[207]

AFMA submits that, in the likely event that fraud on the market becomes a feature of Australian law as a result of the Aristocrat case, it would be considerably easier for aggrieved shareholders to bring class actions against insolvent companies. As a consequence, the detrimental effects on financial markets described at 5 below will only be compounded further, unless such claims are subordinated to creditors' interests.

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[207] Legg, M & Schaffer, R. Op cit @ pages 394 & 395.

For the reasons provided [elsewhere in the submission], AFMA regards the prospect of fraud on the market in the case of corporate insolvency as achieving the same result and negative policy outcomes in the same circumstances as Option 1, except that it would provide an easier mechanism for aggrieved shareholders to bring such claims than is currently the case based on the Sons of Gwalia.

Accordingly, AFMA would be supportive of fraud on the market claims in the event of corporate insolvency being subordinated to secured and unsecured creditors. This would be consistent with the legal position in the US and Canada.

IPA

The Sons of Gwalia administrators have prepared conservative costings of handling aggrieved investor claims, on an approximate cost per shareholder basis, with and without a fraud on the market doctrine being available. The costings show that handling such claims without a fraud on the market doctrine increases the costs of determination by 60%. In Sons of Gwalia, with over 5,000 shareholders, that would add over $3m to the costs of determination of those proofs of debt.

Removing the need to make that assessment, or to make it to the fullest extent, would significantly reduce the costs and time of dealing with such claims.[208]

Law Council – Insolvency Committee

It perhaps goes without saying that the Committee would not support the introduction of a ‘fraud on the market approach’ as suggested in paragraph 9.2 of the Discussion Paper if the law were changed to option 2.

Nehme and Wee

We do not have strong opinions on this question. However, it may appear at first instance that aggrieved investors may find the task of obtaining remedies through litigation very difficult. Proving reliance may be tricky.

Adopting a traditional common law approach that requires proximity between investor and the company may not allow aggrieved investors to sue. The British House of Lords affirmed in the 1990 that under the common law there is no such proximity except if the company actually was aware of the fact that the plaintiff plan to rely on the release. Such an approach may encourage investors to contact the firm to advise them of the reliance and this approach may encourage shareholders' monitoring of the company's affairs.

In Australia, the number of class actions is limited. However, in the last decade four major class actions took place (GIO, *Media World*, *Concept Sport* and *Sons of Gwalia*). There is a high chance that the number of such actions may go up if the ‘fraud on the market theory’ that is applied in the US is introduced into the Australian system. The NERA Economic Consulting noted that securities class actions in the US are on the rise. In 2004, for instance, the mean settlement value was $27.1 million; this figure is an increase in the mean of settlement of 33% of the figure in 2003 which was $20.3 million. This rise in class action was largely fuelled by lawsuits from investors who suffered losses in the bear market. Furthermore, securities class action

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208 We nevertheless accept that breaks in the chain of causation may mean that this approach will not assist in all cases. See the Law Council's submission at [13]; also the discussion paper at [9.2].

in WorldCom, Raytheon and Bristol-Myers Squibb provided three of the eight largest class action of all time with a combined value of over $3.3 billion.

Accordingly, adopting a system like the US may raise the cost of business and open a floodgate of court actions. On the other hand, the fraud on the market theory may have the effect to encourage investors to hold a more diversified portfolio.

You may wish to comment on the possible ramification of facilitating these claims by the adoption of market approach.

The US system does not allow shareholders to rank equally as creditors. However, the current system in Australia allows shareholders claims to be ranked equally to creditors' claims in certain cases. Introducing a fraud on the market approach may open the floodgate of action by shareholders since they know if they prove their claim, they are not subordinated to creditors.

Harris & Hargovan

We support the introduction of fraud on the market approach. If the outcome in the Aristocrat class action (Federal Court - Stone J) is to recognise fraud on the market in Australia, there may be no need to amend the Corporations Act. If the common law does not recognise fraud on the market, then we support its introduction through statutory amendment. If the policy decision is to promote investor confidence through the timely disclosure of quality information, the process for proving damage in securities cases should be made more straightforward. The current requirements for individual causation serves only to add expense and complexity to securities class actions and, as cynics would acknowledge, perhaps enrich financial expert witnesses and law firms.

We believe the introduction of fraud on the market approach may assist in dealing with aggrieved investor claims in an efficient manner saving time and money. If aggrieved investor claims are to remain as legitimate creditor claims, there must be an easier way to assess those claims than testing causation and reliance for each individual case.

Duncan Brakell

Fraud on the market

For the reasons given above, it is not necessary to consider it to achieve investor protection.

Michael Duffy

Primary submission

It is premature to decide whether presumed reliance analogous to a 'fraud on the market' test should be introduced. It is necessary to see how the law develops in this area first. It may be that something analogous to presumed reliance (or at least causation) already exists under Australian law in situations where shares are purchased during the currency of a non disclosure.

Summary of points in support of primary submission

The decision in *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*,[209] suggests that s 82 of the *Trade Practices Act* allows a claim by a person who, although not himself misled by a representation, suffered injury as a direct result of a third party's reliance on the misleading or deceptive representation.

The case law on section 52 and section 82 of the *Trade Practices Act* has generally been persuasive in the interpretation of the cognate provisions of the *Corporations Act* and *ASIC Act* which were lifted from the *Trade Practices Act*.

It is arguable that, applied to the stock market, the *Janssen* decision suggests that a person could suffer loss through reliance by others (the market as a whole) on a misleading statement or a failure to correct a statement which has become inaccurate due to new developments.

These very points may well be determined in the upcoming decision of Justice Stone in the Federal Court in *Dorajay Pty Ltd v Aristocrat Leisure Ltd.*

Though it is not possible to make further submissions on this point until the law is clarified by this and any other future relevant decisions, to the extent that the outcome of these decisions raises a significant procedural barrier for investor claims then it may be appropriate at that point to revisit the question of deemed or presumed causation.

Detailed submission

The 'fraud on the market' theory

The American 'fraud on the market' theory is based on the Efficient Capital Markets Hypothesis (ECMH). It was explained in *Basic v Levinson* as follows:

> *The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. ... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. ...*[210]

Thus where a purchaser purchases stock that is overpriced due to a misleading statement and/or failure to disclose negative news it is unnecessary to show that the purchaser was aware of the particular misleading statement and/or failure to disclose negative news. This is because the market as a whole will be aware of same and the market price will reflect misleading statement and/or failure to disclose negative news.

It has been argued by the author of this submission[211] that the US 'fraud on the market' theory has utility in at least four ways:

1. *It is generally supportive of a philosophy of full disclosure in securities markets;*
2. *It facilitates civil recovery by:*

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[209] (1992) 37 FCR 526 ('*Janssen*').

[210] *Basic Inc v Levinson* 485 US 224, (1988) (Blackmun J) (citations omitted) 241–2 (citations omitted).

[211] Ibid.

i *providing a rebuttable presumption of reliance or causation, even in situations where the misleading representation may not be calculated to induce or in its nature be sufficiently persuasive to induce;*

ii *solving certain conceptual difficulties in establishing reliance on nondisclosures; and*

iii *providing a causal link between unlawful conduct and the mispricing of securities;*

3 *It creates a deterrent to nondisclosure by increasing the civil liability consequences; and*

4 *It goes beyond reliance and embraces the economic effects of nondisclosure on the market as a whole.*

Australian law – the *Janssen* Case

The decision in *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*,[212] suggests that s 82 of the *Trade Practices Act* allows a claim by a person who, although not himself misled by a representation, suffered injury as a direct result of a third party's reliance on the misleading or deceptive representation.

The case was brought by a trader who had lost business when his customers were induced by the misleading representations of a competitor to patronise the competitor. The decision of Lockhart J in that case stands strongly for the principle that entitlement to recover loss or damage under s 82 is not confined to persons who rely on the representations which constitute contraventions of the Act.

The case law on section 52 and section 82 of the *Trade Practices Act* has generally been persuasive in the interpretation of the cognate provisions of the *Corporations Act* and *ASIC Act* which were lifted from the *Trade Practices Act*.

It is arguable that, applied to the stock market, the *Janssen* decision suggests that a person could suffer loss through reliance by others (the market as a whole) on a misleading statement or a failure to correct a statement which has become inaccurate due to new developments. Thus, a form of causation not requiring direct reliance may already be contemplated by Australian law, without any reference to the 'fraud on the market' theory (though such an approach would require an acceptance by the courts of the Efficient Capital Markets Hypothesis – at least in the circumstances of that case).

Thus in a claim for loss by a purchaser of overpriced shares there may be no direct reliance at all on the nondisclosure. The chain of causation in this situation may be based on the market's response to the nondisclosure rather than that of the individual claimant. Indeed, in this type of case the claimant is assumed to be unaffected by nondisclosure as, implicit in his or her claim, is the assumption that he or she would still have purchased the shares (albeit at a lower price) if the true facts had been known.[213]

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[212] (1992) 37 FCR 526 ('*Janssen*').

[213] Interestingly, the *Corporations Act* allows for a claim for compensation by a purchaser of overvalued shares when they were purchased from an insider holding price sensitive information: see *Corporations Act* s 1043L(4). It also appears to allow for such a claim by a purchaser of shares which are overvalued due to a takeover announcement which does not come to fruition: see *Corporations Act* s 670E.

These very points may well be determined in the upcoming decision of Justice Stone in the Federal Court in *Dorajay Pty Ltd v Aristocrat Leisure Ltd*. It is therefore not really possible to make further detailed submissions on this point until the law is clarified by this and other future decisions.

To the extent that the outcome of these decisions raises a significant procedural barrier for investor claims then it may be appropriate at that point to revisit the question of causation. In that regard it is noted that deemed reliance already exists in the *Corporations Act* in relation to misstatements or omissions in a disclosure document.[214] Further, deemed reliance has been legislated in the four Canadian provinces that account for 95 per cent of capital market activity in Canada.[215]

Conclusion.

It is probably premature for the legislature to consider this issue this point until the law is clarified by this and any other future relevant decisions. To the extent that the outcome of these decisions raises a significant procedural barrier for investor claims then it may be appropriate at that point to revisit the question of deemed or presumed causation.

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214 See *Corporations Act* section 729(2).

215 See upcoming paper by Dr Janis Sarra 'Risk Allocation and Efficient Administration: A comparative analysis of the treatment of equity securities claims in insolvency' p14 (draft paper presented at Corporate Law Teachers Conference, Sydney Australia 4th February 2008). See Ontario *Securities Act*, RSO 1990, c S-5, ss 130, 131.

10 Member claims

The submissions in this chapter are summarised in Section 7.5 of the report.

ABA

The ABA supports the approach, in line with the Canadian proposal, that shareholders with aggrieved investor claims should only be able to vote in an insolvency proceeding in circumstances where the court grants leave. Where the aggrieved investor claimants are subordinated to the body of unsecured creditors, such claimants should not be able to influence the outcome of the administration other than in circumstances where they have an economic interest in the outcome of the insolvency proceedings.

Baker & McKenzie

The Canadian approach to treatment of member claims captured by section 563A of the Corporations Act should be adopted in Australia. To allow members to participate in the external administration process as creditors will create a new class of creditor that has interests divergent with those of ordinary unsecured creditors. This approach will also permit junior ranking creditors to potentially control that process due to their large number.

ASIC

Voting rights for creditors with member claims

1. Chapter 10 of the [Discussion] Paper considers whether shareholders, who have claims in their capacity as members of the company within the meaning of s 563A and whose claims are therefore postponed, are nevertheless creditors of the company.

2. We consider that the legal position is uncertain. However, allowing shareholders with claims in their capacity of members within the meaning of s 563A to participate in external administrations as creditors could add a significant burden to the external administration process, by adding a potentially large new group creditors with the potential to out-vote other creditors.

Therefore, ASIC supports legislative amendment to provide expressly that shareholders whose claims are postponed by s 563A are not entitled to creditor voting rights. This amendment could be modelled on the new Canadian provision applying to corporate debt reorganisations, discussed in section 10.4 of the Paper,[216] which requires shareholders with 'equity claims', that is, claims arising from the rescission of a purchase or sale of shares, to be placed in a separate non-voting creditor class, unless a court deems otherwise.

Harris & Hargovan

We support the exclusion of subordinated members from having voting rights at creditors meetings.

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216 Subsequent to the writing of the Paper, the legislation introducing this section was passed on 29 October 2007 and is due to come into force in February 2008 as s 22 of the *Company Creditors' Arrangements Act 1933* (Can).