CASE NOTES

SHAREHOLDER CLAIMANTS MAY RANK ALONGSIDE ORDINARY CREDITORS: SONS OF GWALIA LTD "SHAREHOLDER TEST CASE"

Sons of Gwalia Ltd (subject to Deed of Company Arrangement) v Margaretic & Anor ([2007] HCA 1)

Companies – Winding up – Proof and ranking of claims – Claim by shareholder against company for misrepresentation inducing purchase of shares – Sections 553 and 563A of the Corporations Act – Whether claim admissible to proof under section 553 of the Corporations Act 2001 – Whether claim postponed by operation of section 563A of the Corporations Act 2001

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HIGH COURT'S DECISION

On 31 January 2007, the High Court of Australia delivered its decision in *Sons of Gwalia Ltd (subject to Deed of Company Arrangement) v Margaretic & Anor*[1] (SOG appeal).

The High Court held by a majority of 6 to 1 that a claim by a shareholder for damages for loss sustained in the acquisition of shares arising from the company's misleading or deceptive conduct is:

- a provable debt in the winding up or in the deed of company arrangement of a company; and
- not a debt due to a shareholder in his capacity as a member and, accordingly, section 563A of the Corporations Act 2001 does not apply to postpone such a claim to the debts due to ordinary unsecured creditors.

In practical terms, shareholders' damages claims in relation to the purchase price of their shares may now rank equally with the claims of ordinary creditors.

BACKGROUND

Priority Regime under the Corporations Act

The SOG appeal was primarily concerned with sections 553(1) and s 563A of the *Corporations Act*. These sections appear within Part 5.6 of the *Corporations Act* which deals with the winding up of companies and establishes a system of administration under which the assets of an insolvent company are to distributed.

Part 5.6 necessarily embodies a number of value judgments about the relative priority of the various kinds of liabilities owed by an insolvent company, and the order in which these liabilities should be discharged out of the limited funds available for this purpose. The insolvent company's

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1 [2007] HCA 1.

assets are distributed, after payment of the costs associated with the winding up, in a descending order of priority, firstly to employees and finally to shareholders.[2]

The subordination of shareholders' claims to the claims of ordinary creditors is encapsulated in section 563A which provides:

> "Payment of 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, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied."

The effect of section 563A is to provide for the deferral of debts owed to members in their capacity "as members" until after all non-member claims have first been satisfied.

Conventional Assumption: Shareholder's Claims are Postponed

Until the High Court's decision in the SOG appeal, the conventional assumption was that misleading or deceptive conduct claims against the company by members in respect of statements made inducing the members to invest in the company would be deferred under section 563A. This assumption found judicial support in the High Court's decision in *Webb Distributors (Aust) Pty Ltd v State of Victoria*.[3] In that case, the High Court held that a subscriber shareholder's claim for damages for misrepresentation was a claim in the person's capacity as a member for the purposes of the statutory predecessor of section 563A.[4] The High Court found that such a claim was a claim against the capital of the company and, accordingly, fell within the ambit of the section.[5]

Uncertainty Regarding Conventional Assumption

However, other decisions raised questions regarding the application of the High Court's reasoning in *Webb*, particularly with respect to defrauded shareholders who purchased their shares on market (ie transferee shareholders).

In *Soden v British & Commonwealth Holdings PLC*,[6] the House of Lords drew a distinction between claims by a subscribing shareholder "for compensation for misrepresentation or breach of contract" and claims "founded on a misrepresentation made by the company on the purchase of existing fully paid shares from a third party". The House of Lords narrowly interpreted the High Court's decision in *Webb* as applying only to subscriber shareholders, not transferee shareholders. The distinction was founded upon a construction of the equivalent section in the English *Insolvency Act*, to the effect that it applied only to "rights founded upon a statutory contract and not otherwise". The House of Lord's analysis found favour with certain members of the judiciary in Australia.[7]

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2 See section 556 of the *Corporations Act*.
3 (1993) 179 CLR 15.
4 That is, section 360(1)(k) of the *Companies (Victoria) Code*.
5 (1993) 179 CLR 15 at 36-37.
6 [1998] AC 298 at 325-326.
7 See, for example, the obiter comments of Finkelstein J in *Re Media World Communications* (2005) 52 ACSR 346.

In light of the foregoing, there was growing uncertainty with respect to the application of the principles set down by the High Court in *Webb* not only in respect of disaffected transferee shareholders, but also in relation to the application of the decision to the current provisions in the *Corporations Act*.

SOG APPEAL: "SHAREHOLDER TEST CASE"

Claim by Margaretic

Margaretic purchased shares in Sons of Gwalia Ltd (SOG) on the Australian Stock Exchange shortly before the company was placed into voluntary administration. Margaretic's shares were worthless by the time the administrator was appointed to SOG.

Margaretic claimed damages against SOG for misrepresentation and misleading or deceptive conduct in failing to disclose relevant information as required by continuous disclosure laws. By virtue of Margaretic's claim, he asserted that he was entitled to prove alongside other ordinary creditors of SOG. Margaretic submitted an informal proof of debt to SOG's administrators to this effect. However, clause 4.2(d) of SOG's deed of company arrangement expressly incorporates section 563A.[8] The issue then arose as to whether Margaretic's claim was provable and whether it should be postponed by the operation of section 563A.

Application by SOG Administrator for Declarative Relief

SOG's administrators applied to the Federal Court of Australia for a declaration that:

- Margaretic's claim is not provable in the deed of company arrangement of SOG; or alternatively
- payment of Margaretic's claim under the deed of company arrangement of SOG will be postponed until all debts owed to, or claims made by, persons otherwise than in their capacity as members of SOG, have been satisfied.[9]

The key issue was whether a statutory right of compensation for alleged misrepresentation inducing a person to purchase shares on the stock market from existing members constituted a debt owed to the member in their capacity as a member under section 563A.

At first instance and on appeal, the Federal Court found that a defrauded transferee shareholder could prove and rank alongside other ordinary creditors, and would not be postponed by the operation of section 563A. SOG's administrators appealed to the High Court.[10]

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8 Clause 4.2(d) of SOG's deed of company arrangement relevantly provides: "…payment of any debts or liabilities owed by the Company to Members in the Members' capacity as a member of the Company, whether by way of dividends, profits or otherwise are, to the extent contemplated by Section 563A of the [Corporations] Act and the general law, to be postponed until all debts owed to, or claims made by, Creditors have been satisfied."

9 ING Investment Management LLC, one of the larger ordinary creditors of SOG, also joined the proceedings in its own right as an interested creditor. In addition, Margaretic filed a cross claim seeking a declaration that he was a creditor for the purposes of the company's voluntary administration and was therefore entitled to the ordinary rights of such creditors, including the right to vote at a creditor's meeting.

10 ING Investments Management LLC also appealed to the High Court on substantially the same grounds as SOG's administrators.

High Court's Judgment

The High Court dismissed the appeal by a majority of 6 to 1.[11]

All members of the court considered the appeal should be decided primarily on the basis of the construction of the section applying established principles of statutory interpretation. They stated that the case was not concerned with the application of common law principles which anticipated, or would circumvent the application of, the statutory criteria. According to Gummow J: "The apparently seamless continuity in the reception and development of the common law in Australia is apt to distract attention from the supreme importance of statute law."[12]

Members of the majority questioned the key propositions underlying the High Court's decision in *Webb*, and some even questioned its correctness.[13]

The High Court recognised that the construction of section 563A inevitably involved policy considerations regarding the allocation of risk between investors and creditors and the priorities between them upon insolvency.[14] While this was relevant, the primary starting point was the text of the statute. The text of s 563A does not adopt a general policy of "members come last" in corporate insolvency.[15]

Section 563A requires a line to be drawn between a shareholder claiming in his capacity as a member and a shareholder claiming otherwise than in his capacity as a member.[16] Gleeson CJ concluded that:[17]

> "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 the first appellant… The respondent's membership of the company was not definitive of the capacity in which he made his claim."

A connection between the company's obligation to the member and membership must be shown. Hayne J observed:[18]

> "The expression now found in s 563A, 'in the person's capacity as a member of the company' (like its legislative ancestor, 'in his character of a member') must, of course, be given work to do in the provision. The expression defines (and confines) the particular kinds of obligations that are to be postponed. That is, it identifies the particular kinds of 'debt owed by a company' (formerly, 'sum due to any member of a company') to which particular consequences are attached. These consequences are now identified as postponement until all debts owed to, or claims made by, persons otherwise than as

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11 *Sons of Gwalia Ltd (subject to Deed of Company Arrangement) v Margaretic & Anor* [2007] HCA 1. Note, as all seven members of the High Court wrote their own reasons for decision, it is difficult to discern common threads in the reasons of the majority.

12 Gummow J at [35].

13 Gummow J at [96]; and, to a lesser extent, Gleeson CJ at [14].

14 Gleeson CJ at [18]; Gummow J at [39]; and Kirby J at [109].

15 Kirby J at [118].

16 Gleeson CJ at [28].

17 Gleeson CJ at [31].

18 Hayne at [201]-[202].

> members of the company have been satisfied; they were formerly identified as not being 'deemed to be a debt of the company, payable to such member in a case of competition between himself and any other creditor not being a member of the company'. And once it is recognised that the provision, both in its present and in its historical form, singles out particular obligations for the attachment of the specified consequences, two observations may be made. First, the words 'by way of dividends, profits or otherwise' can more readily be seen as examples of the kinds of obligation in question, rather than as words limiting or defining the obligations with which the provision deals. Secondly, the need to connect the obligation with membership is more apparent.
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> 'Membership' of a company is a statutory concept. That is why the connection between obligation and membership that must be shown, if the obligation is to fall within s 563A, will find its ultimate foundation in the relevant legislation, now the 2001 Act. It is the legislation which defines the obligations owed by and to the members of a company."

Members of the majority contrasted the position under section 563A with other jurisdictions. Under the Bankruptcy Code in the United States, claims by shareholders arising out of the purchase of shares are expressly subordinated to the claims of creditors. Section 510(b) of the *Bankruptcy Code* relevantly provides:

> "[A] claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such a claim has the same priority as common stock."

By contrast, section 563A does not manifest any express legislative policy in this respect. The absence of a specific exclusion in the Australian statute was interpreted by some members of the court to mean that the Australian Parliament did not intend to subordinate shareholder claimants per se.

The absence of any specific legislative policy was seen as being against the construction contended for by SOG's administrators. According to Kirby J:[19]

> "had it been the purpose of the Parliament in Australia to adopt a general principle postponing, to the claims of general creditors, claims by disappointed shareholders against a company which becomes insolvent, it would have been relatively easy for that purpose to be given effect in the Act."

Kirby J concluded that the Australian Parliament could have copied the drafting in the relevant provisions of the Bankruptcy Code (US).

Callinan J dissented. His Honour noted the inherent risks involved in becoming a shareholder and, unlike other members of the majority, was prepared to construe section 563A in light of the long held understanding that claims by shareholders for losses on the acquisition of shares are postponed to the claims of ordinary creditors.

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[19] Kirby J at [129].

The rationale for shareholder postponement has been articulated by Professors Slain and Kripke to the effect that:[20]

- unsecured creditors generally rely upon the equity cushion that shareholder funds provide; and
- shareholders should justifiably bear the risk of fraudulent or misleading conduct in relation to securities given that they had the most to gain from the company's success and could be taken to have assumed that risk.

In his dissenting judgment in this case, Callinan J appeared to be cognisant of these issues. Callinan J noted that Margaretic was prepared to invest in SOG and take any investment gains and returns in the event that SOG was successful. Margaretic should not be permitted to join the ranks of creditors when things went wrong.

CONSEQUENCES OF THE HIGH COURT'S DECISION

In practical terms, claims by shareholders in relation to losses on shares based on the misleading and deceptive conduct on the part of the company and its officers will rank equally with claims of ordinary unsecured creditors.

There has been some conjecture whether this is true of both shareholders by subscription and transferee shareholders. It is. How the shareholder became a shareholder is not the relevant inquiry. A claim made by a subscribing shareholder under the *Corporations Act* as a result of misleading and deceptive information in a document inviting subscription and a claim made by a transferee shareholder because of a company's failure to make appropriate disclosures to the market, are not claims brought in the capacity of a member within the meaning of section 563A because neither claim is connected to membership. Accordingly, section 563A is not applicable to postpone the claims.

The funds previously assumed to be available only for ordinary creditors in a winding up must now be shared with misled shareholders. For shareholders, the SOG appeal adds further incentive for the commencement of class actions against companies and provides further encouragement to litigation funders.

The decision is also likely to result in an increased focus on material disclosure by companies, with, in the immediate future, keen interest in the ASX's consideration of whether its governance rules should specifically cover the disclosure of material business risks. Notwithstanding the foregoing, the greatest impact of the decision is likely to be felt by insolvency practitioners and credit providers.

Insolvency Practitioners

The obvious impact for insolvency practitioners is that they will potentially have many more proofs of debt to process. Claims by alleged misled shareholders will require separate adjudication which is likely to result in delay and greater administration costs.

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[20] Slain and Kripke "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 26.

Insolvency practitioners will need to assess whether there has been sufficient reliance by the shareholder claimant to justify allowing a proof. Another issue which arises is not only whether such claims are likely to succeed but, if they do succeed, for how much? Many shareholder claimants will simply claim as their loss the amount paid for their shares (ie, the difference between the price paid for the shares and the current value – typically zero). However, there is the potential for some shareholder claimants to claim a greater sum by way of damages, being an amount representing the value of the loss of opportunity that they would have earned if they used the money they invested in the failed company and instead invested it in other shares which had increased in value.

The advent of class action shareholder claims has the potential to impact heavily on the efficient administration of the insolvency regime. Insolvency practitioners will need to consider, inter alia:

- the notices required to be sent to shareholder claimants (section 447A *Corporations Act* orders may be appropriate);
- the right of shareholder claimants to vote at first and second meetings of creditors (including how the claim should be treated for voting purposes); and
- the ability to deal efficiently and cost effectively with a multitude of damages claims.

The above factors are likely to result in increased costs, greater complexity and ultimately longer administrations and delays in the distribution of dividends.

Credit Providers

The outcome of this case is also of particular importance to lending institutions who, in pricing facilities to customers, rely on assumptions regarding priority for recovering debts in the event of insolvency.

The risk carried by lending institutions in providing a particular facility, such as a loan, directly influences the price of providing that facility. It follows that lending institutions use information, such as the types of claims that are provable in a deed of company arrangement or winding up, to assess their potential exposure in providing a loan facility, which in turn dictates the price of that facility. Rightly or wrongly, lending institutions have typically priced loan facilities on the assumption that a claim by a shareholder is not provable in a deed of company arrangement or winding up, and that a shareholder cannot rank alongside ordinary unsecured creditors.

In these circumstances, the High Court's decision is likely to force lenders to consider:

- the amount of leverage sought when pricing loan facilities (eg, in the form of adjustments to interest rates); and
- the type of security typically sought (eg, whether money is lent on a secured or unsecured basis).

Some authors have also suggested that lenders may be forced to consider protecting their investment by way of a cross guarantee.[21] This involves obtaining repayment covenants from subsidiary companies of publicly listed parent companies so that the assets of those subsidiary companies are available to lenders before any residue is available to the parent company (and

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[21] Stumbles "Members as creditors: Sons of Gwalia Limited: Federal Court Appeal Unsuccessful" (2006) 25 ARELJ 90 at 98.

thereby its creditors and shareholder claimants). Whether this will achieve the desired result is questionable given that most publicly listed companies and their subsidiaries enter into statutory deeds of cross guarantee (to allow consolidation of their accounts) effectively making all of the assets in the group available equally to the creditors of the group.

Immediately following the High Court's decision there were a number of complaints from investors to the effect that Australian borrowers would now encounter greater difficulty in accessing overseas debt markets and that they would be required to pay higher interest rates to take into account the additional level of risk now faced by lenders.[22]

It is interesting to note that the position in Australia largely accords with the priority principles in the United Kingdom and that this appears not to have had any noticeable impact on the availability of corporate debt in that region.[23] However, Australian debt capital markets are not of the same scale as those of the United Kingdom and the risk profile of Australian companies, particularly mining companies, is different to the risk profile of European companies. Accordingly, it should not be assumed that the position in the United Kingdom will necessarily be replicated in Australia.[24]

The experience in Canada suggests that the position varies from country to country. Like Australia, Canadian companies are reliant on American capital. The subordination principles in Canada were based on common law principles and were not statutorily enshrined. Due to that uncertainty, companies began re-organising in the United States to take advantage of the clear postponement provisions of the US *Bankruptcy Code* and the resultant lower cost of funds to them. To staunch this outflow, the Canadian Parliament amended Canada's insolvency laws to bring them into line with the US position.

CONCLUSION: THE POTENTIAL FOR LEGISLATIVE CHANGE

If sufficient public pressure eventuates in Australia, there is a possibility of Parliament amending section 563A of the *Corporations Act* to postpone shareholder claims and restore the conventional assumption that such claims are subordinated regardless of the basis of a particular claim.

As this article is going to press, several industry bodies have called for law reform to overturn the effect of the High Court's decision, including the Australian Bankers Association, the Australian Financial Markets Association, and perhaps surprisingly the Australian Institute of Company Directors.[25] The latter's participation in such a call may not be so surprising if one believes that

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22 Stumbles "Creditors have new reason to worry" *Australian Financial Review*, 1 February 2007 at p 55.

23 Section 111A of the *Companies Act 1985* (UK) provides: "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."

24 Harris and Hargovan "Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies: should members be permitted to claim contingent creditor status?" Australian Corporate Law Teachers' Conference, University of Queensland, Brisbane, 5-7 February 2006.

25 Drummond "Gwalia prompts closer look at law" *Australian Financial Review*, 8 February 2007 at p 9.

shareholders invest in public companies for profit (which requires the cost of debt funding to be minimised) and not for protection in the unlikely event of insolvency.

While the High Court's decision is not open to any further judicial challenge, it may be that the Australian Parliament considers the wrong balance has been struck between the rights of creditors and shareholders. Kirby J specifically noted that:[26]

> "If the Parliament concludes that the interpretation adopted by the Federal Court in these appeals, now confirmed by this Court, strikes the wrong balance between the rights of general creditors and the claims of disaffected shareholders, it can easily repair the defect by amending s 563A of the Act."

On 8 February 2007, the Australian government announced that it had asked an advisory committee on company law, the Corporations and Markets Advisory Committee, to examine the issues arising from the High Court's decision in this case.

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[26] Kirby J at [233].