Australian Government

Corporations and Markets
Advisory Committee

SHAREHOLDER CLAIMS AGAINST INSOLVENT COMPANIES

Implications of the *Sons of Gwalia* decision

Discussion Paper

September
2007

Corporations and Markets **Advisory Committee**

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1 Introduction

*This chapter outlines the High Court decision in **Sons of Gwalia**, the context in which it arose and some of its wider ramifications, sets out the reference to the Advisory Committee and provides information to those who may wish to make submissions to the Committee.*

1.1 The essence of the matter

The decision of the High Court of Australia in *Sons of Gwalia Ltd v Margaretic* (2007)[1] (*Sons of Gwalia*) has raised questions about the appropriate treatment of claims that shareholders may have as 'aggrieved investors' against a company in voluntary administration or liquidation.

For the purpose of this paper, the term 'aggrieved investors' refers to shareholders who claim that the loss to the value of their shareholding has been caused by some misconduct of the company for which they have a legal remedy against the company. It does not cover shareholders who are simply disappointed with the outcome of their equity investment.

Prior to the High Court decision, there appears to have been a fairly widely held view in the commercial community that all claims by shareholders against a company that arose from their shareholding, including as aggrieved investors, were claims in their capacity as members. In consequence, it was thought that aggrieved investor claims conferred no right on shareholders to participate as creditors in a voluntary administration or liquidation and ranked last in a winding up, along with all other member claims.

In *Sons of Gwalia*, the High Court held that the plaintiff shareholder, who claimed as an aggrieved investor in that he was misled by the company into acquiring his shares in the company through misrepresentation or defective market disclosure, was not claiming

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1 (2007) 232 ALR 232, 60 ACSR 292, 25 ACLC 1.

in his capacity as a member. His claim, based on various investor protection provisions, was in the capacity of a victim of corporate misconduct, and ranked equally with all other unsecured creditor claims. Also, by necessary implication, he was entitled to participate as a creditor in the voluntary administration of the company.

This outcome raises the question whether, in principle, aggrieved investors should be treated as creditors, thereby giving them a role in deciding the future of a company in voluntary administration and participatory rights in a liquidation.[2] It also raises the question whether, in principle, this type of shareholder claim should rank as an ordinary unsecured creditor claim in a liquidation or be postponed as a member claim.[3]

The determination of these questions may have significant implications for the corporate equity and debt capital markets, the role of investor protection laws in corporate regulation and the process of conducting external administrations.

On the one hand, *Sons of Gwalia* could be seen as enhancing investor confidence in the equity market by making clear that shareholders with investor protection claims against their companies have greater participation and recovery rights in an external administration than may previously have been anticipated. Amending the Corporations Act to deny these aggrieved investors a role as creditors in an external administration, and subordinate their claims in a liquidation, might be seen as selectively weakening these investor protection laws and their potential influence on corporate compliance. Shareholders would have the full benefit of these laws when a company is solvent but find their rights confined when a company is in external administration.

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2 Part 5.3A of the Corporations Act, in particular Divisions 2, 5 and 10, sets out the rights and powers of creditors in a voluntary administration. These include the power of creditors to decide that an administration should end, that the company should execute a deed of company arrangement or that the company should be wound up (s 439C). Creditors have some participatory role in a liquidation: for instance, ss 473(3)(b)(i), 477(2A), (2B), 497, 548. These matters are further discussed in Chapter 4.

3 Claims against companies in liquidation are governed by a priority payment system, with secured creditor claims ranking above various prioritised unsecured creditor debts and claims, followed by remaining creditor claims: Corporations Act Part 5.6 Division 6, in particular s 556. Shareholders claiming in their capacity as members of the company rank last in a winding up: s 563A.

On the other hand, participants in the debt market, as well as trade and other unsecured creditors, may consider that their participation and recovery rights in an external administration are detrimentally affected by the possibility of claims by aggrieved investors. Some lenders may respond by imposing more burdensome restrictions or requirements on the provision of funds to companies. General creditors may be unable to protect themselves in the same way and feel that they have an increased exposure to loss in consequence of aggrieved investor claims where companies are in financial stress.

The legal position as determined in the *Sons of Gwalia* decision also affects the conduct of external administrations, to the extent that administrators or liquidators have to accommodate and assess aggrieved investor claims that previously were considered to be outside the ordinary scope of an external administration.

Following the *Sons of Gwalia* decision, the Government asked the Advisory Committee to consider whether the legal position as set out by the High Court should be retained (and what, if any, reforms to the law of insolvency administration might be useful in that event) or be changed to postpone aggrieved investor claims (and what, if any, additional shareholder protections might accompany any such change).

To assist it in its deliberations, the Advisory Committee invites submissions on these questions. This paper sets out background material, including some possible broader implications of the decision, that respondents may find useful in preparing their submissions.

1.2 The concept of aggrieved investors

Aggrieved investors are 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 principle, it makes no difference whether these shareholders have purchased the shares from the company itself[4] or from a third party, either privately or on-market.

Also, in the same vein, the corporate misconduct complained of could arise, or still be on foot, at the time of the share purchase (for instance, corporate misconduct that induced a person to acquire its shares, as in *Sons of Gwalia*) or could occur subsequent to the purchase (for instance, corporate misconduct that induced a pre-existing shareholder to retain, rather than sell, its shares).[5] The same principles concerning aggrieved investor claims should apply whenever the corporate misconduct occurs.[6] This approach has also been taken in US case law.[7]

There are other types of equity-linked investors who, while not shareholders, may have the same type of claim as aggrieved investors. Examples include holders of various warrants, options or derivatives that in some circumstances convert into equity interests. Their claims have not hitherto been treated as member claims. An argument can be made that these claims against the company should be treated in the same manner as aggrieved investor claims. This issue is particularly relevant in the context of considering the

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4 This would include a person who acquires shares in the company pursuant to an underwriting agreement on a share issue.

5 There is nothing in the majority judgments in *Sons of Gwalia* that would confine the principles in that case to persons who had purchased shares during the period of the corporate breach. Also, Callinan J, the minority judge, at [224], observed that in light of the majority judgment in this case:

> there is no reason why a shareholder, who, unlike [the plaintiff shareholder], has subscribed for, or bought shares in [the company] in earlier, seemingly happier, times and has been induced to hold them on the faith of the deceptive conduct constituted by non-compliance with the continuous disclosure rules, could not frame a claim in almost identical terms to that of [the plaintiff].

6 However, a shareholder claiming against a company for a corporate breach that occurred after the share purchase may in some respects have more difficulty in establishing damages than a person who acquired shares in the company during the breach. This is further discussed in Section 3.2.4.

7 See the facts of the US cases *In re Telegroup, Inc* (2002) and *Re Geneva Steel* (2002), discussed in Section 6.3.2. In both cases, the shareholder complaint concerned corporate behaviour subsequent to the purchase of the shares. The courts applied the same rules (to subordinate the claims in accordance with the US legislation) in these situations as where corporate misconduct had induced the share purchase.

possible options for the future treatment of aggrieved investor claims.[8]

1.3 The *Sons of Gwalia* litigation

1.3.1 The facts and issue

Sons of Gwalia Ltd was a gold mining company listed on the Australian Stock Exchange (ASX). The plaintiff shareholder purchased shares in the company on the ASX. Shortly thereafter, the company went into voluntary administration and the value of the shares held by the shareholder (and other shareholders) was reduced to nil. The company subsequently executed a deed of company arrangement arising from the voluntary administration that provided for distributions from the company's assets to take place in the same order of priority as would apply if the company were being wound up. The relevant clause in that deed expressly incorporated s 563A, to rank payments to shareholders in their capacity as members behind those of all other corporate debts and claims against the company.[9]

The shareholder commenced an action against the company, claiming that at the time of his share purchase the company was in breach of the continuous disclosure requirements,[10] in that the company had failed to notify the ASX that its gold reserves were insufficient to meet its gold delivery contracts and therefore it could not continue as a going concern. Alternatively, the shareholder claimed that, in consequence of the non-disclosure, he was a victim of misleading or deceptive conduct by the company, involving breaches of s 52 of the *Trade Practices Act 1974*, s 1041H of the Corporations Act and s 12DA of the *Australian Securities and Investments Commission Act 2001*.

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8 See further Sections 7.3.2 and 7.4.2.

9 Clause 4.2(d) of the Sons of Gwalia deed of company arrangement provided that:

> 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.

10 s 674.

The shareholder claimed to be entitled to compensation from the company for the difference between the purchase price of his shares and their value after the company went into voluntary administration. There were other shareholders with similar claims.

The shareholder lodged a proof of debt with the administrator. The issue for judicial determination was whether the shareholder should be admitted as an unsecured creditor under the deed of company arrangement, ranking equally with other unsecured creditors, on the assumption that he had been induced to buy shares of the company as a result of misleading conduct by the company prior to its insolvency.

The relevant section for the purpose of determining this matter was s 563A of the Corporations Act, which provides that in a liquidation:

> 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.

1.3.2 The High Court decision

In *Sons of Gwalia*, the High Court, upholding decisions of the Federal Court at first instance and on appeal,[11] held (by a majority of 6 to 1) that the shareholder in this case was not claiming in his capacity as a member. He had the right to be admitted as a contingent creditor with the same participation rights as other unsecured creditors under the deed of company arrangement if the claim could be made out. The shareholder's claim would also rank equally with those of other unsecured creditors in any liquidation of the company. The High Court decision, like earlier decisions in this litigation, was concerned with determining the status of the shareholder, not the merits of his claim.

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[11] *Sons of Gwalia Ltd v Margaretic* (2005) 55 ACSR 365, 24 ACLC 244 (Emmett J), *Sons of Gwalia Ltd v Margaretic* (2006) 56 ACSR 585, 24 ACLC 256 (Full Federal Court (Finkelstein, Gyles and Jacobson JJ)). Finkelstein J in *Re Media World Communications Ltd (admin apptd)* (2005) 52 ACSR 346, 23 ACLC 281 also reached the same conclusion, as did Gzell J in obiter dicta in *Johnston v McGrath* [2005] NSWSC 1183, 24 ACLC 140. Callinan J, the dissenting judge in the High Court decision, is the only judge to have reached a different view.

The High Court held that, as a matter of statutory construction, claims by persons who buy, or subscribe for, shares in a company, relying upon misleading or deceptive information, or material non-disclosures, from the company were not claims within the meaning of s 563A, which would have postponed them behind the claims of conventional unsecured creditors in the winding up of the company. That provision did not apply merely because the plaintiff had to plead his shareholding to make out the claim.

The High Court held that claims that come within s 563A, and are therefore postponed, must relate to rights obtained or obligations incurred by virtue of membership in the company,[12] for instance:

- a right to recover paid-up capital
- a right to avoid a liability to make a contribution to the company's capital
- a right to be paid a dividend.

In *Sons of Gwalia*, the sources of the plaintiff's claims were the rights and protections given to him under consumer protection legislation, not the rights that he had as a member of the company.[13]

1.4 Reference to the Advisory Committee

Following the *Sons of Gwalia* decision, the Parliamentary Secretary to the Treasurer, the Hon. Chris Pearce, MP (the Parliamentary Secretary) wrote to the Advisory Committee in February 2007 to refer an issue to it for consideration and advice:

> The issue concerns the impact of the High Court decision in *Sons of Gwalia*. The decision has reinterpreted a longstanding provision of the law, making it easier for shareholders to recover funds in circumstances where they acquired shares as a result of misleading conduct prior to a company becoming insolvent.

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12 Gleeson CJ at [31], Kirby J at [106].

13 See, for instance, Gleeson CJ at [31], with whom Kirby J agreed (at [134]), Hayne J at [205]-[206].

Section 563A of the *Corporations Act 2001* (the Act) states that payment of a debt owed by a company to a person 'in the person's capacity as a member of a company' is to be postponed until all creditors are paid out. The High Court found that the respondent's claim was not made 'in the capacity as a member of a company' as it arose from his rights to compensation under various investor protection statutes, as opposed to arising from his statutory contract with the company.

The decision effects a transfer of risk from shareholders to creditors. This raises an initial question about which party is best able to manage the risk of misleading statements by a company prior to an insolvency. Some have argued that creditors are in a better place to protect themselves against these types of risks, by monitoring borrowers or taking security. Others argue that shareholders enjoy the profits of the business, and as such should bear the risk of its failure.

Commentators have made a number of additional points in relation to the commercial impact of the decision. One comment has been that the decision may have a positive impact on standards of corporate conduct as more attention is provided to corporate disclosure practices by shareholders, companies and lenders. Another comment has been that the decision may add to the complexity of insolvency proceedings and, in some cases, lead to increased costs and delays in finalising such proceedings.

I note that the decision may not affect all shareholders or all companies that fail. Only those shareholders who were induced to buy shares by misleading statements made by the company would be treated as unsecured creditors. Each shareholder would need to establish that they relied on specified misleading statements made by a company whilst making a decision to purchase shares. Existing case law indicates that the evidentiary burden of establishing reliance is not insignificant. My understanding is that long-standing shareholders would be unlikely to benefit from the decision in the *Sons of Gwalia* case.

I would also note that the approach to shareholder claims in a liquidation varies across jurisdictions. Section 510 of the United States *Bankruptcy Code* specifically precludes such claims whilst section 111A of the UK *Companies Act 1985* specifically provides for such claims to be made by a shareholder. The practical impact of this disparity is moderated by differences in the relative ease of bringing a shareholder class action in each jurisdiction and differences in insolvency regimes. An issue for the Committee to

> consider is whether the legal position of shareholder claims after the *Sons of Gwalia* case is a good fit with the Australian insolvency regime and the general law.

In that letter, the Parliamentary Secretary referred the following questions to the Advisory Committee:

> 1. 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?
>
> 2. If so, are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims?
>
> 3. If not, are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information?

1.5 Structure of the paper

The Advisory Committee has prepared this discussion paper in response to the request from the Parliamentary Secretary.

The first part of the paper sets out the broader context of the *Sons of Gwalia* decision:

- Chapter 2 outlines the current position concerning the rights of aggrieved investors in light of the High Court decision
- Chapter 3 analyses the implications for the conduct of aggrieved investor claims
- Chapter 4 considers the implications for the conduct of external administrations
- Chapter 5 discusses possible broader implications, including for corporate financing, trade creditors and the distressed debt and other financial markets
- Chapter 6 outlines the differing approaches in some other jurisdictions.

Taking into account the matters raised in these chapters:

- Chapter 7 considers the first question in the terms of reference, namely whether to retain or change the law as laid down in *Sons of Gwalia*
- Chapter 8 considers the second question in the terms of reference, namely what changes might be made on the assumption that the principles of law determined in the *Sons of Gwalia* decision are retained
- Chapter 9 considers the third question in the terms of reference, namely what changes might be made on the assumption that the principles of law determined in the *Sons of Gwalia* decision are reversed by statute
- Chapter 10 considers questions arising for shareholder claims that are postponed under s 563A.

1.6 Request for submissions

The Advisory Committee invites submissions on any aspect of the matters covered in the terms of reference and in this paper. The Committee is particularly interested in responses to the matters raised at sections 2.5, 3.3, 4.4, 5.4, 6.5, 7.6, 8.5, 9.3 and 10.6. The Committee would also welcome any empirical data relevant to the issues under consideration.

Please email your submission, in Word format, to:

john.kluver@camac.gov.au

If you have any queries, you can call (02) 9911 2950.

Please forward your submissions by **Friday 21 December 2007**.

All submissions, unless marked confidential, will be made available at www.camac.gov.au

1.7 The Advisory Committee

The Advisory Committee is constituted under Part 9 of the *Australian Securities and Investments Commission Act 2001*. Its functions under s 148 of that Act include, on its own initiative or when requested by the Treasurer or the Parliamentary Secretary to the Treasurer, to provide advice to the Minister about corporations and financial services law and practice.

The members of the Advisory Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The current members of the Advisory Committee are:

- Richard St John (Convenor)—Special Counsel, Johnson Winter & Slattery, Melbourne
- Zelinda Bafile—Lawyer, Director and former General Counsel and Company Secretary, Home Building Society Ltd, Perth
- Barbara Bradshaw—Chief Executive Officer, Law Society Northern Territory, Darwin
- Jeremy Cooper—Deputy Chairman of the Australian Securities and Investments Commission
- Alice McCleary—Company Director, Adelaide
- Marian Micalizzi—Chartered Accountant, Brisbane
- Ian Ramsay—Professor of Law, University of Melbourne
- Robert Seidler—Partner, Blake Dawson Waldron, Sydney
- Greg Vickery AM—Chairman and Partner, Deacons, Brisbane
- Nerolie Withnall—Company Director, Brisbane.

The function of the Legal Committee is to provide expert legal analysis, assessment and advice to the Advisory Committee in

relation to such matters as are referred to it by the Advisory Committee.

The members of the Legal Committee are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their expertise in corporate law.

The current members of the Legal Committee are:

- Nerolie Withnall (Convenor)—Company Director, Brisbane
- Lyn Bennett—Partner, Hunt & Hunt, Darwin
- Elizabeth Boros—Professor of Law, Monash University, Melbourne
- Damian Egan—Partner, Murdoch Clarke, Hobart
- Jennifer Hill—Professor of Law, University of Sydney
- James Marshall—Partner, Blake Dawson Waldron, Sydney
- David Proudman—Partner, Johnson Winter & Slattery, Adelaide
- Laurie Shervington—Partner, Minter Ellison, Perth
- Simon Stretton—South Australian Crown Solicitor, Adelaide
- Gabrielle Upton—Legal Counsel, Australian Institute of Company Directors, Sydney.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Anne Durie—Legal Officer
- Thaumani Parrino—Office Manager.

2 Current position

This chapter considers the types of claims that shareholders may make against a company, the rights arising from those claims in light of the ***Sons of Gwalia*** *decision and the relevance to these claims of the rule in* ***Houldsworth's*** *case.*

2.1 Types of shareholder claims

The type of shareholder claims considered in *Sons of Gwalia* can be analysed in the context of the general framework of the limited liability company, as it has developed over time, and the rights of shareholders within that framework.

2.1.1 General principles

The modern limited liability company was created by statute in the 19th century as a vehicle for investment. Under this structure:

- shareholders of a successful company can profit through dividends, realised capital gains on the sale of their shares and any surplus on a liquidation
- shareholders of a failed company can lose the entirety of their share capital but are not liable in a liquidation for any further payments to the company's creditors.

Some general principles concerning the relationship between claims by shareholders against a company and claims by other persons who have a financial relationship with the company, including lenders, trade creditors and other contractual creditors (conventional unsecured creditors), have developed over time and are unaffected by *Sons of Gwalia*.

- *Solvent companies.* Subject to the rule in *Houldsworth's* case affecting some claims (see Section 2.3), shareholders with claims against an ongoing solvent company, including as aggrieved investors, are in the same position as conventional

unsecured creditors. There is no need for a statutory prioritisation of payments, as a solvent company is in a position to pay its debts as and when they become due and payable.[14] Likewise, solvent companies may undertake to compensate shareholders for particular corporate conduct.[15]

- *Claims unrelated to shareholding.* Claims by shareholders against a company in external administration that are unrelated to the shareholding, such as a claim in tort for personal injury caused by the company, a claim to recover money lent to the company, or an employee claim against the company, entitle the shareholder to participate as a creditor in the external administration, with their claims ranking equally with those of the company's other general unsecured creditors.

- *Member claims.* Claims by shareholders for any unpaid dividend, or capital repayment, on their shares can be paid in the liquidation of a company only if all other persons to whom the company owes money have been paid in full.

2.1.2 Consumer protection provisions

In more recent times, certain rights of action against a company have been conferred on shareholders under provisions for the protection of investors and consumers generally.

These provisions cover various situations, including where shareholders have suffered loss to the value of their shares through misconduct of the company in question. For instance, the continuous disclosure obligations apply to the disclosing entity as well as persons involved in the disclosing entity's contravention.[16] Also, the misleading or deceptive statement provisions of the takeovers provisions,[17] the fundraising disclosure obligations[18] and the market

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14 s 95A.

15 For instance, the *Multiplex Limited enforceable undertaking* (under s 93AA of the ASIC Act) of December 2006 involved the company compensating all persons who had acquired its securities in a particular period when certain information known to the company had not been disclosed to the market.

16 ss 674, 675.

17 s 670A.

18 s 728.

misconduct provisions[19] apply to 'a person', which can include the company itself. Any person, including a shareholder, who has suffered loss through a breach of these provisions has a right to claim damages from the company in breach.[20] Remedies may also be available to shareholders, and others, where companies engage in misleading or deceptive conduct.[21]

The treatment in an external administration of claims by shareholders under these new investor protection rights, and the ranking of those claims compared with claims by general creditors in a winding up, were at issue in the *Sons of Gwalia* litigation.

2.2 Shareholder claims affected by *Sons of Gwalia*

The High Court decision deals with shareholder claims, arising from the shareholding, against a company that is in external administration when the claims are made or subsequently goes into external administration while the claims are still on foot.

The decision turned on the meaning of s 563A, which provides:

> Payments 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.

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19 ss 1041A ff.

20 ss 670B(1), 729(1), 1041I, 1325 of the Corporations Act and s 12GF of the ASIC Act. An example of an action by former shareholders against a company under s 729(1) for loss to the value of their shares in consequence of the company's alleged contraventions of the prospectus provisions is *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 56 ACSR 309. In that case, the plaintiffs had acquired shares pursuant to a prospectus, which contained profit forecasts that subsequently were not achieved, causing a material fall in the share price. The plaintiffs had since sold their shares at the reduced price and claimed for the difference between the original purchase price and the sale price. The Full Federal Court (at [49]) held that this claim for misrepresentation in respect of a prospectus was a claim in the person's capacity as a member, which was subordinated under s 563A. This aspect of the decision has now been superseded by the *Sons of Gwalia* decision.

21 s 1041H, *Trade Practices Act 1974* s 52.

At issue were:

- the question of which shareholder claims in an external administration come within, and which fall outside, s 563A (discussed in Section 2.2.1)
- the consequences for shareholder claims that are not restricted by s 563A (discussed in Section 2.2.2).

Some aspects of the decision are also relevant to shareholder claims that do fall within s 563A (discussed in Section 2.2.3).

2.2.1 The boundaries of s 563A

Prior to the *Sons of Gwalia* case, there appears to have been a fairly widely held view that all shareholder claims against a company in external administration that relate to the shareholding, including aggrieved investor claims under investor protection provisions, were made in the shareholders' 'capacity as a member of the company' and accordingly were postponed by s 563A. That perception may have been based on a broad reading of the words 'or otherwise' in that provision.

However, the High Court did not accept that s 563A embodied a 'creditors come first, shareholders come last' approach in all respects.[22]

Claims within s 563A: member claims

The High Court considered that shareholder claims that come within s 563A are those where there is a connection between the company's obligation and the claimant's membership.[23] This connection is founded on the rights shareholders obtain or the obligations they incur as members under the Corporations Act, including those given by constituent documents of the company.[24] Those matters relate to

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[22] Gleeson CJ at [19], Kirby J at [118], Hayne J at [200].
[23] Hayne J at [202].
[24] Hayne J at [203].

dividend, capital repayment or other rights[25] arising from the person's membership of the company.[26] Examples include where a company has declared but not paid a dividend or the shareholders have authorised a reduction of capital but the company has not yet acquired the shares according to the terms of the agreement.

Some remedies under the Corporations Act may give rise to claims that fall within s 563A. According to *Ford's Principles of Corporations* Law (*Ford's Principles*):

> An application for relief under the oppression provisions of the Corporations Act (ss 232–235) may be made by a member and certain others. It seems that a member seeking a compensation order under the oppression provisions may be suing in the capacity of member, so that the claim would be postponed under s 563A should the company go into liquidation, but that will not necessarily be so. Much will depend on the nature of the claim and the precise circumstances alleged to constitute the oppressive or unfair conduct.[27]

Claims outside s 563A: aggrieved investor and other claims

Aggrieved investor claims. The High Court held that claims by shareholders against a company under consumer or investor protection legislation, while connected with their shareholding, do not arise from the statutory rights of membership (including any rights derived from the company's constitution) and therefore fall outside s 563A.

The section is not attracted simply because the claim is related to their shareholding. For instance:

> If money is paid to the company to *create* the relationship of member (as will be the case when a person subscribes for shares) the company's obligation to pay damages for

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25 The High Court referred to *Re Addlestone Linoleum Co* (1887) 37 Ch D 191, where a company had issued, as fully paid, shares that were in fact not fully paid, and the liquidator made a call for the unpaid balance. The shareholders sought to prove in the winding up for damages measured by their liability on the call. The court held that the shareholder claims came within the statutory equivalent of s 563A, as the shareholders were making their claims in the character of members of the company.

26 See, for instance, Gleeson CJ at [31], Hayne J at [191], [203]-[206].

27 HAJ Ford, RP Austin, IM Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, looseleaf) at [24.506].

> fraudulent misrepresentation inducing that subscription, or to pay damages because loss was occasioned by the company's misleading or deceptive conduct, will not, in the absence of specific legislative provision to the contrary, be an obligation whose foundation can be found in the legislative prescription of the rights and duties of members.[28]

The High Court noted the broader investor protection context of the case:

> 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 other securities.[29]

Part of the Court's reasoning for determining that these shareholder claims were not caught by s 563A was that they were based on statutory consumer protection provisions, which were not restricted to members. If a claim could be brought against a company by a non-member, then membership of the company was not essential to the claim:

> In the present case, the obligation which [the shareholder] seeks to enforce is not an obligation which the 2001 [Corporations] Act creates in favour of a company's members. The obligation [the shareholder] seeks to enforce, in so far as it is based in statutory causes of action, is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct and the company's liability to suffer an order for damages or other relief at the suit of *any* person who has suffered, or is likely to suffer, loss and damage as a result of the contravention. In so far as the claim is put forward in the tort of deceit, it is a claim that stands altogether apart from any obligation created by the 2001 Act and owed by the company to its members. Those claims are not claims 'owed by a company to a person in the person's capacity as a member of the

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28 Hayne J at [205].
29 Gleeson CJ at [18].

> company'. For these reasons, s 563A does not apply to the claim made by [the shareholder].[30]

There is a wide range of Corporations Act remedies that may give rise to aggrieved investor claims of a kind that falls outside s 563A. According to *Ford's Principles*:

> Many of the remedial provisions of the Corporations Act allow any person who suffers loss (or, sometimes, a person aggrieved) to recover damages in respect of the contravention, even though the plaintiff will often be a member of a contravening company seeking relief against it (eg ss 175(2), 283F, 729, 1041I, 1022B, 1317HA, 1317J(3A), 1325(2)). Presumably such claims are not made in the capacity of member and are outside s 563A, with the consequence that the claims are not postponed to external creditors if the company is in liquidation.[31]

Other claims. Other claims referred to by the High Court as falling outside s 563A include:

- a claim by a holder of partly paid shares to interest payable by the company on an interest-bearing advance to the company by that person in anticipation of later calls on the shares. The person was not obliged as a member to make the advance, and had no right as a member to receive the interest. The interest claim was in effect to recover interest on money lent to the company and therefore was not in the capacity of a member[32]

- a claim for damages by a former member in consequence of the company forfeiting his shares without giving notice as required by the constitution. The claim arose by reason of the person being deprived of his membership rights. It was not due to him in the character of a member, but was 'on the contrary, due to him in the character of non-member'[33]

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30 Hayne J at [206].

31 at [24.506].

32 Hayne J at [195]-[197], referring to *King v Tait* (1936) 57 CLR 715 at 758–759, *Lock v Queensland Investment and Land Mortgage Co* [1896] 1 Ch 397 (Court of Appeal), [1896] AC 461 (House of Lords).

33 Hayne J at [198], quoting from *In re New Chile Gold Mining Co* (1890) 45 Ch D 598 at 605.

- a claim for damages by an employee against a company for breach of the company's obligation, undertaken in his employment contract, to find a purchaser for the company shares issued for him when he took up employment, if that employment was terminated.[34] The claim arose pursuant to the employment contract, not because he was a member of the company
- a claim by an employee against a company for arrears of salary and breach of the contract of employment. The fact that the employee was obliged by the company's constitution to be a shareholder was irrelevant.[35]

2.2.2 Consequences for shareholder claims outside s 563A

Aggrieved investor claims

As made clear in the High Court decision, claims by shareholders as aggrieved investors against a company:

- entitle the shareholders to participate as creditors in the voluntary administration or liquidation of the company. This gives them rights to receive information and exercise voting rights as creditors, and
- rank with all other general unsecured creditor claims in a corporate distribution arising from the external administration.

The High Court recognised the competing policy considerations that are relevant in weighing up the appropriate balance between giving force to consumer protections for shareholders and the practical implications for insolvency law:[36]

- on the one hand, extending the range of claims by shareholders increases the number of potential creditors in a winding up and

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34 Gleeson CJ at [29] and Hayne J at [199], referring to *In re Harlou Pty Ltd* [1950] VLR 449, in which the Court ruled that the amount claimed was:

> not due to him in his character of a member at all. It is not because he is a shareholder that he is entitled to these damages, but it is because he has made a contract with the company … which contract the company has broken.

35 Gleeson CJ at [29], referring to *In re Dale and Plant Ltd* (1889) 43 Ch D 255.

36 Gleeson CJ at [18].

will normally 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 shareholders often arises in the event of insolvency, such protection may be illusory if the relevant shareholder claims are subordinated to the claims of ordinary creditors.

These and other possible consequences of the *Sons of Gwalia* decision, and consideration of the three questions in the terms of reference arising from that decision, are discussed in Chapters 3 to 9.

Other claims

Claims by shareholders that are unrelated to their shareholding also fall outside s 563A. The principles governing the treatment of these claims as creditor claims are well accepted (see Section 2.1.1).

2.2.3 Consequences for shareholder claims within s 563A

An analysis of statutory developments indicates that shareholders with claims that were postponed by earlier provisions corresponding to s 563A did not have the right to participate as general creditors in an external administration. However, a statutory amendment in 1992, which introduced the current s 563A, appears to have changed that position.

While the High Court was not called upon in *Sons of Gwalia* to determine this matter, observations by some of the judges support the proposition that shareholders with claims that are postponed under s 563A are still to be treated as creditors. This issue is particularly significant for voluntary administration, in which creditors play a central decision-making role.

However, it is not in doubt that those shareholder claims that fall within s 563A are postponed behind other claims in a liquidation.

The current position, including whether shareholders whose claims are postponed by s 563A should still be able to participate in an external administration as creditors, is further discussed in Chapter 10.

2.3 The rule in *Houldsworth's* case

2.3.1 Statement and rationale of the rule

The rule in *Houldsworth's* case[37] 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 [by the company].[38]

This rule does not apply to shareholders who have purchased the shares from a third party.

The rule might be characterised as an application of the principle of maintenance of corporate capital, as the payment of damages by a company to its subscribing shareholders in relation to their shares would constitute, indirectly, a return of the subscription capital.[39] For instance, if the shares are worthless, the shareholder's damages are equivalent to at least the subscription price. By contrast, if the claimant is not a subscriber, the damages sought from the company would reflect the purchase price paid for the shares to a third party, rather than any subscription of capital to the company.

2.3.2 Application of the rule

The rule in *Houldsworth's* case, and the capital maintenance principles on which it is based, are subject to any contrary statutory

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37 *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317.

38 This statement of the rule is found in *Re Media World Communications Ltd* (2005) 52 ACSR 346 at [10]. See generally *Ford's Principles* at [24.501].

39 id at [24.502]. This capital maintenance approach to the rule is reflected in *Re Addlestone Linoleum Co* (1887) 37 Ch D 191 at 205-206:

> a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that is inconsistent with his position as a shareholder, while he remains as such, to claim back any part of that money—he must not directly or indirectly receive back any part of it.

The same capital maintenance basis of the rule in *Houldsworth's* case was recognised by the High Court in *Webb Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR 15 at 33.

provision. Statutory exceptions to the capital maintenance principle have long existed.[40]

The High Court in *Sons of Gwalia* made some observations about the rule in *Houldsworth's* case (although the Court need not have dealt with this matter, as the rule only applies to subscribers for shares from the company and the plaintiff in that case had purchased the shares on the ASX).

Following the High Court decision, the current position of the rule in *Houldsworth's* case in Australia, as summed up in light of the discussion in *Ford's Principles*,[41] is that:

- the rule applies to a subscriber claim against a company for damages measured by reference to the subscription price, except where the rule has been abrogated by statute
- the rule has been abrogated for:
  - subscriber claims against a company in liquidation, given that ss 553A and 563A, which apply to liquidations, exhibit a legislative intention to exclude the rule in a winding up
  - subscriber claims against a company that is subject to a deed of company arrangement that imports s 563A (as was the case in *Sons of Gwalia*[42])
  - subscriber claims against a company under a specific statutory provision, such as s 729, which gives a remedy for

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40 In *Sons of Gwalia,* Gummow J at [62] observed that the UK *Companies Act 1862* ss 8 and 12 prohibited limited liability companies from reducing their share capital. However, shortly thereafter, the UK *Companies Act 1867* s 9 permitted a company to include in its memorandum of association a power to reduce its share capital, subject to the confirmation of the court. The current share capital reduction power is found in ss 256B ff of the Corporations Act. Companies may also reduce their share capital through share buy-backs (ss 257A ff).

41 *Ford's Principles* at [24.501]-[24.510] sets out a detailed analysis of the relevant case law on the rule in *Houldsworth's* case, up to and including *Sons of Gwalia*.

42 See footnote 9.

misleading or deceptive statements or omissions in a prospectus[43]

- the rule still applies to subscriber claims, other than under any statutory regime that abrogates the rule, against:
  - a company that is not in external administration
  - a company in voluntary administration prior to adoption of a deed of company arrangement
  - a company subject to a deed of company arrangement that does not import s 563A
- where the rule still applies, a subscriber shareholder seeking damages must take proceedings against the company for:
  - rescission of the share subscription contract and
  - recovery of the subscription price by way of restitution in integrum
- however, rescission may not be possible, for instance if:
  - the subscriber has sold the shares to a third party[44]
  - the company is in voluntary administration, unless the court otherwise orders,[45] though the subscriber claim may revive once the voluntary administration is finished.[46]

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43 *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 56 ACSR 309 at [46]:

> the legislature has made clear its intention that a subscribing shareholder is entitled to recover damages under s 729(1) against a company issuing a prospectus, provided that the statutory conditions set out in the section, which do not include the rule in *Houldsworth*, are satisfied.

This decision of the Full Federal Court was not considered in *Sons of Gwalia.*

44 This was the problem facing the subscriber shareholders in *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 56 ACSR 309 at [1] and [7]. However, as indicated in the previous footnote, the Full Federal Court held that the rule in *Houldsworth's* case had been abrogated in the circumstances and therefore the problem of rescission did not arise.

45 s 437F, as applied in *Re Media World Communications Ltd* (2005) 52 ACSR 346 at [15].

In the United Kingdom, the rule is excluded in all cases.[47]

2.3.3 Possible abrogation of the rule

Possible arguments for retaining the rule are:

- the residual application of the capital maintenance principles should be retained
- the rule may reduce the range of claims by shareholders relating to their shareholding that permit them to participate as creditors in a voluntary administration.

Arguments for abolishing the rule are:

- shareholders with subscriber claims covered by the rule (for instance, a tort claim for deceit against a company in voluntary administration) may be precluded from participating as creditors in that administration, whereas purchasers of shares from third parties with exactly the same type of claim against the company would have participation rights as creditors
- corporate law already recognises many exceptions to capital maintenance principles
- in the United Kingdom, the rule in *Houldsworth's* case has been abrogated in all circumstances for some decades,[48] without any apparent concern about the implications for capital maintenance.

2.4 Other rights

Any assessment of the competing claims in a voluntary administration or liquidation of shareholders and conventional

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46 *Ford's Principles* at [24.503], taking into account observations in *Re Media World Communications Ltd* (2005) 52 ACSR 346 at [15].

47 UK *Companies Act 2006* s 655 (previously UK *Companies Act 1985* s 111A).

48 Section 655 of the UK *Companies Act 2006*, which adopted s 111A of the UK *Companies Act 1985*, 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 of members in respect of shares.

unsecured creditors, such as trade creditors, also needs to take into account that each group may have rights in addition to those against the company.

2.4.1 Shareholders

Shareholders may be able to take consumer protection actions against the individual directors involved[49] (as well as against the company[50]). This may give them indirect access to corporate assets in an external administration, given that, subject to various statutory restrictions,[51] directors may have indemnity rights against the company, which may in turn have insurance covering its liabilities to the directors (though the availability of this insurance may depend on the wording of the relevant insurance contract).

2.4.2 Trade creditors

Trade creditors may have indirect access to persons behind the corporate veil, namely where the directors have allowed the company to trade while insolvent and the liquidator has consented to the creditor's action against the directors or the court has granted the creditor leave.[52]

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49 For instance, shareholders may have a right to seek compensation against any defaulting directors, or other involved persons, where a disclosing entity breaches the continuous disclosure requirements:

- s 674(2A) imposes a civil penalty on anyone 'involved' in the continuous disclosure breach. This attracts the accessorial liability tests in s 79
- s 1317DAA defines 'compensation proceedings' for infringement of the continuous disclosure provisions to include proceedings under s 1317HA
- s 1317HA(1) provides for compensation to any person who has suffered damage from the contravention (breach of the continuous disclosure requirements is a breach of a financial services civil penalty provision, defined in s 1317DA and s 1317E(1)(ja))
- s 1317J(3A) provides that any person who suffers damage from the alleged contravention may apply for a compensation order.

50 Proportional liability, introduced by CLERP 9 in Part 7.10 Div 2A, would be relevant if the directors, as well as the company, are sued.

51 ss 199A, 199B, 199C.

52 ss 588M, 588R, 588S, 588T.

2.5 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters that are raised in this chapter and are not dealt with elsewhere in this paper.

The Committee would be particularly interested in receiving your views on whether the rule in *Houldsworth's* case (discussed in Section 2.3) should be abrogated by statute.

3 The scope for shareholder claims

*To assist consideration of the implications of the **Sons of Gwalia** decision, this chapter looks at the circumstances in which aggrieved investor claims may arise in an external administration and some of the practical issues shareholders will face in establishing these claims.*

3.1 Potential impact of the decision

Shareholders who have aggrieved investor claims that are accepted for the purpose of a voluntary administration or liquidation will be in a position to participate and recover as unsecured creditors. The voting rights of other unsecured creditors, including unsecured lenders and trade creditors (conventional unsecured creditors), as well as the pool of funds otherwise available to conventional unsecured creditors in the external administration, will be reduced.

In principle, shareholders could claim as aggrieved investors in every situation where they have suffered damage related to their shareholding through corporate misconduct and a remedy is open to them. That misconduct could include, but not be confined to, the types of disclosure breaches considered in *Sons of Gwalia*.

In practice, shareholders are most likely to claim as aggrieved investors where a company in financial stress fails to keep equity investors informed of material price-sensitive information known to the company and:

- the company is a disclosing entity[53] and is therefore subject to the continuous disclosure requirements
- it goes into voluntary administration or liquidation[54]

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[53] The tests for listed and unlisted disclosing entities are set out in Part 1.2A Div 2 of the Corporations Act. These tests have an investor protection focus. For instance, an entity will be a disclosing entity if it has issued a prospectus or has more than 100 investors.

- it has significant assets available for distribution to unsecured creditors
- it is arguable that the failure properly to disclose the information involves breaches of the law by the company for which shareholders can claim damages against the company as creditors.

In considering the impact of such claims, it should be noted that:

- disclosing entities represent only a small proportion of incorporated entities, albeit that they are typically larger public companies with a substantial shareholder base
- in many cases, the assets available to ordinary unsecured creditors of companies in liquidation (taking into account the priority of secured creditors and various priority unsecured creditors, such as employees) are very limited,[55] thereby reducing the financial incentive of shareholders to litigate against a company in these circumstances
- the traditional 'costs follow the event' rule in civil litigation (whereby the court-awarded costs of the successful party are borne by the unsuccessful party) is a material disincentive to shareholders undertaking claims, though this disincentive may be mitigated to some extent by litigation funding.[56]

Also, claimant shareholders may face a range of issues in establishing their claims, as discussed below.

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54 A creditors' or members'/creditors' scheme of arrangement under Part 5.1 could also be affected by the *Sons of Gwalia* decision, though schemes involving creditors are rare since the introduction of the voluntary administration provisions.

55 Internal ASIC statistics show that, in 2005-2006, less than 5% of companies that lodged an insolvency report with ASIC paid a dividend of 10 cents in the dollar or more to unsecured creditors. The figures for the 2004-2005 period were similar.

56 *Campbells Cash and Carry Pty Limited v Fostif Pty Limited* (2006) 229 ALR 58; 80 ALJR 1441.

3.2 Issues in establishing an aggrieved investor claim

Shareholders will not necessarily have grounds for making claims as aggrieved investors simply because the value of their shares declines in consequence of the company going into external administration. The *Sons of Gwalia* litigation was conducted on the assumption that the claimant could eventually make a legitimate claim, based on corporate misconduct. The Federal Court and the High Court were not required to rule on the claim itself.

An aggrieved investor may claim as a creditor in an external administration, without first establishing the claim in litigation. A deed administrator or liquidator may accept that claim for some or all purposes or require a judicial determination (see Section 4.3). Their decision may be influenced by their assessment of the likelihood of the claim succeeding in court.

Obtaining a remedy through litigation as an aggrieved investor can be a difficult task, and turns on whether the shareholder can establish:

- corporate misconduct for which the shareholder has a remedy
- a causal connection between that misconduct and the loss or damage to the shareholder
- reliance on any corporate misrepresentation
- damages incurred.

3.2.1 Corporate misconduct

A shareholder seeking to prove a claim as an aggrieved investor must establish some breach by the company of relevant investor protection or other law under which the shareholder is entitled to claim damages.[57]

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[57] See Section 2.1.2.

3.2.2 Causation

A shareholder claiming damages for misrepresentation by a company must establish a causal link between that misconduct and the loss or other damage incurred by the claimant.[58] For instance, causation is an implicit requirement in s 1041I of the Corporations Act, which creates a statutory right to recover loss or damage arising from misleading or deceptive conduct or false or misleading statements.

An aggrieved investor claim would fail if the chain of causation is broken, either by events subsequent to the misrepresentation or through the conduct of the shareholder. For instance, in *Johnston v McGrath*,[59] the Court rejected a claim by a shareholder under the *Trade Practices Act 1974* that he had suffered damage in consequence of misleading or deceptive corporate misrepresentations. One of the grounds for dismissing the action was that the actions of the plaintiff, subsequent to the corporate conduct and before he engaged in the share transactions (namely ignoring repeated warnings in the printed media which he assiduously read and which contradicted the misrepresentations), were so dominant as to cut the causal link between the misrepresentations and the losses through the share purchases.[60]

3.2.3 Reliance

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.

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58 In *Henville v Walker* (2001) 206 CLR 459, the High Court confirmed that an action under the *Trade Practices Act* would fail if the plaintiff's actions destroyed the causal connection between the contravention and the loss or damage.

59 [2005] NSWSC 1183, 24 ACLC 140.

60 id at [40]:

> In this case, however, a common sense approach to causation requires the conclusion that the misrepresentations by [the company] were overtaken by subsequent events, namely, printed media reports that [the shareholder assiduously read and that] contradicted the representations.

The reliance requirement may be expected to reduce, perhaps considerably, the number of successful aggrieved investor claims against companies. Moreover, the fact that one shareholder can prove reliance does not in itself ensure that other shareholders can do so.[61]

The shareholder's own reliance

The general principle is that a plaintiff must prove reliance on any misrepresentation complained of to obtain damages. If it were otherwise, plaintiffs 'could succeed even though they knew the truth, or were indifferent to the subject matter of the representation'.[62]

While a plaintiff may in some cases be able to establish reliance by way of inference,[63] proving it in other instances may not be easy. For instance, in *Johnston v McGrath*,[64] the Court rejected a claim by a shareholder under the *Trade Practices Act 1974* that he had suffered damage in consequence of misleading or deceptive corporate conduct. The Court held that, even if the conduct were misleading or deceptive, and the chain of causation had not been broken (see Section 3.2.2), the shareholder had failed to establish that he had relied upon the company's misconduct in his relevant share

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[61] Another approach, found in the USA, is that proof of reliance on the relevant corporate conduct is unnecessary, provided the market generally has been misled: see Section 9.2 **Introduce a fraud on the market approach**. This approach overcomes the need for each plaintiff to prove reliance. Equally, it may significantly increase the number of individual or class actions by shareholders against companies.

[62] *Digi-Tech (Australia) Ltd v Brand & 5 Ors* [2004] NSWCA 58 at [159]. The *Digi-Tech* case was approved in *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets (No 6)* [2007] NSWSC 124 (30 March 2007).

[63] In *Gould v Vaggelas* (1983) 157 CLR 215 at 236, Wilson J said:

> If a material representation is made which is calculated to induce the representee to enter into a contract and that person in fact enters into the contract there arises a fair inference of fact that he was induced to do so by the representation. The inference may be rebutted, for example, by showing that the representee, before he entered into the contract, either was possessed of actual knowledge of the true facts and knew them to be true or alternatively made it plain that whether he knew the true facts or not he did not rely on the representation. The representation need not be the sole inducement. It is sufficient so long as it plays some part even if only a minor part in contributing to the formation of the contract.

[64] [2005] NSWSC 1183, 24 ACLC 140.

transactions. Rather, his share trading was based on factors unrelated to that corporate conduct.[65]

Another person's reliance

A plaintiff can establish reliance by proving reliance by an agent when acting on the plaintiff's behalf.[66]

There is a possibility that plaintiffs may be able to prove a claim for damages for a misrepresentation if they can establish that their loss was caused by someone else's reliance on that misrepresentation. For instance, in the *Janssen* case,[67] the Court upheld a claim under the *Trade Practices Act* by a plaintiff (a market competitor of the defendant company) who did not rely on a corporate misrepresentation, but who nevertheless suffered damage (loss of market share) because other parties (purchasers of the relevant products) did rely on the misrepresentation. However, the Court also held that there must be a sufficient link between the misconduct and the damage: the damage must directly result from or be caused by the relevant conduct.[68]

The *Janssen* case may also be authority for the proposition that entitlement to recover loss for a corporate misrepresentation is not confined to those who were directly misled, provided that the loss is caused through a chain of reliance. If this proposition is applied to the stock market, anyone who, say, acquires shares in reliance on advice from an analyst, who in turn has relied on, and been misled by, a company, could claim damages against the company.

3.2.4 Damages incurred

Shareholders whose claim is based on corporate misconduct that arises, or is still on foot, at the time of the share purchase could claim compensation for the difference between the purchase price and the lower value of the shares after the true position of the company becomes generally known.

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65 id at [28]-[32].
66 *Port Stephens Shire Council v Booth* (2005) Aust Torts Rep 81-807.
67 *Janssen-Cilag Pty Limited and Pfizer Pty Limited* (1992) 109 ALR 638.
68 at 642.

However, shareholders whose claim is based on corporate misconduct, such as breach of the continuous disclosure obligations, that occurred after the share purchase may have greater difficulty in establishing damages.

The problem in quantifying loss for these pre-existing shareholders is that the market value of their shares may have been artificially high in consequence of the corporate breach. If the market had been properly informed, the market price of the shares would have declined in consequence.

Given this, it may be necessary for these shareholders to establish that, had the relevant information been available, the share price would have declined over time and that they would have sold during that period, at a price higher than the eventual value of the shares. The quantum of damages would be the difference between this hypothetical sale price and the lower value of the shares after the true position was revealed. The extreme example would be claims by shareholders in a collapsed company alleging that they would have sold if the disclosure had been made before the collapse and that the shares would still have had some value at the time of sale.

3.3 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter.

The Committee would be particularly interested in receiving any information on the possible consequences for aggrieved investor claims that are mentioned in the chapter.

You are also invited to suggest any other implications that may arise for the conduct of aggrieved investor claims.

4 Implications for external administration

*This chapter summarises a range of views on consequences for the conduct of voluntary administration and liquidation that may flow from the **Sons of Gwalia** decision.*

4.1 Overview

The *Sons of Gwalia* decision places aggrieved investors on the same footing as conventional unsecured creditors in a voluntary administration or a liquidation.[69] It does not affect the current priority rights of secured creditors and priority unsecured creditors (such as employees) in either of these forms of external administration.[70]

A distinction should be drawn between:

- conducting a voluntary administration (which generally ends when the creditors decide that the company should execute a deed of company arrangement (DOCA), resume trading without a DOCA, or be wound up), and
- implementing a DOCA or conducting a winding up (whether or not resulting from a voluntary administration).

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69 The various forms of external administration are set out in Chapter 5 of the Corporations Act. They include voluntary administrations under Part 5.3A and liquidations under Parts 5.4 ff. They also include schemes of arrangement under Part 5.1. However, creditors' schemes of arrangement are not in common use following the introduction of the voluntary administration provisions and therefore are not separately discussed in this paper. Also, the provisions in Part 5.2 dealing with receivers concern the rights of secured creditors, which are unaffected by the *Sons of Gwalia* decision.

70 Prioritised unsecured debts and claims are:
- expenses related to insolvency administration (s 556(1)(a)-(df))
- wages and superannuation contributions (s 556(1)(e))
- injury compensation (s 556(1)(f))
- payments for leave of absence (s 556(1)(g)), and
- retrenchment payments (s 556(1)(h)).

The main issues in relation to aggrieved investor claims in a voluntary administration concern the impact on the content and dissemination of information to be provided to creditors, and voting at creditors' meetings.

The main issue in considering aggrieved investor claims in implementing a DOCA or conducting a liquidation concerns the process of assessing these claims and thereby determining the amount that other unsecured creditors are ultimately to receive.[71]

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. Claims by aggrieved investors may simply add to their tasks.

4.2 Conducting a voluntary administration

4.2.1 Information to creditors

An administrator must, within 28 days of his or her appointment, convene the major meeting of creditors and send to 'as many of the company's creditors as reasonably practicable' a statement setting out the administrator's opinion about whether it would be in the creditors' interests for the company to execute a DOCA, come out of administration or be wound up.[72]

This requirement entails, among other things, the administrator estimating the returns to creditors in a liquidation as against returns under any proposed DOCA. An administrator may find it difficult, where there are aggrieved investor claims, to provide in that statement sufficient details of potential shareholder actions within the stipulated time period of 28 days. Consequently, creditors at the major meeting may have to make a decision with incomplete

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71 The Parliamentary Secretary to the Treasurer, the Hon. Chris Pearce, MP, in May 2007, referred to the Advisory Committee various insolvency law reform issues raised by interested parties during consultation on the Corporations Amendment (Insolvency) Bill 2007 (subsequently enacted). These issues include the information to be contained in insolvency notices in newspapers, electronic communication with creditors and postal voting on various matters. They are relevant to any insolvency involving a large and diversely spread group of claimants, whether or not that group includes shareholders with aggrieved investor claims. The reference can be found at **www.camac.gov.au**

72 s 439A(3), (4)(b).

information.[73] However, the problem of incomplete information can also arise where no shareholder claims are involved.

4.2.2 Voting at the creditors' meetings

Following the *Sons of Gwalia* decision, there is the prospect that more shareholders will lodge a proof of debt as contingent creditors[74] (possibly with the assistance of litigation funders[75]) where they consider that the company has engaged in some impropriety that affects the value of their shares. A contingent creditor does not have to prove a claim in order to vote at a creditors' meeting, provided there is a 'just estimate' of the value of the claim.[76] An administrator may choose to admit these shareholders to vote at the creditors' meeting for the full, or a nominal, amount.[77]

Possible increased influence

Creditors have the choice whether the company should end the administration and resume trading, enter into a DOCA or be wound up.[78] 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).[79] In some instances, aggrieved investors could have, by weight of numbers rather than the value of their claims, a decisive

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73 Mark Korda of KordaMentha, 'Gwalia ruling creates need for new legal category of aggrieved shareholder', *Age*, 2 February 2007.

74 Section 553 provides that all debts payable by, and all claims against, the company are admissible to proof against the company if the circumstances giving rise to the debts or claims occurred before the relevant date. The meaning of 'relevant date' is determined by the s 9 definition of 'relevant date' and Part 5.6 Div 1A.

75 Reg 5.6.40 provides that a proof of debt or claim may be prepared by a creditor personally or by a person authorised by the creditor. Where a proof of debt is prepared by an authorised person, the authorised person must state his or her authority and means of knowledge.

76 Corp Reg 5.6.23(2).

77 Subsequent to the High Court decision, the administrator of Sons of Gwalia Ltd admitted the shareholders for the full amount of damages alleged by them in consequence of the failure of the company to notify the ASX of certain information (as described in Section 1.3.1).

78 s 439C.

79 A resolution is carried by a vote in favour by a majority in number and value (Corp Reg 5.6.21(2)) and defeated by a vote against by a majority in number and value (Corp Reg 5.6.21(3)). In the event that votes by number and value differ, the administrator has the casting vote (Corp Reg 5.6.21(4)).

influence over the outcome of administrations (even if they cannot in the end substantiate their claim).

The possible effect of increased shareholder influence is speculative and may differ between companies. On the one hand, shareholders might be more concerned to cut their losses by liquidating the company and taking a taxation write-off, rather than support a reconstruction plan aimed at the company continuing in business.

On the other hand, shareholders might have a loyalty to the company that will cause them to take all available steps to revive it. It may even be in the interests of shareholders in some circumstances to accept a limited return on their claims for damages as part of a DOCA whereby the company will come out of administration and return to active trading.

Possible detriment

Situations may occur where shareholders with aggrieved investor claims do not have material voting weight either by numbers or by value. In these circumstances, it is possible that their interests may be detrimentally affected.

A DOCA binds all creditors of the company (generally excluding secured creditors) so far as concerns 'claims arising on or before the day specified in the deed'.[80] This covers 'debts or claims the circumstances giving rise to which occurred before the relevant date', thereby including various future or contingent debts or claims.[81] A DOCA could therefore seek to limit the return to aggrieved investors to a proportion of any judgment debt that they may eventually obtain against the company. However, an aggrieved investor could apply to the court to declare the deed void as being oppressive or unfairly prejudicial, or unfairly discriminatory, if

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80 s 444D. The Advisory Committee report *Corporate Voluntary Administration* (1998) para 1.14 sets out in detail all the parties bound by the deed.

81 *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 22 ACSR 169. The meaning of 'relevant date' is determined by the s 9 definition of 'relevant date' and Part 5.6 Div 1A.

aggrieved investors were treated in a detrimental manner compared with other creditors to be bound by the deed.[82]

4.3 Implementing a DOCA and conducting a liquidation

A key challenge for administrators in implementing a DOCA, and for liquidators in conducting a winding up, is how to respond to the claims of aggrieved investors, and measure their loss or damage as creditors, without unduly prejudicing the rights of other creditors or incurring disproportionate delay or legal costs in this process.

A deed administrator or liquidator must assess, and can reject, aggrieved investor claims. This assessment process involves:

- *determining the validity of claims.* This may involve:
  - determining whether each shareholder can establish the elements necessary to prove a claim (as discussed in Section 3.2), including whether the shareholder relied on the corporate misconduct in making a decision about the shares
  - engaging experts to assist in determining shareholder claims
  - conducting court examinations of directors to ascertain their actions and state of mind when relevant corporate decisions were made[83]
  - running court cases to establish whether corporate misconduct has taken place

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82 s 445D(1)(f). In *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 22 ACSR 169, the Full Federal Court considered the tests for determining whether a DOCA is oppressive, unfairly prejudicial or unfairly discriminatory. In that context, the Court observed (at 185) that, where a proposed deed:

> will discriminate between creditors and there is no community of interest between the groups, it is important that an administrator examine the proposal carefully and critically in order to ensure that the less advantaged group is not unfairly prejudiced. That must involve at least that the administrator take steps to ensure, so far as it is possible, that the deed is no less beneficial to all creditors than liquidation is likely to be.

83 A liquidator and a deed administrator of a company are eligible applicants (s 9 definition of 'eligible applicant') for a court order summoning an officer of the company for examination about the examinable affairs (including business affairs) of the company (s 596A).

- *determining the quantum of accepted claims.* This will usually involve:
  - taking into account the different times and circumstances in which each shareholder purchased shares in the company[84]
  - if the damage suffered by each shareholder is the cost price of the shares less present value—awaiting receipt of each shareholder's claim, as the company may not know the cost price of transferee shareholders' shares.

Persons whose claims have been rejected must be notified of their right to apply to the court to challenge the decision.[85]

Deed administrators or liquidators may choose to negotiate a settlement with aggrieved investors, as they may do with other creditors, given that there may well be a considerable delay in obtaining a judicial determination of their claims or that the company may have insufficient funds to contest these claims in court.

4.4 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter.

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84 Subsection 554(1) requires that the amount of a debt or claim of a company be computed for the purposes of the winding up as at the 'relevant date'. The meaning of 'relevant date' is determined by the s 9 definition of 'relevant date' and Part 5.6 Div 1A. Under s 554A(2), where the debt or claim does not bear a certain value, the liquidator must:
(a) make an estimate of the value of the debt or claim as at the relevant date; or
(b) refer the question of the value of the debt or claim to the Court.

85 Under reg 5.6.54, a liquidator must within 7 days after the liquidator has rejected all or part of a formal proof of debt or claim:
(a) notify the creditor of the grounds for that rejection; and
(b) give notice to the creditor at the same time:
(i) that the creditor may appeal to the Court against the rejection within the time specified in the notice, being not less than 14 days after service of the notice, or such further period as the Court allows; and
(ii) that unless the creditor appeals in accordance with subparagraph (i), the amount of his or her debt or claim will be assessed in accordance with the liquidator's endorsement on the creditor's proof.

The Committee would be particularly interested in receiving any information on the matters dealing with aggrieved investor claims in external administrations that are canvassed in this chapter, including the way they are or might be handled by deed administrators or liquidators in practice.

You are also invited to suggest any other implications that may arise in relation to aggrieved investor claims for voluntary administrations or liquidations.

5 Broader implications

*This chapter summarises a range of views on possible broader consequences of the **Sons of Gwalia** decision. Many of these possible consequences are of a longer-term nature and remain speculative.*

5.1 Corporate financing

It has been argued that there may be longer-term effects on the provision of unsecured loan finance to companies now that it is clear that aggrieved investor claims are creditor claims. These possible ramifications, which are uncertain at this stage, include:

Increased cost or reduced availability of finance

- Australian companies may find it more expensive, or more difficult, to raise unsecured debt capital in overseas corporate bond markets. For instance, lenders may increase their interest rates. Also, debt investors may be unwilling to acquire some corporate bonds, given the perceived additional risk of delay or difficulty in recovering their investment in the event of the company's insolvency. This may particularly occur in the US market, where US debt investors are accustomed to all shareholder claims being postponed behind their claims, as is the case under their domestic laws[86]

Loan agreements more complex and time-consuming

- *taking security*. Financiers who are concerned about their position may seek to reduce their exposure to risk by taking security, for instance, a fixed or floating charge over the assets of the company.[87] Financiers may be less inclined to offer

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86 The relevant US law is discussed in Chapter 6.

87 Gummow J in *Sons of Gwalia* (at [43]) noted that:

> large institutional lending may be made, at least in contemporary circumstances, without taking security in its traditional forms. The reasons for this may reflect the market strength of corporate borrowers at any one period, stamp duty considerations and other matters peculiar to the nature of the project to be funded.

negative pledge lending, which substitutes a promise for a security

- *reducing loan limits.* Lenders may place stricter limits on funds available on an unsecured basis
- *additional conditions.* Lenders may impose more onerous conditions on the provision of credit by making:
  - covenants and undertakings in loan and bond documentation more restrictive
  - due diligence and monitoring of corporate management more rigorous, for instance, by requiring greater assurances from company directors about full and complete disclosure
- *guarantees.* Financiers, whether secured or unsecured, might require guarantees from asset-owning subsidiaries of the borrower, in an attempt to ensure that aggrieved investor claims are structurally subordinated[88]
- *dealing with subsidiaries rather than holding company.* Potential lenders might provide financial accommodation to a corporate group at a level below the holding company, so that shareholders of the holding company in respect of any aggrieved investor claims concerning shares acquired in the holding company are structurally subordinated to the claims of direct

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88 However, use of guarantees would be ineffective where the holding company and its subsidiaries have executed a class order deed of cross-guarantee to secure relief from the requirement that each company in the group produce separate audited accounts. Under a class order deed of cross-guarantee, each company guarantees for the benefit of all creditors the payment of all the debts of each other company on a winding up. This would include shareholder claims whether or not they are subordinated, so that in relation to the assets of guaranteeing companies all unsecured creditors and claimants, including shareholder claimants, will rank equally. Financiers may therefore prefer that listed holding companies not execute class order deeds of cross-guarantee.

lenders to subsidiaries. This could be supported by cross-guarantees by other subsidiaries within the group.[89]

Shareholders may be disadvantaged to the extent that companies in which they invest have reduced opportunities to obtain debt finance or credit, or the cost of doing so is significantly increased.

Another view is that Australian companies typically have a higher ratio of secured to unsecured debt than comparable US companies, which needs to be taken into account in assessing the impact of the *Sons of Gwalia* decision on corporate financing.

5.2 Trade creditors

Trade creditors, particularly of disclosing entities, may be less inclined to extend credit, may make greater use of retention of title clauses, or may build the added risk into the cost of their goods or services, given the potentially lower return to them in an insolvency in consequence of any aggrieved investor claims.

However, in practice, trade creditors of disclosing entities may not have the option of protecting themselves by taking security and may therefore be more exposed than other categories of creditors to the consequences of aggrieved investor claims. Also, they may not be financially secure enough to be able to choose the companies to which they extend credit. This is less likely to be an issue for trade creditors who deal with companies that are not disclosing entities, given that those companies may be at less risk of aggrieved investor claims.[90]

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89 However, this approach may be of limited assistance if the corporate group with which a creditor deals has given a class order guarantee. If a shareholder has a claim against a holding company and if the holding company is a member of a group that has provided a class order guarantee, this would be a means whereby those shareholders could obtain access to the assets of other companies within the group and thereby negate any structural priority accorded to financiers who had lent to subsidiaries within the group.

90 See Section 3.1.

5.3 Financial markets

5.3.1 Corporate bond markets

As already indicated (Section 5.1), Australian companies may find it more expensive, or more difficult, to raise unsecured debt capital in overseas corporate bond markets.

5.3.2 Distressed debt markets

These markets, in the USA, Europe and elsewhere, permit secured or unsecured creditors of companies under financial stress to transfer their credit risk at discounted prices that take into account the financial risks to anyone acquiring those rights.[91] This type of market is an important aspect of an efficiently functioning financial system.

The pricing mechanism in this market for distressed debt of Australian companies would take into account the potential for aggrieved investor claims in light of the *Sons of Gwalia* decision.

5.3.3 Possible disclosure benefit for financial markets

There may be some transparency benefit for financial markets to the extent that 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 actions against the company. Financial markets are more efficient and less volatile to the extent that companies provide timely and accurate disclosures about their real financial position and prospects.

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[91] Distressed debt usually refers to any debt that is owed by a borrower whose credit rating or financial position has deteriorated below a level that the lender finds acceptable. Persons who have a sufficient risk tolerance and are prepared to purchase the debt create a secondary market in which the debt may be traded.

5.4 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter.

In so doing, you may wish to respond to one or more of the following questions arising from the current legal position:

- is there any indication of Australian financial institutions changing their approach to providing corporate finance?
- are there discernible effects on the cost and availability to Australian companies of US or other overseas finance?
- are there discernible effects on the position of unsecured creditors of Australian companies in seeking to offset their risk in US or other distressed debt markets?
- is it likely that there will be any effect on the assessment of Australian companies by rating agencies?

Also, are there significant differences between the relative ratios of secured and unsecured debt for comparable US and Australian companies and, if so, what, if any, implications might this have for the issues being considered in this paper?

6 Overseas law

This chapter summarises the legal position of aggrieved investor claims in the United Kingdom, the USA and Canada.

6.1 Overview

In the three overseas jurisdictions examined in this paper, there are differing approaches to the question of the status of aggrieved investor claims:

- UK law is consistent with the *Sons of Gwalia* approach
- North American jurisdictions subordinate all claims by shareholders relating to their shares, including as aggrieved investors, to those of conventional unsecured creditors.

6.2 United Kingdom

The position in the United Kingdom is consistent in effect with that in Australia as determined in the *Sons of Gwalia* decision.

A legislative amendment introduced in the 1980s makes it clear that shareholders are not to be precluded from claiming against a company in their capacity as creditors, thereby abrogating the rule in *Houldsworth's* case (see Section 2.3).[92]

Subsequently, in *Soden v British and Commonwealth Holdings plc*,[93] the House of Lords, in interpreting the UK equivalent of s 563A, decided that claims by an aggrieved investor that it was induced by a

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92 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.

93 [1997] UKHL 41; [1998] AC 298; [1997] 4 All ER 353; [1997] 3 WLR 840; [1997] BCC 952.

company's misrepresentation to acquire the company's shares ranked equally with conventional unsecured creditor claims.

The Court held that these types of claims by shareholders against a company do not involve rights given to them in their capacity as members under the company's constitution (which would rank last in a winding up) and thus rank equally with other unsecured creditors in the liquidation of a company.

As a practical matter, UK law governs commercial transactions in other jurisdictions through the widespread reference to UK law in 'choice of law' clauses in contracts. The UK position whereby aggrieved investor claims rank equally with conventional unsecured creditors may therefore potentially affect a large number of commercial transactions throughout the world.

The issue of the status of aggrieved investor claims has re-emerged in the United Kingdom. The *Davies Review of Issuer Liability: Final Report* (June 2007) noted conflicting responses to the question whether the UK law should be amended to subordinate these investor claims in an insolvency. According to the report, 'this issue needs further work', including taking into account the outcome of the Advisory Committee review of *Sons of Gwalia*.[94]

6.3 USA

Section 510(b) of the US Bankruptcy Code, introduced in 1978 and regarded as part of what is known as the 'absolute priority' rule,[95] specifically postpones claims arising from the purchase or sale of securities behind those of unsecured creditors in a liquidation.[96] This

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[94] paras 61 and 62. That report stated (at para 62):

> I note that in Australia the issue, arising out of the decision of the High Court in the *Sons of Gwalia* case, has been referred to [CAMAC]. I recommend that the [UK] Government should consider its resulting report as part of any future policy developments.

[95] As summed up in J Harris & A Hargovan, 'Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies' (2007) 25 C&SLJ 7 at footnote 111, the absolute priority rule is that in a corporate liquidation secured creditors must receive full payment before unsecured creditors, who in turn must receive full payment before shareholders.

[96] §510(b). The relevant part of the provision states that:

shareholder subordination principle was introduced to reverse previous case law to the effect that these shareholder claims were not subordinated, but ranked equally with claims of other unsecured creditors in a liquidation.

6.3.1 Rationale for the rule

The legislation adopted the recommendations of a Commission on the Bankruptcy Laws, established in 1973, which supported this postponement 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.

This conclusion reflects the views of two commentators,[97] who argued that shareholders should bear the risk of fraudulent or misleading corporate conduct affecting their shares. Shareholders have the most to gain from the company's success, through their unique right to share in the profits, unlike conventional creditors who bargain for a fixed return:

> 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. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency.[98]

The commentators argued that to rank shareholder claims relating to their shares with general creditor claims would dilute the capital

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> 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 …

97 J Slain and H Kripke, '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.

98 id at 286-287.

reserve 'cushion of security' available to repay general creditors. By contrast, giving general creditors an absolute priority over all claims by shareholders arising from the purchase or sale of their shares would:

> prevent disappointed shareholders from recovering the value of their investment by filing bankruptcy claims predicated on the issuer's unlawful conduct at the time of issuance [of the shares], when the shareholders assumed the risk of business failure by investing in equity rather than debt instruments.[99]

In *In re Telegroup, Inc* (2002),[100] the Court considered that, in enacting this provision, Congress adjudged that, as between shareholders and general unsecured creditors, it is the former who should bear the risk of any illegality in the issue of their shares, should the corporation go into liquidation. Shareholders should not be able to use claims of corporate fraud 'to bootstrap their way to parity with' general unsecured creditors. The Court accepted the proposition that:

> because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the business's collapse—up to the full amount of their investment.[101]

In Re WorldCom (2005) also adopted the view that the burden of insolvency should fall on the shareholders as part of the risks they undertake in acquiring the shares, which includes the risk of corporate fraud or other misconduct.[102]

6.3.2 Application to corporate misconduct whenever occurring

An issue in interpreting s 510(b) has been whether it extends beyond corporate misconduct that induced a person to acquire shares (as in *Sons of Gwalia*), to corporate misconduct that occurred after the acquisition and induced a shareholder to retain shares, with subsequent loss.

99 id at 267-268.
100 281 F 3d 133 (3rd Cir, 2002).
101 id at 140.
102 329 BR 10 at 14 (Bankr SDNY, 2005).

Although differing views have been expressed in the case law, the trend in more recent decisions is to give the provision a broader interpretation, thereby subordinating claims by shareholders related to their shareholding that arise from corporate misconduct whenever occurring.[103]

In *In re Telegroup, Inc*, various shareholders alleged that, subsequent to the purchase of shares from the company, the company failed in its contractual obligation to them under the share purchase agreements to ensure that the company's shares were freely tradeable by a nominated date. The company went into Chapter 11 bankruptcy some months after the nominated date without meeting its obligation, and the value of the shares declined. The shareholders claimed that, if the company had complied with its contractual obligations by the nominated date, they could have sold their shares as soon as they became tradeable, and before the company went into bankruptcy, thereby avoiding the losses incurred when their shares subsequently declined in value. The Court held that these shareholder claims came within s 510(b) and were subordinated.[104]

In *Re Geneva Steel* (2002),[105] a shareholder alleged that the company had acted in a fraudulent manner after he had acquired the shares, and that this corporate conduct had induced him to retain, rather than

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[103] The statutory interpretation problem has been whether the phrase 'arising from' in s 510(b) should be given a narrow or broad application. The section provides that:

> 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 …

The relevant case law is analysed in A Hargovan and J Harris 'Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience' (2007) 20 *Australian Journal of Corporate Law* 265 at 281–285.

[104] The Court said (at 142):

> Congress intended to prevent disaffected equity investors from recouping their investment losses in parity with general unsecured creditors in the event of bankruptcy … because [the shareholder] claimants retained the right to participate in corporate profits if [the company] succeeded, we believe that s 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors.

[105] 281 F 3d 1173 (10th Cir, 2002).

sell, the shares, which subsequently lost value. The Court considered that this shareholder claim should be subordinated under s 510(b).[106]

6.4 Canada

6.4.1 Common law

Canadian courts have adopted the approach of subordinating aggrieved investor claims in an insolvency.

In a leading case, *Re Blue Range Resource Corp* (2000),[107] a shareholder claimed that its decision to purchase shares on the share market had been induced by the company's fraudulent misrepresentation in breach of its common law duties to the investor.

The Court confirmed that a shareholder's claim against a company that is unrelated to the shareholding is not subordinated.[108] However, in this case the claim was directly related to the status of the claimant as a shareholder.[109] As such, it was subordinated to those of non-shareholder creditors, on the basis that it was, in effect, a return of capital and therefore ranked last in the insolvency:

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106 The Court said (at 1180):

> [the shareholder's] claim, at its essence, accuses [the company] of manipulating information concerning his [share] investment. He acquired and held that [share] investment with the belief that its value would increase, though he no doubt recognized that for any number of reasons it might not; indeed, he recognized that it might even lose value. In contrast, a mere creditor of [the company] could expect nothing more than to recoup the value of goods or services supplied to the company. Yet now, having watched his investment gamble turn sour, [the shareholder] would shift his losses to those same creditors. We think this effort clashes with the legislative policies that section 510(b) purports to advance.

107 *Re Blue Range Resource Corp* (2000) 15 CBR (4th) 169; 259 AR 30.

108 The Court said (at [22]):

> There may well be scenarios where the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, such as where a shareholder is also a regular trade creditor of a corporation, or slips and falls outside the corporate office and thus has a claim in negligence against the corporation.

109 The Court also said (at [22]):

> In the current situation, however, the very core of the claim is the acquisition of [the company's] shares by [the shareholder] and whether the consideration paid for such shares was based on misrepresentation. [The shareholder] had no cause of action until it acquired shares in [the company] … as it suffered no damage until it acquired such shares. This tort claim derives from [the shareholder's] status as a shareholder, and not from a tort unrelated to that status.

> A tort award to [the shareholder] could only represent a return of what [the shareholder] invested in the equity of [the company]. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment.[110]

The Court also referred to some other general factors that it considered supported the principle of subordinating aggrieved investor claims, including:

- creditor expectations that they will have priority over shareholders in having access to the company's equity base
- the problems that external administrators would face in adjudicating these shareholder claims if they ranked equally with general creditors.[111]

In a subsequent case, *National Bank of Canada v Merit Energy Ltd* (2001),[112] the Court ruled that the subordination principle applied even where the shareholder claimed under a statutory cause of action, rather than in common law tort, as in *Re Blue Range Resource Corp*:

> It is true these shareholders [in this case] are using statutory provisions to make their claims in damages or rescission rather than the tort basis used in *Re Blue Range Resource Corp*, but in substance they remain shareholder claims for the return of an equity investment. The right to a return of this equity investment must be limited by the basic common law principle that shareholders rank after creditors in respect of any return of their equity investment.[113]

6.4.2 Proposed legislation

Corporate restructurings under Canada's insolvency regime are governed by the provisions of the *Bankruptcy and Insolvency Act* (BIA)[114] relating to proposals between insolvent persons and their

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110 id at [23].
111 id at [29] ff.
112 [2001] 294 AR 15. This decision was affirmed at [2002] 299 AR 200.
113 294 AR at [50].
114 Corporate liquidations are usually conducted under the bankruptcy provisions of the BIA.

creditors or by similar provisions in the *Companies' Creditors Arrangement Act* (CCAA).[115]

There are as yet no provisions in either statute dealing specifically with claims by shareholders as aggrieved investors. However, amendments have been proposed to the BIA and the CCAA[116] that would be consistent with US law to the effect that shareholders who claim that they were induced by the company to transact in its shares through a corporate fraud are in substance making a claim for the return of their equity investment, which ranks behind the claims of unsecured creditors in a liquidation. These claimants would also be prevented from voting as creditors on any proposed reorganization.

6.5 Request for submissions

The Advisory Committee invites comments on the relevance of overseas law to the questions posed in this paper.

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115 The CCAA has less structured rules and regulations than the BIA. It gives the debtor and the supervising court a great deal of flexibility when conducting restructuring proceedings, but is only available to debtors with total debts of over $5 million. For further background to the Canadian insolvency provisions, see *Debtors And Creditors Sharing The Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act*, Report of the Standing Senate Committee on Banking, Trade and Commerce (November 2003).

116 Proposed amendments to the BIA would codify Canadian common law by enacting a wide-ranging shareholder subordination principle in a liquidation:

> A creditor is not entitled to a dividend in respect of an equity claim until all damages that are not equity claims have been satisfied.

Under the 2006 amendments, 'equity claim' would include claims relating to:

- dividends
- capital returns
- redemption or retraction obligations
- monetary losses resulting from share ownership, and the purchase, sale or rescission of an 'equity interest' (which is also a defined term), and
- contributions or indemnities in respect of any of the above claims.

An equity interest, in the case of most corporations, would be defined as a share, warrant, option or other right to acquire a share in the corporation (though not if the interest arises from a convertible debt instrument).

These definitions would subordinate a wide range of shareholders' equity claims against insolvent companies.

A proposed amendment to the CCAA would prevent equity claimants from voting at creditors' meetings unless the court orders otherwise. As with the BIA amendments, the terms 'equity claim' and 'equity interest' are to be defined in the CCAA.

An effect of the amendments to the BIA and the CCAA will be to subordinate those claims that are based on a rescission of the purchase of the reorganizing debtor's or bankrupt's shares or damages arising from the purchase of those shares.

In particular, you may wish to respond to one or more of the following questions:

- did the *Soden* decision in the United Kingdom have a demonstrated adverse effect on corporate financing or on the conduct of external administrations?
- are there material differences between the legal environment in the United Kingdom and Australia, for instance, in relation to class actions and litigation funding, that need to be taken into account in considering the UK experience?

7 Retain or change the law

This chapter sets out a range of arguments that have been put forward in support of either retaining or reversing the current legal position that shareholders with aggrieved investor claims are ordinary creditors in an external administration.

7.1 Terms of reference

The Advisory Committee has been asked to advise on whether shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency should be able to participate in the distribution of funds in an insolvency proceeding equally with other unsecured creditors who are not shareholders in relation to any debts that may arise out of that misleading conduct.

7.2 Policy options

Three options for dealing with aggrieved investor claims are discussed in this chapter:

- *Option 1: retain the current law, as determined in light of the High Court decision* (Section 7.3), so that aggrieved investors will continue to be entitled to participate as creditors in a voluntary administration or liquidation and their claims will rank equally with other general unsecured creditor claims where the liquidation provisions apply

- *Option 2: amend the Corporations Act to reverse the effect of the law as determined in the High Court decision* (Section 7.4), so that aggrieved investors would not be entitled to participate as creditors in a voluntary administration or liquidation and their claims would be postponed behind those of general unsecured creditors and rank equally with member claims under s 563A

- *Option 3: as per Option 2, with an internal ranking of shareholder claims* (Section 7.5), so that aggrieved investors would be in the same position as under Option 2, except that their claims would rank above member claims that are postponed by s 563A.

Another possible option would be to recognise shareholders with aggrieved investor claims as creditors in an external administration, but postpone their claims in a winding up in the same manner as member claims under s 563A. However, this may give aggrieved investors an unwarranted influence in decisions affecting conventional unsecured creditors.

Nothing in this chapter affects claims by shareholders, whether as aggrieved investors or otherwise, against ongoing solvent companies or claims by persons who are shareholders but are suing in some other capacity.[117]

7.3 Option 1: no change

Under this option, the principles in *Sons of Gwalia* would stand.

This option would be consistent with the UK approach.

7.3.1 Arguments for Option 1

Some of the matters raised in earlier chapters on the implications of the decision could also be used as arguments for this option. Further arguments that have been advanced include:

Focused impact of the decision

- while aggrieved investor claims could potentially be made against any company, in practice they are most likely to arise in the external administration of disclosing entities. Shareholders in these publicly listed companies typically need to rely on the company for accurate information affecting the value of the investment

Investor protection

- since the need for protection of equity investors often arises only in the event of insolvency, such protection may be illusory if the relevant claims are subordinated to the claims of ordinary creditors[118]

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[117] These other types of shareholder claims are discussed in Section 2.1.1.
[118] Gleeson CJ at [18].

- one of the aims of the continuous disclosure provisions is to compensate shareholders and potential shareholders for the losses that might be suffered from undisclosed facts and to reduce the incidence of such losses. It may not encourage reliance on financial markets if, in the very situation (a voluntary administration or liquidation) in which investors may need to rely on relevant statutory remedies, their rights are postponed to other creditors simply because the damage they have suffered stems from their investment in shares[119]

- another aim of the continuous disclosure, and other corporate disclosure, requirements is to promote a properly informed market, thereby enhancing the integrity and reputation of that market and encouraging investment. All things being equal, prospective shareholders will be more likely to invest in the Australian share market if they feel confident that they will have a meaningful remedy, should the companies in which they invest fail to make adequate disclosure. They may be less likely to invest in that market if they feel that they will not be compensated for inadequate disclosures by the company if it happens to collapse

Fairness

- aggrieved investors should be in no worse a position in an external administration than holders of options or convertible notes who have been similarly deceived into acquiring their securities at the same time by means of the same faulty disclosure or non-disclosure (option and note holders have never been considered to be postponed to other creditors under s 563A)

Argument based on acceptance of risks invalid

- the risks of equity investment do not include that a company may have concealed information or provided false or misleading information affecting the investment decision

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[119] Kirby J at [106].

Promote market neutrality

- both the debt and equity markets rely on the consumer protection provisions and should receive the same protections in the event of corporate misconduct

Corporate control

- in some companies, such as large listed companies, ordinary shareholders, even institutional shareholders, may have no real ability to direct the company and in reality may have no greater power than creditors

Corporate culture

- the *Sons of Gwalia* decision reminds boards of the importance of a culture of corporate compliance with statutory disclosure obligations and the increased possibility of shareholder claims if that culture is disregarded

Private enforcement

- treating aggrieved investors as creditors may encourage shareholder class actions against companies, which may act as a form of private enforcement of corporate obligations. In class actions, the aggregation of individual claims can significantly increase the amount that a company may have to pay. This possibility may complement traditional regulatory techniques in enforcing corporate compliance

Overseas markets

- various possible 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 House of Lords decision in *Soden* almost a decade ago (see Section 6.2), which is similar to that of the High Court in *Sons of Gwalia*

Argument about administrative burden insufficient

- making external administrations simpler, quicker or more expedient does not justify postponing a category of shareholder creditors. Any procedural difficulties may be able to be ameliorated by appropriate administrative reforms.

7.3.2 Option 1 and other equity-linked interests

There are various types of equity-linked investors who are not 'members' within the meaning of s 231 of the Corporations Act and whose claims for damages to their equity interest from corporate misconduct were never considered to be postponed as shareholder claims under s 563A. This position has not been affected by the *Sons of Gwalia* decision.

These equity-linked investors include:

- persons who were never on the share register, because they invested in equity through nominees, custodians or trusts
- holders of various options or warrants over shares or other equity derivatives, rather than the shares themselves.

Adoption of Option 1 would result in a consistent approach to all holders of equity-linked interests, whether or not they are registered shareholders. They would all be entitled to claim, in appropriate circumstances, as aggrieved investors, thereby being creditors, and their claims, if properly made out, would rank equally with those of other general unsecured creditors.

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

Under this option, shareholders with aggrieved investor claims against the company would not have the right, pursuant to those claims, to participate as creditors in a voluntary administration or liquidation. Also, these shareholder claims would be subordinated in a liquidation to the same level as member claims that come within s 563A.

7.4.1 Arguments for Option 2

Some of the matters raised in earlier chapters on the implications of the decision could also be used as arguments for this option. Further arguments that have been advanced include:

Debt/equity distinction

- it is important to maintain the traditional distinction between the respective roles of equity and debt in a limited liability company, namely:

  – while shareholders, like creditors, risk losing the money they have put into the company (and, in the case of partly paid shares, being called on to contribute any unpaid capital), they have an unlimited upside, in the form of potential dividends and capital gains, together with various statutory legal remedies and the right to vote for directors. Given this, all claims by shareholders relating to their shares should be postponed to claims by other creditors in a corporate insolvency

  – by contrast, creditors can only recover from a company their principal and any interest provided for in the contract

- 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[120]

- 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

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120 Callinan J in *Sons of Gwalia* at [242].

Fairness

- equity investors are often able to manage their risk by diversifying their share and other investments, whereas this flexibility may not be available to trade creditors
- whereas financiers can often adopt various means to protect themselves, some trade creditors may not have the same options
- the risk involved in purchasing shares 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[121]

Administrative burden

- depending on how courts deal with the reliance issue (see Section 3.2.3), each claim by a misled shareholder may require separate adjudication, occasioning delay and costs in an external administration and thereby further reducing the return to the other unsecured non-shareholder creditors

Efficient markets

- an element of an efficient market is the expeditious and cost-effective administration of insolvent companies, which could be hindered by the time and complexity involved in dealing with shareholder claims
- prices offered to unsecured creditors seeking to transfer their rights in the secondary or distressed debt market could be reduced if the law is not changed

Consistency with North American law

- adoption of Option 2 would make Australian law consistent with US and Canadian law

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[121] Kirby J at [109].

Argument relating to class actions

- it may be difficult to extrapolate from the UK position[122] to Australia, given the potential in Australia for funded litigation and class actions, which may be more in line with practices in the USA and which may encourage shareholder actions and therefore reduce the possible return to other unsecured creditors.

Option 2 is consistent with the shareholder subordination principle in s 510(b) of the US Bankruptcy Code. It could be achieved by extending s 563A to include the circumstances referred to in that US provision, while making clear that the subordination provision applies to all aggrieved investor claims arising from corporate misconduct, whenever occurring.[123]

7.4.2 Option 2 and other equity-linked interests

It is arguable that, to achieve consistency, the subordination rule should apply to all holders of equity-linked interests (as described in Section 7.3.2), not just registered shareholders.

This approach would be consistent with amendments proposed for Canadian legislation, which would subordinate shareholder and other equity-linked claims.[124]

7.5 Option 3: Option 2 with sub-category of aggrieved investor claims

This option would incorporate an additional element in Option 2 so that, in the distribution of any excess in a liquidation after all claims by conventional unsecured creditors have been satisfied, any aggrieved investor claims referred to in Option 2 would take priority over any other claims, or residual rights of distribution, by shareholders.

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[122] The situation in the United Kingdom is still evolving. Currently, claimants have to opt in to a case in a class action suit. An alternative form for these actions, which is under consideration, is that anyone who fits the definition of the class is automatically included unless they opt out. A similar move in the 1960s in America sparked the rise in mass actions. Expensive cases in the UK are also increasingly being financed by hedge funds, pension funds and others seeking to profit from the compensation involved.

[123] See further Section 6.3.

[124] See footnote 116.

Hence, the order for recovery in a liquidation would be:

- secured claims
- priority unsecured claims
- ordinary unsecured claims
- aggrieved investor, and other equity-linked, claims
- remaining shareholder claims.

On one view, this option would not give misled or deceived shareholders any 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.

7.6 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter, including the three options on whether to retain or amend the current law.

You may also wish to indicate whether there are any other approaches to aggrieved investor claims that are not discussed in this chapter and may better accommodate the various interests.

8 Possible reforms if law unchanged

This chapter considers possible ways to facilitate the efficient conduct of external administration proceedings involving aggrieved investor claims if the current legal position is retained.

8.1 Terms of reference

The Advisory Committee has been asked to advise on possible reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of shareholder claims if the current law is retained (as discussed in Option 1 at Section 7.3).

8.2 Calling a creditors' meeting

8.2.1 Notice of meeting

Administrators are currently required to give written notice of creditors' meetings to as many of the company's creditors as reasonably practicable.[125] An administrator may be uncertain about whether this notice needs to be given to some or all shareholders, where the administrator knows that one or more shareholders have commenced, or intend to make, an aggrieved investor claim.

One possibility to alleviate the administrator's burden may be to state expressly that 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, even where the administrator has been put on notice that one or more shareholders intend to make such a claim.

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125 s 436E(3)(a).

Considerations supporting this approach are:

- in practice, aggrieved investors may often already know of the creditors' meeting and in that event will seek to be admitted as unsecured creditors
- it should be sufficient for the administrator to advertise the meeting,[126] 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.

A contrary view is that the current law raises no practical problem for administrators. They do not have a duty to seek out non-obvious creditors, whether located in Australia or elsewhere, such as retailers and consumers who suffered economic loss only.[127]

8.2.2 Time and place of meetings

A creditors' meeting must be held at a time and place convenient to the majority of creditors.[128] Where the creditors include aggrieved investors, there may be practical difficulties, as these investors can be located anywhere in the world. A contrary view is that aggrieved investors do not raise a novel problem, given that other creditors can also be located anywhere in the world and insolvency practitioners often need to correspond with foreign parties of various kinds.

If a legislative change is considered necessary, one option may be to exclude aggrieved investors in considering this matter. Another option would be to give external administrators a greater discretion in these circumstances.

8.3 Determining aggrieved investor claims

There are two situations in which external administrators need to make decisions about claims:

- for the purpose of determining voting rights

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126 Corp Reg 5.6.14A.
127 *Selim v McGrath* (2003) 47 ACSR 537 at [126].
128 Corp Reg 5.6.14.

- for the purpose of making a distribution to creditors.

These decisions are not unique to aggrieved investor claims. Administrators and liquidators have always had the potential problem of having to deal with alleged, but as yet unproved, claims by possible creditors.

8.3.1 For the purpose of determining voting rights

A person may vote at a meeting of creditors if the person has lodged particulars of his or her debt or claim, or a formal proof of the debt or claim, with the chair of the meeting or the person named in the notice of meeting to receive the particulars.[129] However, a creditor may not vote on an unliquidated or contingent debt or claim or a debt whose value is not established unless a 'just estimate' of the value has been made.[130]

Currently, administrators adopt the practice of admitting a claimant for a nominal amount (usually one dollar) where there is some uncertainty about the claim. Administrators may take this course in relation to aggrieved investor claims.[131] The effect of this may be that shareholders with these claims may constitute a majority by number, but not a majority by value, on any creditors' resolution. A resolution is carried by a vote in favour by a majority in number and value[132] and defeated by a vote against by a majority in number and value.[133] In the event that votes by number and value differ, the administrator may exercise a casting vote.[134]

Persons who are admitted for only a nominal amount can object, have that objection noted in the minutes of the creditors' meeting and subsequently apply to the court to have their claim recognised in

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[129] Corp Reg 5.6.23(1)(b).

[130] Corp Reg 5.6.23(2).

[131] Subsequent to the High Court decision, the administrator of Sons of Gwalia Ltd admitted the shareholders for the full amount of damages alleged by them in consequence of the failure of the company to notify the ASX of certain information (as described in Section 1.3.1.).

[132] Corp Reg 5.6.21(2).

[133] Corp Reg 5.6.21(3).

[134] Corp Reg 5.6.21(4). On the exercise of the casting vote, see *Ausino International Pty Ltd v Apex Sports Pty Ltd* (2007) 61 ACSR 532 (Barrett J).

full by value. In practice, the meeting is not delayed by any such objection.

Nevertheless, one possible means to achieve greater certainty could be to amend the relevant regulation[135] to be more specific about what is required for the making of a 'just estimate' of the value of a claim by a shareholder against the company for damages in connection with that person's shareholding. For instance, the regulation could 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).

There might also be a requirement that the particulars of claim be verified by statutory declaration of the shareholder or (in the case of a corporate shareholder) a director of the shareholder.

The intention would be to assist the process of providing relevant information, without depriving the chair of the current discretion to accept or reject shareholder proofs of debt.[136]

An argument against this approach is that, although it aims at making the insolvency practitioner's role less burdensome, it appears to involve more complex procedures. Also, assessing the information from a shareholder might increase the insolvency practitioner's task in determining whether a 'just estimate' of the value of the claim has been made.

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135 Corp Reg 5.6.23(2).
136 Corp Reg 5.6.26.

An alternative approach would be for an industry body to put out a general statement of best practice or some other guideline to assist administrators and creditor applicants in understanding what factors should be taken into account in considering claims.

8.3.2 For the purpose of distribution to creditors

The most complex and time-consuming aspect for external administrators in applying the current law, as determined in *Sons of Gwalia*, is likely to be the adjudication of proofs of debt by aggrieved investors to determine the size of their claims compared with other unsecured creditor claims, for the purpose of distributing any available corporate assets to unsecured creditors.

Possible ways to expedite the claims procedure and make it more efficient include:

- providing for one judicial determination for a common aggrieved investor issue, including through a single proof of debt
- having a rebuttable presumption that a court's determination of a common question of fact in one proceeding applies in all subsequent proceedings.

Single judicial determination for a common issue

This approach could involve:

- providing for a single proof of debt on behalf of all aggrieved investor claimants, with any court ruling following a shareholder's objection to an external administrator's ruling binding all shareholders (this would be analogous to a current similar provision for employees[137]) and
- requiring 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

137 Corp Reg 5.6.45(1).

administrator being involved in multiple court actions on this matter.

However, the degree of commonality of interests between the various shareholders may be less than that between the interests of employees. An issue common to every claim by aggrieved investors would be whether the company engaged in misconduct affecting their shares, such as making misleading or deceptive statements. However, there may not be sufficient commonality of claims to make a single proof of debt workable if each shareholder must prove reliance.[138]

If a single proof of debt is not a practical option, it may still be possible to devise a streamlined procedure to deal with the common element(s) of these shareholder claims, based on aspects of existing procedures such as:

- representative actions under Part IVA of the *Federal Court of Australia Act 1976* and equivalent State legislation (such as Part 7 Division 2 of the *Uniform Civil Procedure Rules 2005* (NSW))
- joinder of multiple plaintiffs or multiple plaintiffs and defendants under the rules of each State Supreme Court[139] and of the Federal Court.[140]

(i) Representative actions

Under the *Federal Court of Australia Act*, a plaintiff who personally has standing may be given standing to sue as a representative for the other members of a group[141] where:

- the claims of group members arise out of, or are in respect of, the same, similar or related circumstances[142]
- there is a substantial common issue of law or fact.[143] In the case of aggrieved investor claims, this issue may be whether the

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138 See further Section 3.2.3.

139 For instance, *Supreme Court (General Civil Procedure) Rules 2005* (Vic) Order 9, *Uniform Civil Procedure Rules 2005* (NSW) Part 6 Division 5.

140 Federal Court Rules Order 6 Rule 2.

141 s 33C(1)(a).

142 s 33C(1)(b).

company's conduct was misleading or deceptive. The common issues may form the basis of a representative action even though the circumstances of the various parties may differ in other respects (for instance, the circumstances relevant to establishing reliance by each of the claimants[144]).

Features of representative actions that might be incorporated into a procedure for aggrieved investor claims include:

- the specification of common questions,[145] the answers to which can be expected to be common to all the claims of the represented parties[146]
- not requiring the representative claimant to plead material facts specific to each individual member of the represented class, but only sufficient facts to convey the basis of the action to the other party[147] (though once the litigation develops past the initial common questions, the matters need to become progressively more particularised[148])
- a broad discretion for the court to make orders when issues that are not common to all represented parties need to be determined, such as orders establishing subgroups[149] or fragmenting the proceedings into individual hearings once the common issues have been determined[150]
- a requirement to notify group members of an application for court approval of a settlement.[151] As settlements bind all plaintiffs, the court, when presented with a proposed settlement

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143 s 33C(1)(c). See *Symington v Hoechst Schering Agrevo Pty Ltd* (1997) 78 FCR 164.
144 See further Section 3.2.3.
145 s 33H(1)(c).
146 *Bright v Femcare Ltd* (2002) 195 ALR 574; [2002] FCAFC 243; BC200204689 at [14] per Lindgren J.
147 This flexibility is the basis of the utility of Part IVA: see *Philip Morris (Aust) Ltd v Nixon* (2000) 170 ALR 487, (2000) ATPR ¶41–759 at [131]-[136]; W*illiams v FAI Home Security Pty Ltd (No 2)* [2000] FCA 726 at [17].
148 *Bright v Femcare Ltd* (2002) 195 ALR 574; [2002] FCAFC 243 at [52]-[55], [60]-[64].
149 s 33Q.
150 s 33R.
151 s 33X(4).

for approval,[152] must ascertain whether it represents a fair and reasonable compromise of the claims made on behalf of the group members.[153]

(ii) Joinder of multiple parties

The Federal Court Rules allow for an order for the joinder of claimants in an appropriate case.[154] The basic principle governing the exercise of the discretion is that the court should attempt to take the best course for the just resolution of the dispute between the parties, in a way that minimises delay and costs.[155] It has been held[156] that the court, when exercising its discretion, should be satisfied that:

- joinder is unlikely to result in unfairness to any party
- one solicitor or firm is accountable for the conduct of the proceedings for the applicant(s)
- it is expedient to join the claims, as all applicants propose to rely on some common or similar facts and the evidence intended to be relied upon in support of the claims is similar.

The Rules of the State Supreme Courts also allow for the joinder of multiple plaintiffs and defendants where there is a common question of law or fact and the relief being claimed relates to a particular transaction,[157] or otherwise where the court grants leave.[158]

Rebuttable presumption

Under this approach, the legislation could include a presumption that a court's determination of a question of fact (for instance, whether the conduct was misleading or deceptive or likely to mislead or

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152 s 33V.
153 *Lopez v Star World Enterprises Pty Ltd* (1999) ATPR ¶41–678 per Finkelstein J.
154 Order 6 Rule 2.
155 *Bishop v Bridgelands Securities Ltd* Federal Court of Australia 1990 (unreported) BC9003681 per Wilcox J.
156 ibid.
157 For instance, the *Uniform Civil Procedure Rules 2005* (NSW) Part 6 Division 5 rule 6.19. The forerunner of this rule was applied in *Dean-Willcocks (as liq) v Air Transit International Pty Ltd* (2002) 42 ACSR 328 per Austin J.
158 Leave was required in *Dean-Willcocks (as liquidator) v Air Transit International Pty Ltd* (2002) 42 ACSR 328 per Austin J.

deceive) in one proceeding constitutes a rebuttable presumption in subsequent proceedings that involve a determination of the same question of fact.[159]

8.4 Exercising proxy votes

Persons are prohibited from acting as a proxy if they are in a position to receive any remuneration out of assets of the company, except as a creditor sharing rateably with other creditors of the company.[160] This may preclude shareholders from appointing as their proxies law firms or others who are undertaking a class action on their behalf.[161]

One possibility is to permit persons acting on behalf of particular shareholders to vote as the proxy of those shareholders, even if they may receive a financial benefit.

8.5 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter concerning possible ways to facilitate the efficient conduct of voluntary administration or liquidation proceedings in the presence of aggrieved investor claims, if the current law is retained.

159 cf s 588E.
160 Corp Reg 5.6.33.
161 The Advisory Committee report *Corporate Voluntary Administration* (1998) recommended that any person should be permitted to vote for or against any resolution in accordance with a special proxy, whether or not that vote is to the person's financial advantage (rec 17). However, it did not discuss the specific matter of litigation funders exercising proxy votes.

9 Possible reform if law changed

This chapter discusses a possible way better to protect aggrieved investors if the current law is changed to postpone their claims.

9.1 Terms of reference

The Advisory Committee has been asked to advise on possible reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information, if the current law is changed to postpone claims by shareholders to those by conventional unsecured creditors (as discussed in Options 2 and 3 at Sections 7.4 and 7.5).

9.2 Introduce a fraud on the market approach

A possible way to facilitate proof of aggrieved investor claims may be a statutory amendment to introduce a 'fraud on the market' approach. This would assist shareholder litigation against companies by establishing a rebuttable presumption of reliance on misleading or deceptive information from the company. It would overcome the need to prove reliance (as explained in Section 3.2.3).

Fraud on the market is a concept that has developed in US jurisprudence. As applied in US case law to misleading statements or disclosures, it permits persons to claim damages without having to establish specific knowledge of and reliance on the misrepresentations.

The concept is based on the idea that publicly available information about a company is reflected in its market price, and so an investor's reliance on any material public representations may be presumed for the purpose of an action alleging fraudulent or deceitful practices.[162]

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[162] These actions are based on Rule 10b-5 of the Securities Exchange Act 1934, which reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

In other words, reliance (referred to in the American literature as 'transaction causation') is taken to have been established upon proof that the misrepresentations or omissions would induce a reasonable, relying investor to misjudge the value of the shares. The fraud on the market concept is not confined to criminally fraudulent behaviour, but applies to a much wider range of situations in which investors might be misled.

This concept was adopted by the US Supreme Court in *Basic Inc v Levinson* (1988).[163] In that case, the Court considered that a requirement for plaintiffs who have traded on an impersonal market to show a speculative state of facts (that is, how they would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made) would impose an unnecessarily unrealistic evidentiary burden.

Under US law, the threshold facts necessary for shareholders to prove their loss are:

- the defendant made public misrepresentations
- the misrepresentations were material
- the shares were traded on an efficient market
- the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares
- the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.

The presumption of reliance may be rebutted by showing that the link between the alleged misrepresentation and the price received (or paid) by the plaintiff, or the plaintiff's decision to trade at a fair market price, has been severed.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

163 485 U.S. 224 (1988).

The effect is that shareholders can rely on the presumption that all available material information is built into the share price and not have to prove that they personally were misled. This development in US law has facilitated shareholder class actions.[164]

The fraud on the market concept has, in effect, been adopted in Australia for a solvent company in at least one regulatory context.[165]

A statutory amendment to apply the concept in Australia might reinforce shareholder rights by increasing the possibility of their succeeding in an action, and recovering, against a solvent ongoing company.

However, in circumstances where a company has become insolvent, introduction of this concept would only assist claimant shareholders in those rare cases where the company was able to pay the claims of all creditors and had sufficient funds remaining to meet aggrieved investor claims.

9.3 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter concerning possible ways better to protect shareholders if the current law is changed to postpone aggrieved investor claims.

In particular, you may wish to comment on the possible ramifications of facilitating these claims by adopting a fraud on the market approach.

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164 See generally M Duffy, '"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.

165 The *Multiplex Limited enforceable undertaking* (under s 93AA of the ASIC Act) of December 2006 related to the company not informing the market for a number of weeks of particular price-sensitive information known to it, which, when subsequently released, led to a material drop in the market price of the company's securities. ASIC was concerned that this delay in reporting may have contravened the continuous disclosure requirements. The company, without admitting that any contravention had taken place, undertook to compensate all persons who had acquired the securities in that period, without the need for those persons to establish any form of reliance on the company's conduct.

10 Member claims

This chapter considers whether shareholders who have claims against a company in their capacity as members that are postponed by s 563A are nevertheless entitled, by virtue of those claims, to participate as creditors in a voluntary administration or liquidation and, if so, whether any changes are warranted.

10.1 The issue

It is clear from the decision in *Sons of Gwalia* that shareholders with claims against a company that relate to their shares, but that fall outside s 563A, are creditors having the same information, voting and recovery rights as other general unsecured creditors in a voluntary administration or liquidation.

There is, however, a further matter, not required to be considered in that case, concerning shareholders who have claims in their capacity as members of the company within the meaning of s 563A (member claims). While these claims rank behind other claims in the distribution of funds in a winding up, the issue is whether those claimants are nevertheless entitled to participate in a voluntary administration or liquidation as creditors, with information and voting rights.

In the light of observations in *Sons of Gwalia,* member claims include:

- a right to recover any paid-up capital under any operative buy-back or capital reduction scheme
- a right to avoid a liability to make a contribution to the company's capital
- a right to receive a declared but unpaid dividend.

These types of claim are relatively rare in an external administration. However, where they exist, the analysis in this chapter indicates that claimants can exercise voting rights, together with other creditors. This is particularly significant for a voluntary administration, where creditors play a central role in determining the future of the

company. The issue is less significant for liquidations, where creditors do not play an equivalent determinative role.

10.2 Member claims are creditor claims

The Corporations Act uses the term 'creditor' in the voluntary administration and liquidation provisions, but does not define it. However, it has been held that any person with a claim under s 553 is a creditor for the purpose of those provisions.[166]

Under s 553(1):

> all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the circumstances giving rise to which occurred before the relevant date, are admissible to proof against the company.

Two other provisions indicate that claims by shareholders in their capacity as members come within s 553(1), thereby making these shareholders creditors of the company.

s 553A

The language of s 553A is premised on the assumption that claims by shareholders in their capacity as members are debts owed to them by the company:

> 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 not admissible to proof against the company unless the person has paid to the company or the liquidator all amounts that the person is liable to pay as a member of the company.

s 563A

The language of s 563A (see Section 10.3.2) is also premised on shareholders with member claims having a debt owed to them by the company.

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166 *Brash Holdings Ltd v Katile Pty Ltd* (1994) 13 ACSR 504 at 514–515.

10.3 Legislative history

The current position stems from legislative amendments in 1992. Previously, shareholders with member claims were not treated as creditors.

10.3.1 Pre-1992

Before 1992, the legislation followed a pattern, traceable back to the UK *Companies Act 1862*, that excluded member claims from being creditor claims by denying their status as a corporate debt where general creditor claims remained unsatisfied.

Subsection 38(7) of that UK Act provided, in the context of a liquidation, that:

> No sum due to any member of a company, in his character of a member, by way of dividends, profits, or otherwise, shall be 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; but any such sum may be taken into account, for the purposes of the final adjustment of the rights of the contributories amongst themselves.

A similar provision was found in the pre-1981 State-based legislation,[167] in the 1981–1990 co-operative scheme uniform national law[168] and in the original provisions of the Corporations Law, which came into effect in 1991. As set out in the then s 525 of the Corporations Law:

> A sum due to a member in that capacity, whether by way of dividends, profits or otherwise, shall not be treated as a debt of the company payable to that member in a case of competition between the member and a creditor who is not a member, but may be taken into account for the purposes of the final adjustment of the rights of the contributories among themselves.

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167 For instance, *Companies Act 1961* (NSW) s 218(1)(g).

168 *Companies Act 1981* s 360(1)(k) and the equivalent provision in the State and Territory Codes.

The 1988 report of the Australian Law Reform Commission *General Insolvency Inquiry* (the Harmer Report), in the context of a discussion of priorities in an insolvency, recommended that:

> the claims of members which arise by reason of their membership of the company should not be admitted as a claim unless, after payment in full of all admitted claims, there remains a surplus.[169]

To achieve this, the Harmer Report proposed a provision that:

> A claim by a member of a company, in the capacity of member, by way of dividend, profits or otherwise shall not be admitted unless, after payment in full of all admitted claims and the costs, charges and expenses of the winding up, there remains a surplus.[170]

The Harmer recommendations would have continued the pre-1992 position under which members could not participate as creditors unless ordinary creditors had been paid in full.

10.3.2 Post-1992

The 1992 amendments introduced the voluntary administration provisions in Part 5.3A. Those provisions gave various powers to 'creditors', without defining that term. The Explanatory Memorandum outlined the role of creditors, but did not explain who was to be covered by that term.[171] The question whether member claims were intended to be treated as creditor claims was not directly addressed.

The 1992 amendments also replaced s 525 with the current s 563A, which states:

> 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.

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169 vol 1, para 750.

170 vol 2, cl P4.

171 Corporate Law Reform Bill 1992, Explanatory Memorandum, November 1992, paras 444 ff.

The Explanatory Memorandum stated that the new provision:

> provides that the payment of debts due to members in their capacity as members is postponed to the payment of debts to persons other than as members. Section 525 of the Corporations Law already has this effect.[172]

Section 563A maintained the pre-1992 position, under which member claims were postponed. However, it did not make clear that shareholders with member claims are not entitled to be treated as creditors in a liquidation while other outstanding corporate debts remain.

The High Court was not called upon to consider this matter in *Sons of Gwalia*. However, some observations in the judgments support the proposition that member claims coming within s 563A are included within the general category of creditor claims in a voluntary administration or a liquidation, albeit that those claims are postponed for the purpose of recovery of funds in a liquidation. For instance:

> These appeals raise an issue concerning the subordination of what are sometimes called 'shareholder claims' to claims of other creditors in the application of the insolvency provisions of the Corporations Act 2001 (Cth) ('the Act').[173]

> If the company comes under external administration before it has satisfied the shareholder's claim, and the company's affairs are to be administered as on a winding up, does the shareholder's claim rank with the claims of other creditors, or is it postponed?[174]

10.4 Canadian proposal

A proposed amendment to the Canadian *Companies' Creditors Arrangement Act* would prevent equity claimants from voting at creditors' meetings under that Act unless the court orders otherwise.[175]

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172 para 957.
173 Gleeson CJ at [1].
174 Hayne J at [135].
175 See footnote 116.

10.5 Legislative clarification

The apparent right of a person with a member claim under s 563A to participate as a creditor in an external administration, even though the claim is postponed as a member claim in a distribution, may be seen as anomalous. It gives shareholders voting power on issues affecting the rights of general unsecured creditors whose claims have a higher priority. It could result, for instance, in shareholders having an influence on whether a particular proposal affecting general unsecured creditors is adopted or on which of several alternative proposals for those creditors is adopted.

One solution would be to amend the legislation to make clear that shareholders with member claims are not creditors in relation to these claims in an external administration. This change could be made regardless of whether any change is made to the current law regarding aggrieved investor claims.

10.6 Request for submissions

The Advisory Committee invites you to forward submissions on any aspect of the matters raised in this chapter concerning whether the legislation should be amended to clarify the status of member claims under s 563A and if so in what manner.