



Australian Government

Corporations and Markets

Advisory Committee

SHAREHOLDER CLAIMS AGAINST INSOLVENT COMPANIES

Implications of the
Sons of Gwalia decision

Report

**December
2008**

Corporations and Markets **Advisory
Committee**

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insolvent companies
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22 December 2008

Senator the Hon Nick Sherry
Minister for Superannuation and Corporate Law
Parliament House
CANBERRA ACT 2600

Dear Minister

I am pleased to present a report by the Advisory Committee on *Shareholder claims against insolvent companies: implications of the Sons of Gwalia decision*.

Yours sincerely

A handwritten signature in black ink that reads 'Richard St. John'.

Richard St. John
Convenor

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1 Introduction

This chapter provides background, outlines the terms of reference and the review process, and summarises the proposals by the Advisory Committee to resolve the issues arising from the decision of the High Court in Sons of Gwalia.

1.1 Issue at stake

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 by aggrieved shareholders against a company in voluntary administration or liquidation.

Aggrieved shareholders for this purpose are persons who claim that 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 was a view in the commercial community that all claims by shareholders against a company that arose from their shareholding were claims in their capacity as members. In consequence, it was thought that claims of the type that subsequently arose in *Sons of Gwalia* 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 shareholder in that he was misled by the company into acquiring his shares in the company through misrepresentation or defective market disclosure, was not claiming in his capacity as a member, which would have postponed the claim behind unsecured creditor claims in the corporate insolvency. Rather, his claim, based on various investor protection provisions, was in the capacity of a victim of corporate misconduct, and ranked

¹ [2007] HCA 1, 231 CLR 160, 232 ALR 232, 60 ACSR 292, 25 ACLC 1.

equally with all other unsecured creditor claims in the insolvency. Also, by necessary implication, the plaintiff was entitled to participate as a creditor in the voluntary administration of the company.

While clarifying the effect of the relevant statutory provision on the external administration of a company, the decision opened up underlying policy considerations (as was recognised by the Court) concerning the respective rankings in a corporate insolvency of claims by shareholders for loss to the value of their shareholding arising from some corporate misconduct and claims by conventional unsecured creditors (such as debt finance providers and other contractual creditors). It brought into focus the largely unanticipated conflict between, on the one hand, the provision to shareholders of statutory remedies against companies for inadequate corporate disclosure or other corporate misconduct affecting them and, on the other hand, traditional notions of shareholder interests being postponed behind those of conventional unsecured creditors in a liquidation.

One response in the commercial community was that the High Court decision confirmed the rights of aggrieved shareholders under various statutory provisions for the protection of investors, while reinforcing the statutory obligations on listed companies to provide accurate and timely disclosure to the market, for the benefit of all interested parties, including creditors.

Another response was that the decision cut across customary notions about the distinction between equity and debt and the primacy of general creditors over shareholders in an insolvency. The recognition of claims by aggrieved shareholders as creditor claims will disadvantage unsecured lenders and trade and other creditors with whose claims they will compete, while adding complexity and delay in the conduct of external administrations. Also, solvent companies may find it more difficult to attract unsecured debt finance, while the possibility of attracting capital for successful corporate rehabilitations may be reduced by the presence of aggrieved shareholder claims.

The decision has raised the question whether, in principle, aggrieved shareholders 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 raised 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 resolution of these questions may have significant implications for companies in the corporate equity and debt capital markets, the role of investor protection laws in corporate regulation and the process of conducting external administrations.

1.2 The *Sons of Gwalia* litigation

1.2.1 The facts and issue

Sons of Gwalia Ltd was a gold mining company listed on the Australian Securities 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 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.⁴

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 Section 2.3.

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.

⁴ 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.

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,⁵ 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*.

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.

⁵ s 674.

1.2.2 The decision

The High Court, upholding decisions of the Federal Court at first instance and on appeal,⁶ held (by a majority of six to one) that the shareholder in this case was not claiming in his capacity as a member. He had the right to be admitted as a 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, if made out, 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.

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 as a member 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,⁷ 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.

⁶ *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.

⁷ Gleeson CJ at [31], Kirby J at [106].

In *Sons of Gwalia*, the sources of the plaintiff's claims were the rights and protections given to him under investor protection legislation, not the rights that he had as a member of the company.⁸

1.3 Terms of reference

Following the *Sons of Gwalia* decision, the then 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.

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

⁸ See, for instance, Gleeson CJ at [31], with whom Kirby J agreed (at [134]), Hayne J at [205]–[206].

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?

1.4 Types of claims

1.4.1 Aggrieved shareholder claims

The *Sons of Gwalia* litigation involved an action by a shareholder against a company in external administration. The shareholder had acquired shares on-market during a period when the company was alleged to have breached its continuous disclosure obligations by not disclosing market price-sensitive negative information.

The High Court decision has broader ramifications for claims against insolvent companies. There is nothing in the decision that would confine the principle of treating shareholders as creditors in an external administration to persons who had purchased shares, either on-market or from the company itself,⁹ during the period of the corporate breach. The right to be treated as a creditor in an external administration could equally apply to anyone who purchased, sold, or retained shares during a period where any form of relevant corporate misconduct took place.¹⁰

For instance, vendors of shares may seek to claim as creditors where they sold during the period that the company was alleged to have breached its continuous disclosure obligations by not disclosing market price-sensitive positive information (which would have increased the market price). In the same vein, continuing shareholders may argue that the corporate misconduct induced them to retain the shares, to their detriment.¹¹

The term ‘aggrieved shareholders’, as used in this report, includes all these classes of claimants against the company.

⁹ This would include a person who acquires shares in the company pursuant to a prospectus or an underwriting agreement on a share issue.

¹⁰ 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].

¹¹ 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 at Section 2.2.2: *Damages incurred*.

1.4.2 Claims not affected by *Sons of Gwalia*

Shareholder claims against solvent companies

The *Sons of Gwalia* litigation dealt with the ranking of aggrieved shareholder claims in an external administration. The High Court decision has no bearing on shareholder claims against a solvent company. No question of ranking or prioritisation of these claims arises, as a solvent company is in a position to meet claims against it in full.¹²

Shareholder suits against solvent companies are relatively common in the USA. There are some indications of an increase in such claims in Australia, including instances of shareholder class actions supported by litigation funding.

There has been some move in Canada to restrict these claims, by imposing a cap on some recovery rights of shareholders against solvent companies.¹³ The rationale is that when some shareholders recover against a solvent company the cost may be borne, directly or indirectly, by the remaining shareholders.¹⁴

¹² s 95A.

¹³ The Ontario Securities Act, Part XXIII.1, which commenced in December 2005 and has been adopted in various other Canadian provinces:

- applies to disclosure breaches by listed companies
- covers all shareholder transactions in the secondary market
- permits class actions by aggrieved shareholders with court approval
- does away with the reliance requirement (thereby reducing the evidential burden of establishing claims)
- caps claims against a company to the greater of 5% of its market capitalisation or Can\$1 million. Shareholders may also claim against involved individuals.

Further details are set out in Appendix 2.

¹⁴ Remaining shareholders may suffer loss to the market value of their shares, and reduced dividends, to the extent that the claims of aggrieved shareholders are met out of corporate funds. Remaining shareholders may also suffer indirect loss if the company suffers reputational loss or is subject to increased premiums for, or loss of availability of, liability insurance.

As observed in the Five Year Review Committee Final Report *Reviewing the Securities Act (Ontario)* (March 2003), at 132:

In a primary offering, an issuer receives funds from the offering that can be used to compensate investors who have bought securities from the issuer and who have been prejudiced by a misrepresentation in a prospectus. In secondary market trading, an issuer receives no proceeds and it is ultimately the shareholders of the company who will bear the costs of a damages award against the issuer where there has been a misrepresentation in a continuous disclosure document.

The Advisory Committee, while recognising the broader context of shareholder claims against solvent companies, deals in this report with shareholder claims against insolvent companies.

Various claims against insolvent companies

Priority creditors. The *Sons of Gwalia* decision does not affect the priority rights of secured creditors and priority unsecured creditors (such as employees) in a voluntary administration or liquidation.¹⁵

Judgment debts. Shareholders who have gone beyond making a claim and have obtained a judgment against a company, while it was solvent, but who have not yet been paid, have always been entitled to participate as ordinary unsecured creditors in any subsequent external administration of the company on the basis of their judgment debts.

Claims unrelated to shareholding. A claim against a company in external administration that is unrelated to any shareholding that the claimant may have, such as a claim in tort for personal injury caused by the company, a claim to recover money lent to the company, or a claim against the company by an employee, has always entitled the shareholder to participate as a creditor in the external administration, with the claim ranking equally with those of the company's other general unsecured creditors.

Member claims. As pointed out in *Sons of Gwalia*, claims by shareholders in their capacity as members coming within s 563A, such as for any unpaid dividend or capital repayment, can be paid in the liquidation of a company only after all claims by priority and conventional unsecured creditors have been paid in full.

¹⁵ 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)).

1.4.3 Claims by others who may be compared with aggrieved shareholders

Equity-linked claims

It is clear following *Sons of Gwalia* that claims by aggrieved shareholders are treated equally with those of other unsecured creditors. It was never in doubt, even before that decision, that claims by persons with other equity-linked interests, including optionholders and holders of equity-linked derivatives, ranked equally with other unsecured creditors and were not postponed.

However, any move to change the legal position of aggrieved shareholders would raise for consideration whether the rights of other equity-linked claims should also be changed in a similar manner.

Unitholders in managed investment schemes

Similarly, it was never in doubt, even before *Sons of Gwalia*, that unitholders in managed investment schemes would be treated as creditors in an action for breach against an insolvent responsible entity.

However, any move to change the legal position of aggrieved shareholders would raise for consideration whether the rights of unitholders should also be changed in a similar manner.

1.5 Investor protection

The *Sons of Gwalia* case arose in the context of legislative developments in recent years to give shareholders remedies against their company, as well as others, where they suffer loss through certain forms of corporate misconduct.

For instance, the continuous disclosure obligations apply to the disclosing entity (the company in question) 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 obligations¹⁸ and the market

¹⁶ ss 674, 675.

¹⁷ s 670A.

¹⁸ s 728.

misconduct provisions¹⁹ 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.

1.6 Review process

1.6.1 Discussion paper

The Advisory Committee published a discussion paper in September 2007 on *Shareholder claims against insolvent companies: implications of the Sons of Gwalia decision*. The discussion paper sought to provide information, draw out issues and stimulate discussion, as part of the process of public consultation.

The paper observed that, from one perspective, *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. Any move to subordinate shareholder claims might be seen as selectively weakening these investor protection laws and their influence on corporate compliance. Shareholders would have

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.

the full benefit of these laws when a company is solvent, but find their rights confined when a company is in external administration.

The paper observed that, from another perspective, participants in the corporate debt market, as well as trade and other unsecured creditors, may consider that their voting influence, and level of return in an external administration, are diluted by the possibility of claims by aggrieved shareholders. 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 shareholder claims where companies are in financial stress.

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

In addition to inviting submissions on the three matters in the terms of reference, the paper also raised two other matters that arose in the course of the Committee's review. They were whether the rule in *Houldsworth's* case, which restricts some subscriber shareholder claims against a company, should be abrogated by statute, and whether shareholders whose claims as members are postponed in a liquidation should still be treated as creditors, with voting and other rights in an external administration.

This report incorporates material information and analysis found in the discussion paper.

1.6.2 Submissions on the discussion paper

The Advisory Committee invited submissions on the matters covered in the terms of reference and in the discussion paper.

The Committee received submissions from:

- the Australian Securities and Investments Commission
- the Australian Bankers' Association
- the Australian Financial Markets Association

- Baker & McKenzie
- Christine Brown (University of Melbourne) and Kevin Davis (University of Melbourne)
- Chartered Secretaries Australia
- Duncan Brakell
- Evan Sylwestrzak
- Jason Harris (University of Technology Sydney) and Anil Hargovan (University of New South Wales)
- IMF (Australia) Ltd
- KordaMentha
- Corporations Committee of the Law Council of Australia
- Insolvency and Reconstruction Committee of the Law Council of Australia
- Marina Nehme (University of Western Sydney) and Claudia Koon Ghee Wee (Central Queensland University)
- QBE Insurance Group
- Insolvency Practitioners Association
- Arnold Bloch Leibler
- NSW Law Society Business Law Committee
- Michael Duffy (Monash University)
- Law Institute of Victoria.

Reference to these submissions is made where appropriate in the following chapters. The submissions are available on the CAMAC website and a collated version is published in conjunction with this report, under 'Reports' at www.camac.gov.au

The Advisory Committee was greatly assisted in its consideration of the issues by the information and views provided in these responses.

The Committee expresses its appreciation to respondents for their contributions.

1.7 Outline of report

Chapter 2 sets out the effects of the High Court decision, including its implications for the determination of shareholder claims and the conduct of external administrations, as well as some broader implications.

Chapter 3 discusses the first question in the terms of reference, namely whether shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency should participate in an insolvency proceeding as unsecured creditors for any debt that may arise out of that misleading conduct.

Four policy options are discussed:

- maintain the current legal position, which treats aggrieved shareholder claims as ordinary unsecured creditor claims
- postpone those claims behind conventional unsecured creditor claims
- maintain those claims as creditor claims but subject them to a monetary cap, or
- prohibit claims by aggrieved shareholders altogether.

The Committee as a whole is not persuaded of the need to change the current legal position. Its reasons are set out in Section 3.4.

Chapter 4 discusses the second question in the terms of reference, namely possible ways to facilitate the efficient conduct of external administration proceedings involving aggrieved shareholder claims if the current legal position is retained. The Committee recommends various ways to streamline the procedure for lodging, and establishing, claims by aggrieved shareholders, including a standardised proof of debt form, a single judicial determination of issues common to these claims and giving courts a general power to make orders in a liquidation.

Chapter 5 discusses the third question in the terms of reference, namely whether, if the current legal position is reversed and

aggrieved shareholder claims are postponed, there are any reforms to the statutory scheme that would better protect shareholders.

The Committee considers that any legislative move to introduce a ‘fraud on the market’ concept, in lieu of the requirement for claimants to establish reliance on a corporate misrepresentation, would have significant consequences for, and would need to be carefully considered in, the broader context of shareholder claims against solvent as well as insolvent companies.

Chapter 6 considers whether the rule in *Houldsworth’s* case, which restricts subscriber shareholder claims against a company in a limited number of circumstances, should be abrogated by statute. The Committee considers that the rationale for the rule has been considerably weakened since its formulation. The rule now applies only in very limited contexts and appears to serve little or no real purpose. Its abolition would ensure a uniform approach to the status of shareholder claims against companies.

Chapter 7 considers whether shareholders whose claims as members are postponed in a liquidation should nonetheless be treated as creditors, with voting and other rights in an external administration. The Committee recommends changes in the legislation to make clear that shareholders are not entitled to receive information, or exercise voting rights, in the capacity of creditors by reference to any members’ claims that they may have against the company.

1.8 The Advisory Committee

The Advisory Committee is constituted under the *Australian Securities and Investments Commission Act 2001*. Its functions include, on its own initiative or when requested by the Minister, 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
- Jeremy Cooper—Deputy Chairman of the Australian Securities and Investments Commission
- Ian Eddie—Professor of Accounting, School of Commerce and Management, Southern Cross University, Tweed Heads
- Alice McCleary—Company Director, Adelaide
- Marian Micalizzi—Chartered Accountant, Brisbane
- Geoffrey Nicoll—Co-Director, National Centre for Corporate Law and Policy Research, University of Canberra, Canberra
- Ian Ramsay—Professor of Law, University of Melbourne
- Robert Seidler—Partner, Blake Dawson, Sydney
- Greg Vickery AM—Chairman and Partner, Deacons, Brisbane
- Nerolie Withnall—Company Director, Brisbane.

A Legal Committee provides 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, Sydney
- David Proudman—Partner, Johnson Winter & Slattery, Adelaide
- Simon Stretton—South Australian Crown Solicitor, Adelaide
- Gabrielle Upton—Legal Counsel, Australian Institute of Company Directors, Sydney
- Rachel Webber—Special Counsel, Jackson McDonald, Perth.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

2 Effects of the High Court decision

This chapter considers the effect of the Sons of Gwalia decision in the context of s 563A of the Corporations Act, the circumstances in which aggrieved shareholder claims could arise in an external administration and some of the procedural and evidential issues involved in establishing claims, the implications of these claims for the conduct of voluntary administrations, implementing a deed of company arrangement and winding up a company, and longer-term implications of the decision, including for corporate financing, trade creditors and financial markets.

2.1 Section 563A of the Corporations Act

The plaintiff shareholder in *Sons of Gwalia* submitted his claim after the company had gone into external administration. The principles in that case would equally apply where a shareholder claim against a solvent company had not been resolved before the company went into external administration.

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.

At issue were:

- which shareholder claims in an external administration come within, and which fall outside, s 563A
- the consequences for shareholder claims that are not postponed by s 563A.

Some aspects of the decision are also relevant to shareholder claims that do fall within s 563A.

2.1.1 The boundaries of s 563A

Prior to *Sons of Gwalia*, 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 claims by aggrieved shareholders 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, drawing on traditional notions, 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 dividend, capital repayment or other rights²⁵ 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)*:

²² Gleeson CJ at [19], Kirby J at [118], Hayne J at [200].

²³ Hayne J at [202].

²⁴ Hayne J at [203].

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 in *Re Addlestone Linoleum* 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].

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 shareholder and other claims

Aggrieved shareholder claims. The High Court held that claims by shareholders against a company under 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 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

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

²⁸ Hayne J at [205].

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 deciding that these shareholder claims were not caught by s 563A was that they were based on statutory investor 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 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 shareholder 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

²⁹ Gleeson CJ at [18].

³⁰ Hayne J at [206].

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 member³²
- 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
- a claim for damages by an employee against a company for breach of the company’s obligation under his employment contract to find a purchaser for company shares issued to 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

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.

³⁴ Gleeson CJ at [29] and Hayne J at [199], referring to *In re Harlou Pty Ltd* [1950] VLR 449 at 454, 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.

2.1.2 Consequences for shareholder claims outside s 563A

Aggrieved shareholder claims

As made clear in the High Court decision, claims by shareholders against a company pursuant to relevant investor protection provisions:

- entitle the shareholders to participate as creditors in the voluntary administration or liquidation of the company, with 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 that competing policy considerations underlie the balance between recognition of investor protection rights afforded to 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 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.

However, as a matter of statutory interpretation, the Court found that the claims by aggrieved shareholders did not fall within s 563A and therefore were not postponed.

Other claims

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

³⁶ Gleeson CJ at [18].

2.1.3 Consequences for shareholder claims within s 563A

An analysis of the relevant legislative history 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, an amendment in 1992, which introduced the current s 553 (which deals with claims that are admissible to proof in a winding up) at the same time as 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.

2.2 Scope for shareholder claims

2.2.1 Likelihood of claims

Shareholders can lodge claims against an insolvent company in any situation where they consider that they have suffered damage related to their shareholding through alleged corporate misconduct and that a remedy is open to them. That misconduct could include the types of disclosure breaches considered in *Sons of Gwalia*.

While lodging a claim in a voluntary administration or liquidation may be relatively easy, pressing that claim can be time-consuming and costly if the claim is resisted by the external administrator. Shareholders would face the task of establishing the elements of the claim, with the possibility of adverse cost orders if unable to do so.³⁷ Litigation funders, in considering whether to support a claim by shareholders, presumably would have regard to the merits of the case as well as the question of costs and possible adverse cost orders.

³⁷ The traditional 'costs follow the event' rule in civil litigation is that court-awarded costs of the successful party are borne by the unsuccessful party.

2.2.2 Elements of claims

Shareholders will not have a basis for a claim against a company simply because the value of their shares has declined. The *Sons of Gwalia* litigation was conducted on the assumption that the claimant could eventually make out a claim, based on corporate misconduct. The Federal Court and the High Court were not required to rule on the claim itself.

An aggrieved shareholder who is required to prove a claim must establish:

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

Corporate misconduct

An aggrieved shareholder seeking to prove a claim must establish some breach by the company of relevant investor protection or other law under which the shareholder is entitled to claim damages.³⁸

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.³⁹ 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 shareholder claim would fail if the chain of causation is broken, either by events subsequent to the misrepresentation or through the conduct of the shareholder. In *Johnston v McGrath*,⁴⁰ the

³⁸ See Section 2.1.2.

³⁹ In *Henville v Walker* (2001) 206 CLR 459, the High Court confirmed that an action under the *Trade Practices Act 1974* would fail if the plaintiff's actions destroyed the causal connection between the contravention and the loss or damage.

⁴⁰ [2005] NSWSC 1183, 24 ACLC 140.

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.⁴¹

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.

The reliance requirement may reduce the number of successful aggrieved shareholder claims against companies. Moreover, the fact that one shareholder can prove reliance does not in itself ensure that other shareholders can do so.⁴²

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'.⁴³

⁴¹ 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.

⁴² 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. This 'fraud on the market' 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.

⁴³ *Digi-Tech (Australia) Ltd v Brand* [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.

While a plaintiff may in some cases be able to establish reliance by way of inference,⁴⁴ proving it in other instances may not be easy. In *Johnston v McGrath*,⁴⁵ 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, the shareholder had failed to establish that he had relied upon the company's misconduct in his relevant share transactions. Rather, his share trading was based on factors unrelated to that corporate conduct.⁴⁶

Another person's reliance. A plaintiff can establish reliance by proving reliance by an agent when acting on the plaintiff's behalf.⁴⁷

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. In the *Janssen* case,⁴⁸ 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.⁴⁹

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

⁴⁴ 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.

⁴⁵ [2005] NSWSC 1183, 24 ACLC 140.

⁴⁶ id at [28]–[32].

⁴⁷ *Port Stephens Shire Council v Booth* [2005] NSWCA 323.

⁴⁸ *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 109 ALR 638.

⁴⁹ at 642.

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.

Damages incurred

A shareholder 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.

However, a shareholder 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 had been incorporated into the share price. 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.

2.3 Implications for external administration

2.3.1 Overview

The *Sons of Gwalia* decision places a shareholder with a claim under investor protection provisions on the same footing as a conventional

unsecured creditor in a voluntary administration or a liquidation.⁵⁰ 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.⁵¹

A distinction should be drawn between:

- the conduct of 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
- the implementation of a DOCA or the conduct of a winding up (whether or not resulting from a voluntary administration).

Claims by aggrieved shareholders in a voluntary administration raise particular issues in relation to the content and dissemination of information to be provided to creditors, and voting at creditors' meetings.

In the implementation of a DOCA or the conduct of a liquidation, claims by aggrieved shareholders raise issues for the assessment of these claims and the determination of the amount that other unsecured creditors are ultimately to receive.

Many of the difficulties that administrators and liquidators may encounter in dealing with aggrieved shareholder claims may also arise with claims by conventional unsecured creditors. Claims by aggrieved shareholders will add to their tasks.

⁵⁰ 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.

⁵¹ 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)).

2.3.2 Conduct of a voluntary administration

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.⁵²

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 shareholder 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 information.⁵³ However, the problem of incomplete information can also arise where no shareholder claims are involved.

Voting at the creditors’ meetings

Following *Sons of Gwalia*, there is the prospect that more shareholders will lodge a proof of debt⁵⁴ (possibly with the assistance of litigation funders⁵⁵) where they consider that the company has engaged in some impropriety that affected the value of their shares. A person lodging a proof of debt 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.⁵⁶ An administrator may

⁵² s 439A(3), (4)(b).

⁵³ Mark Korda of KordaMentha, ‘Gwalia ruling creates need for new legal category of aggrieved shareholder’, *Age*, 2 February 2007.

⁵⁴ 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 definition of ‘relevant date’ in s 9 and Part 5.6 Div 1A.

⁵⁵ Corps 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.

⁵⁶ Corp Reg 5.6.23(2).

choose to admit these shareholders to vote at the creditors' meeting for the full amount of the claim or for a nominal amount.⁵⁷

Possible undue increase in influence of shareholders

Creditors have the choice whether the company should end the administration and resume trading, enter into a DOCA or be wound up.⁵⁸ 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).⁵⁹ In some instances, aggrieved shareholders could have, by weight of numbers rather than the value of their claims, a decisive influence over the outcome of administrations (even if they cannot in the end substantiate their claims).

The possible effect of increased shareholder influence is speculative and may differ between companies. In some instances, shareholders might be more concerned to cut their losses by liquidating the company, rather than support a reconstruction plan aimed at the company continuing in business.

In other cases, 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 to shareholders

Situations could occur where aggrieved shareholders with 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.

⁵⁷ 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.

⁵⁸ s 439C.

⁵⁹ 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)).

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’.⁶⁰ This covers ‘debts or claims the circumstances giving rise to which occurred before the relevant date’.⁶¹ A DOCA could therefore seek to limit the return to aggrieved shareholders to a proportion of any judgment debt that they may eventually obtain against the company. However, an aggrieved shareholder could apply to the court to declare the deed void as being oppressive or unfairly prejudicial, or unfairly discriminatory, if aggrieved shareholders were treated in a detrimental manner compared with other creditors to be bound by the deed.⁶²

2.3.3 Implementation of a DOCA and conduct of a liquidation

An administrator in implementing a DOCA, and a liquidator in conducting a winding up, face a challenge in responding to the claims of aggrieved shareholders, and measuring 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 shareholder 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, including whether the shareholder relied on the corporate misconduct in making a decision about the shares

⁶⁰ s 444D. The Advisory Committee report *Corporate Voluntary Administration* (1998) para 1.14 sets out in detail all the parties bound by the deed.

⁶¹ *Lam Soon Australia Pty Ltd v Molit (No 55) Pty Ltd* (1996) 22 ACSR 169. The meaning of ‘relevant date’ is determined by the definition of ‘relevant date’ in s 9 and Part 5.6 Div 1A.

⁶² 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.

- 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 made⁶³
- running court cases to establish whether corporate misconduct has taken place
- *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 company⁶⁴
 - 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.⁶⁵

Deed administrators or liquidators may choose to negotiate a settlement with aggrieved shareholders, as they may do with other creditors, given that there may well be a considerable delay in

⁶³ A liquidator and a deed administrator of a company are eligible applicants (definition of ‘eligible applicant’ in s 9) for a court order summoning an officer of the company for examination about the examinable affairs (including business affairs) of the company (s 596A).

⁶⁴ 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 definition of ‘relevant date’ in s 9 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.

⁶⁵ Under Corps 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.

obtaining a judicial determination of their claims or that the company may have insufficient funds to contest these claims in court.

2.4 Broader implications

2.4.1 Corporate finance

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 shareholder claims are treated on a par with other unsecured creditor claims. These possible ramifications include:

Reduced availability or increased cost of finance

- Australian companies may find it more difficult, or more expensive, to raise unsecured debt capital in overseas corporate bond markets. Lenders may impose more onerous terms or charge higher interest. 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. In the US market, debt investors are accustomed to all shareholder claims being postponed behind their claims, as is the case under their domestic law⁶⁶

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.⁶⁷ Financiers may be less inclined to offer 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

⁶⁶ The relevant US law is discussed in Appendix 1.

⁶⁷ 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.

- *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-holding subsidiaries of the borrower, in an attempt to ensure that aggrieved shareholder claims are structurally subordinated⁶⁸
- *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 any claims by shareholders of the holding company against that company pursuant to the investor protection provisions are structurally subordinated to the claims of direct lenders to subsidiaries. This could be supported by cross-guarantees by other subsidiaries within the group.⁶⁹

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 increased.

It has been suggested that Australian companies typically have a higher ratio of secured to unsecured debt than comparable US

⁶⁸ 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.

⁶⁹ 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.

companies, which needs to be taken into account in assessing the impact of the *Sons of Gwalia* decision on corporate financing.

2.4.2 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 shareholder 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 shareholder 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 shareholder claims.

2.4.3 Financial markets

Corporate bond markets

As already indicated (Section 2.4.1), Australian companies may find it more difficult, or more expensive, to raise unsecured debt capital in corporate bond markets, especially in the USA.

Distressed debt markets

Distressed debt 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.⁷⁰ This type of market plays a part in an efficiently functioning financial system.

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

⁷⁰ 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.

Disclosure benefit for financial markets

There may be a transparency benefit for financial markets to the extent that the *Sons of Gwalia* decision underlines the obligations of disclosing entities, particularly when they are in financial difficulties, to keep the market fully informed, through continuous disclosure and other notifications. 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.

3 Maintain or change the law

This chapter considers whether to maintain the current position in a corporate insolvency whereby claims by aggrieved shareholders are treated on a par with claims by conventional unsecured creditors, to postpone all or some of those claims behind claims by conventional unsecured creditors, to maintain but cap those claims or to prohibit aggrieved shareholder claims against an insolvent company. The Committee as a whole is not persuaded of the need to change the current position.

3.1 Question for consideration

The first question in the terms of reference is:

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?

3.2 Conflicting principles and perspectives

The High Court held in *Sons of Gwalia* that aggrieved shareholders may participate in insolvency proceedings as ordinary unsecured creditors.

The decision has significant implications for both the corporate equity and debt markets. It has brought into focus the largely unforeseen conflict between the recent provision to shareholders of statutory investor protection remedies and traditional notions of shareholder interests being postponed behind those of conventional unsecured creditors in a liquidation.

This conflict is reflected in the submissions, which tend to be polarised between those who support the current position as in *Sons of Gwalia*, and those who favour reversing the effect of that decision so that claims by aggrieved shareholders rank behind unsecured

creditor claims, and on a par with all other member claims, in a liquidation.⁷¹

3.2.1 General considerations

The discussion paper identified a range of matters relevant to the question whether to maintain or change the current position. They included:

- whether equity investors do, or should, take on the risk of being misled by the company
- the weight to be given to the fact that shareholders, unlike general unsecured creditors, have the potential for dividends and capital gains on their investment
- the level of control that shareholders do, or could, exert over a company
- the degree to which shareholders of listed companies rely on public disclosures by those companies
- whether shareholders have greater opportunity to assess a company's performance than conventional unsecured creditors
- whether, or the extent to which, the current position will encourage speculative claims by aggrieved shareholders.

Respondents supporting the current position stressed the difficulty of justifying giving aggrieved shareholders protective rights against a solvent company, but then, in effect, diminishing the benefits of those rights, often to nothing, if the company goes into liquidation. They argued that subordination of the claims of aggrieved shareholders in an insolvency would undermine statutory investor protection provisions and detract from their effectiveness. They also made the point that the investor protection regime, particularly in

⁷¹ This conflict of views is also found in published commentaries. Contrast, for instance, M Duffy 'After Sons of Gwalia—Some perspectives on the position of shareholders and creditors and the question of law reform' (2008) 22 *Australian Journal of Corporate Law* 161, who supports retaining the current legal position, and A Bilski & P Brown, 'Sons of Gwalia versus shareholder subordination: Fairness versus efficiency' (2008) 26 *Company and Securities Law Journal* 93, who support changing the current legal position.

relation to better corporate disclosure, benefits the market generally, not just shareholders.

Respondents seeking a change in the current position argued that shareholders may have other means to protect their interests, including through the exercise of rights and powers to call company meetings and pass resolutions. Also, the current law may increase the cost of credit for solvent companies, to the detriment of all shareholders, impose undue burdens on the external administration process and make it more difficult to negotiate a solvent financial restructuring. Unsecured debt investors may be unwilling to advance funds or may impose more onerous terms through concern that their chances of recovery in the event of an insolvency could be reduced by actions of the company that result in aggrieved shareholder claims. The presence of aggrieved shareholder claims may discourage a potential investor from providing funds to restore a financially stressed company to financial health, or change the terms on which the investor is willing to do so.

3.2.2 Likely trends in aggrieved shareholder claims

Chapter 2 looked at the circumstances in which claims by aggrieved shareholders could arise in an external administration. In practice, shareholders may be most likely to claim where a company that is a disclosing entity,⁷² and therefore subject to the continuous disclosure requirements,⁷³ has failed to keep investors informed of material price-sensitive information known to it. Shareholders may have a further financial incentive to commence, or persist with, claims where the company has significant assets available for distribution to unsecured creditors.

Chapter 2 also analysed some of the legal hurdles shareholders would face in establishing their claims. Shareholders will not have grounds for making claims as aggrieved shareholders 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,

⁷² 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.

⁷³ Corporations Act Chapter 6CA.

namely that there had been inadequate disclosure. The Federal Court and the High Court were not required to rule on the claim itself.

An aggrieved shareholder 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. The decision on which approach to adopt may be influenced by their assessment of the likelihood of the claim succeeding in court.

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

- *relevant corporate misconduct.* A shareholder must establish some breach by the company of relevant investor protection or other law under which the shareholder is entitled to claim damages
- *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 claimant⁷⁴
- *reliance.* The predominant view is that a plaintiff shareholder must prove that the plaintiff, or in some circumstances another relevant person, relied on the misrepresentation complained of.⁷⁵ Moreover, the fact that one shareholder can prove reliance does not in itself ensure that other shareholders can do so.⁷⁶ The reliance requirement may be expected to reduce, perhaps considerably, the number of successful aggrieved shareholder claims against companies

⁷⁴ 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.

⁷⁵ See, for instance, *Ingot Capital Investment v Macquarie Equity Capital Markets [No 7]* [2008] NSWSC 199 at [32]–[38], where the applicant failed to prove reliance. However, IMF in its submission stated that it is debatable whether aggrieved shareholders need to prove reliance on misleading statements or omissions by the company. The question of reliance was raised in a shareholder class action against Aristocrat Leisure Ltd, but the litigation was settled without the need for a judicial determination: *Dorajay Pty Ltd v Aristocrat Leisure Limited* [2008] FCA 1311.

⁷⁶ The need to prove reliance by each claimant can complicate the conduct of shareholder class actions.

- *damages incurred.* A plaintiff shareholder must establish relevant damages arising from the corporate misconduct. This can raise problems of quantifying loss, for instance, where the market price of the shares at the time of the transaction, and subsequently, may have been influenced by a range of factors, not only the corporate misconduct. These problems of quantification can be exacerbated where a claimant shareholder is asserting that the corporate misrepresentation induced the person to retain, rather than sell, shares.

Submissions referred to a range of factors that may create incentives and opportunities for aggrieved shareholders to commence civil actions against companies for misconduct.⁷⁷ One view was that claims by aggrieved shareholders are likely to arise with every major listed corporate collapse, particularly where there is some evidence that the company breached the continuous disclosure or other disclosure requirements prior to the liquidation. It was argued that, even in the case of a company that has limited assets for unsecured creditors, aggrieved shareholders who have made a significant equity investment may have an incentive to litigate. Also, the lodgement of a claim with an external administrator costs very little, while economies of scale can be achieved through class action claims, some of which may receive private litigation funding.

3.2.3 Implications for the conduct of external administrations

Chapter 2 identified possible effects of the *Sons of Gwalia* decision on the conduct of voluntary administrations and liquidations. The decision has implications for:

- informing creditors in a VA
- voting at creditors' meetings in a VA
- implementing a deed of company arrangement (DOCA) and conducting a liquidation.

Many of the difficulties that administrators and liquidators may encounter in dealing with aggrieved shareholder claims may also

⁷⁷ Chapter 3 of the *Collated submissions*.

arise with claims by conventional unsecured creditors. Claims by aggrieved shareholders may simply add to their tasks.

Information to creditors in a VA

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.⁷⁸

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 claims by aggrieved shareholders, to provide in that statement sufficient details of potential shareholder actions within the stipulated time period.

Voting at the creditors’ meetings

Aggrieved shareholders do 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. An administrator may choose to admit these shareholders to vote at the creditors’ meeting for the full amount of the claim, or for a nominal amount.

Creditors have the choice whether the company should end the administration and resume trading, enter into a DOCA or be wound up. 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). In some instances, aggrieved shareholders, at least by weight of numbers, could have a decisive influence over the outcome of administrations (even if they cannot in the end substantiate their claims).

Implementing a DOCA and conducting a liquidation

Administrators implementing a DOCA that involves a distribution to creditors, and liquidators conducting a winding up, need to take into

⁷⁸ s 439A(3)(a), (4)(b).

account the claims of aggrieved shareholders, and measure their loss or damage as creditors.

A deed administrator or liquidator must assess, and can reject, aggrieved shareholder claims. This process may involve:

- determining whether a shareholder can establish each of the elements necessary to prove a claim, 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
- litigating to establish whether corporate misconduct has taken place.

Deed administrators or liquidators may choose to negotiate a settlement with aggrieved shareholders, 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.

Some respondents argued that the presence of shareholder claims would make an external administration process slower, more costly and more complex, while also making it more difficult to negotiate a solvent financial restructuring of a company.⁷⁹

Concerns raised by respondents included anticipated increased costs and delays in adjudicating aggrieved shareholder claims, which may be numerous and complex and require individual assessment, thus reducing the returns to creditors generally. Respondents also referred to the problems for creditors in having to make decisions in a voluntary administration, as it may not be possible for administrators to provide them with sufficient information about the possible

⁷⁹ Chapter 4 of the *Collated submissions*.

impact of aggrieved shareholder claims before the major meeting. Similar concerns were raised by commentators.⁸⁰

3.2.4 Broader implications

Chapter 2 referred to a range of possible broader, though uncertain, ramifications of the *Sons of Gwalia* decision, including that Australian companies may find it more difficult or expensive to raise unsecured debt capital in domestic or overseas finance markets, it may result in more complex loan agreements, and it may affect the willingness of trade creditors to extend credit to companies, or change the terms on which they will do so (for instance, increased cost of credit or greater use by creditors of retention of title clauses).

The discussion noted that the pricing mechanism in the international distressed debt markets would take into account the potential for claims by aggrieved shareholders against Australian companies following *Sons of Gwalia*.

It was also observed that there may be some transparency benefit for financial markets to the extent that disclosing entities are under pressure, particularly when they are in financial difficulties, to keep the market fully informed, through continuous disclosure and other notifications. Financial markets are more efficient and less volatile to the extent that companies provide timely and accurate disclosures about their financial position and prospects.

Submissions differed on the possible broader implications.⁸¹ One view was that there is no evidence that *Sons of Gwalia*, or the equivalent legal position in the United Kingdom, has detrimentally affected the cost and availability of finance for affected companies. A contrary view was that banks are already reviewing their requirements and risk assessment processes for lending to public companies and there are indications that the decision has adversely affected the ability of some Australian companies, particularly those of lesser credit quality, to tap the US debt markets. Also, it is not yet possible to assess the full longer-term impact of the decision on

⁸⁰ A Bilski & P Brown, 'Sons of Gwalia versus shareholder subordination: Fairness versus efficiency' (2008) 26 *Company and Securities Law Journal* 93 argue that, while there may be good arguments in principle for maintaining the current law, these are outweighed by the problems that the decision causes for the external administration process.

⁸¹ Chapter 5 of the *Collated submissions*.

corporate financing, as some investors may have delayed reacting in anticipation of a change to the law.

Related concerns raised by respondents included the possibility, over the longer term, of increased cost or reduced availability of finance in the debt market as lenders build in the possibility of lower returns if the current legal position remains unchanged, or that lenders will increasingly require cross-guarantees or other security, conduct greater due diligence or impose greater reporting requirements on borrower companies.

3.2.5 Overseas experience

Appendix 1 summarises the legal position of aggrieved shareholder claims in the United Kingdom, the USA and Canada. The UK position is consistent with the *Sons of Gwalia* approach, while the North American jurisdictions subordinate all claims by shareholders relating to their shares to those of conventional unsecured creditors.

It was argued by some respondents that there is no indication that the law in the United Kingdom, which is similar to *Sons of Gwalia*, has reduced the availability or increased the cost of debt finance in that jurisdiction. Another view was that experience in overseas jurisdictions should be treated with caution, as Australian markets differ in various respects, including their scale, from those in the United Kingdom or the USA. It was also argued that class action litigation and litigation funding are not prevalent in the United Kingdom, and it may be misleading to draw on the conduct of insolvencies in that jurisdiction in attempting to assess longer-term developments in Australia.⁸²

3.3 Policy options

Within the context of the above issues and conflicting principles and perspectives, the Advisory Committee has considered four policy options for aggrieved shareholder claims against an insolvent company:

- maintain the current position whereby claims by aggrieved shareholders rank equally with other unsecured creditor claims

⁸² Chapter 6 of the *Collated submissions*.

- postpone all, or some, of those claims behind conventional unsecured creditor claims
- maintain those claims as creditor claims but subject them to a monetary cap
- prohibit such claims altogether.

In considering these options, the Committee has closely considered the information and views put forward in the submissions.⁸³

3.3.1 Maintain the current position

Under this option, aggrieved shareholders will continue to be entitled to participate as creditors in a voluntary administration or liquidation and their claims will rank equally with those of other general unsecured creditors where the liquidation provisions apply. This is the position in the United Kingdom.

Arguments for this option include:

Limited impact of the decision

- while aggrieved shareholder 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 rely on the company for accurate information affecting the value of the investment

Argument based on acceptance of risks invalid

- the risk that equity investors take is that the venture in which they are investing will not succeed (including because the managers were incompetent). However, shareholders (and creditors) do not take on the risk that a company may have concealed information or provided false or misleading information affecting the investment decision

Investor protection and market confidence

- the High Court decision is consistent with the direction of investor protection law, including its extension to the financial services sector

⁸³ Chapter 7 of the *Collated submissions*.

- since the need for shareholder protection may be most marked in the event of insolvency, such protection may be illusory if relevant claims are subordinated to the claims of ordinary creditors⁸⁴
- 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 resort to relevant statutory remedies, their rights are postponed behind those of conventional unsecured creditors⁸⁵
- 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 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. Promoting investor confidence in the equity market may generate greater liquidity in that market and offset, in whole or part, increased costs for companies in the smaller debt market⁸⁶

Promote market neutrality

- both the debt and equity markets rely on the investor 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, have limited practical ability to direct the company and in reality may have

⁸⁴ Gleeson CJ in *Sons of Gwalia* at [18].

⁸⁵ Kirby J in *Sons of Gwalia* at [106].

⁸⁶ A Hargovan and J Harris, 'Shareholders as creditors: A response to the CAMAC discussion paper on law reform' (2008) 22 *Australian Journal of Corporate Law* 135 at 144–145 provide data indicating that considerably more funds are raised by companies on the equity market than on the debt market, suggesting the need 'to maintain and nurture strong confidence in our equity markets'.

no greater power than creditors. They therefore need a comparable level of protection in an insolvency

Corporate culture

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

Private enforcement

- aggrieved shareholder claims can act as a form of private enforcement and help promote the integrity of corporate conduct, in particular the reliability of public disclosures, to the benefit of lenders and the market generally, not just shareholders

Implications for debt markets

- lenders in the debt finance market can protect their interests in various ways, such as by adjusting the terms on which they provide finance to companies
- in the United Kingdom, the House of Lords decision in *Soden* a decade ago (see Section A1.2 of Appendix 1), which is similar in effect to that of the High Court in *Sons of Gwalia*, does not appear to have affected the market for corporate debt
- there is some indication in US investor restitution legislation of a move away from blanket subordination of aggrieved shareholder claims⁸⁷

Fairness and workability in an external administration

- aggrieved shareholders 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)

⁸⁷ See A Hargovan and J Harris, 'The Intersection Between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective' in J Sarra (Ed) *Annual Review of Insolvency Law 2007*, Thomson Carswell, Canada, 2008, 699 at 700–701, 728–729.

- although aggrieved shareholder claims may add a layer of complexity to external administrations, administrators already have to deal with complex situations, including determining certain claims by conventional unsecured creditors (for instance, product liability claims)
- making external administrations simpler, quicker or more expedient does not justify postponing a category of shareholder creditors. Any procedural difficulties may be ameliorated by appropriate administrative reforms.

Arguments for changing the law in some way are set out below (Sections 3.3.2–3.3.4).

3.3.2 Postpone the claims

Under this option some or all aggrieved shareholders would lose their entitlement to participate as creditors in a voluntary administration or liquidation, with their claims ranking behind conventional unsecured creditor claims, and either before,⁸⁸ or equally with, member claims under s 563A.

This option raises two key issues for consideration:

- the rationale for postponement
- if some form of postponement is justified, what equity-linked claims should be postponed.

Rationale for postponement

Arguments in support of the principle of postponement 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 that they have put into the company (and, in the case of partly

⁸⁸ On one view, this ‘middle ranking’ 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.

paid shares, being called on to contribute any unpaid capital), they have an unlimited upside, in the form of potential dividends and capital gains

- by contrast, creditors can only recover from a company their principal and any interest provided for in the contract
- shareholders' statutory rights and powers, their 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 ranking, on the failure of the company, with ordinary unsecured creditors⁸⁹
- 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 (managerial risk)

Risk management

- 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 and other creditors
- whereas financiers can often adopt various means to protect themselves, some trade creditors may not have the same risk management options

⁸⁹ Callinan J in *Sons of Gwalia* at [242].

- 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 risks⁹⁰

Restoring distressed companies

- the presence of aggrieved shareholder claims, unless they are postponed, may reduce the chances of attracting new equity or loan capital for a company in financial stress

Reduced position of conventional unsecured creditors

- aggrieved shareholder claims could dominate the voting at creditors' meetings and considerably reduce the return to conventional unsecured creditors, thereby reducing the incentive to provide unsecured debt or alter the terms on which it is offered
- it is possible that the courts will extend recoverable damages to include damages for loss of opportunity. This would have the effect of increasing the quantum of aggrieved shareholder claims and reducing the funds available to conventional unsecured creditors in an insolvency

Administrative burden in external administrations

- depending on how courts deal with the reliance issue, 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 non-shareholder unsecured creditors
- by contrast, postponement would reduce the level of complexity and cost in the administration of some voluntary administrations and liquidations. Also, liquidators could complete the winding up process without having to take these claims into account, unless a surplus remained after general unsecured creditors had been paid in full
- an expedited liquidation process may also assist those conventional unsecured creditors who need some early return from the liquidation in order to stay in business

⁹⁰ Kirby J in *Sons of Gwalia* at [109].

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 America

- adoption of this option would make Australian law consistent with the position in the USA and Canada where claims by aggrieved shareholders are postponed in a liquidation
- by contrast, maintaining a different approach between the law applicable in Australia and that in the US and Canadian markets may have detrimental consequences for companies seeking unsecured funding from those markets

Argument relating to class actions

- care needs to be taken in comparing the United Kingdom⁹¹ with Australia, given the development in Australia of funded litigation and class actions which, more in line with practice in the USA, may encourage shareholder actions and therefore reduce the possible return to other unsecured creditors.

Arguments against postponement are set out above in Section 3.3.1.

What equity claims to postpone

Transactions in shares

The *Sons of Gwalia* case involved a claim by a purchaser of shares who held no other shares in the company at the time of purchase. Other cases could involve claims by an existing shareholder who acquired further shares at the time of the relevant corporate

⁹¹ 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 United Kingdom are also increasingly being financed by hedge funds, pension funds and others seeking to profit from the compensation involved.

misconduct, or who retained shares during that period, or claims by someone who sold shares. There is nothing in the High Court decision to contradict the proposition that, under the current law, persons who sell shares or retain shares during the period of a corporate breach can also claim as ordinary creditors.⁹²

One approach would be to postpone all those claims, given that each of them involves the plaintiff pleading a shareholding (whether acquired, held or sold) to make out the claim.

Another approach, put forward by one respondent, would be to exempt from postponement the claims by purchasers of shares who had no existing shareholding in the company at the time of the relevant purchase (as in *Sons of Gwalia*). This exemption for new investors 'is based upon the rights, powers and advantages that existing shareholders have over new equity investors'.⁹³

Transactions in other equity-linked interests

It has never been in doubt, even before *Sons of Gwalia*, that equity-linked claims against a company other than through registered shareholdings, such as through share options, or equity-related derivatives, were unsecured creditor claims and were not postponed as member claims.

Some respondents have suggested that any move towards postponement should apply to this broader category of equity-linked claims. Postponing only shareholder claims would result in differential treatment between them and claims by holders of other equity interests. This may create an incentive for persons to avoid becoming registered as members, for the purpose of seeking to ensure that any claim arising out of their equity-linked interest is not postponed.⁹⁴

⁹² Refer footnote 10.

⁹³ A Hargovan and J Harris, 'Shareholders as creditors: A response to the CAMAC discussion paper on law reform' (2008) 22 *Australian Journal of Corporate Law* 135 at 147 ff. See also Submission by A Hargovan and J Harris.

⁹⁴ The Canadian legislation postpones 'equity interests', which extend beyond shares to 'a warrant or option or another right to acquire a share in the corporation—other than one that is derived from a convertible debt'.

The relevant postponement legislation in the USA and Canada extends beyond claims by registered shareholders to encompass claims based on a broader range of equity-linked interests.⁹⁵

A contrary view is that registered shareholders have various rights associated with their membership of the company, including voting rights and rights to bring derivative actions on behalf of the company.⁹⁶ Persons with other equity-linked investments do not have equivalent rights, and therefore should not be subject to the same postponement if the position in *Sons of Gwalia* is reversed. Also, only persons on the register of members are within the knowledge of the company, as companies do not have to go behind or beyond that register.

A possible extension beyond registered shareholders might be to holders of options over shares, who have a right to be registered upon exercise of the options. However, any further extension to other equity-linked financial instruments may run into the difficulty of how to characterise some derivative financial instruments that combine equity and other forms of investment.

What managed investment scheme interests to postpone

Nothing in *Sons of Gwalia* affects the proposition that unitholders in a managed investment scheme would be treated as creditors in the winding up of that scheme in the event of their having claims against the responsible entity for breach.

However, any move to postpone the claims of aggrieved shareholders raises the question whether the rights of unitholders should also be changed in a similar manner. On one view, the priority accorded to the claims of aggrieved shareholders in a corporate external administration, and that accorded to the claims of unitholders against the responsible entity in the event of the winding up of a managed investment scheme, should be similar.

Whether complete postponement is possible

Any move to postpone all or some equity-linked claims would also have to take into account that shareholders may also have remedies

⁹⁵ See Appendix 1.

⁹⁶ Chapter 2F of the Corporations Act.

against directors or other involved officers⁹⁷ (as well as against the company⁹⁸). A claim against directors or other officers may give shareholders indirect access to corporate assets in an external administration, given that, subject to certain restrictions,⁹⁹ these officers commonly have contractual rights of indemnity against a company (which may or may not have adequate indemnity insurance). Any move to preclude access to these indemnity rights would risk treating directors unduly harshly by treating them in effect as personal insurers of the liability of a company.

3.3.3 Cap the claims

The concept of a cap on aggrieved shareholder claims has a precedent in Canadian legislation, albeit that those provisions deal with shareholder claims against a solvent company. Further details of the Canadian legislation are set out in Appendix 2.

Under a cap approach for shareholder claims against an insolvent company, aggrieved shareholders would continue to be treated as unsecured creditors in the manner recognised in *Sons of Gwalia*, for notification and voting purposes. However, a statutory maximum or cap, say 10%, would be placed on the proportion of the net realisable assets of the company available for unsecured creditors, as estimated by the liquidator, that could be distributed to aggrieved shareholders in an insolvent liquidation.

⁹⁷ 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.

In consequence of *Sons of Gwalia*, aggrieved shareholders, as creditors, may also seek to move against directors of corporate trustees under s 197 of the Corporations Act: This possibility is discussed in S McCracken “‘Shareholder creditors’: Further risk for directors of corporate trustees?” (2008) 19 *Journal of Banking and Finance Law and Practice* 114.

⁹⁸ Proportional liability, introduced in 2004 in Part 7.10 Div 2A, would be relevant if the directors, as well as the company, are sued.

⁹⁹ ss 199A, 199B, 199C. See further, in the context of aggrieved shareholder claims, E Boros ‘Shareholder litigation after *Sons of Gwalia Ltd v Margaretic*’ (2008) 26 *Company and Securities Law Journal* 235 at 246–247.

Rationale for a cap

Arguments that might be put forward include:

- a cap only changes the current legal position in one respect, so that aggrieved shareholders would otherwise retain their rights to participate in external administrations as unsecured creditors
- aggrieved shareholders would be better off than if the law was reversed and their rights subordinated behind unsecured creditors, while in some instances they could be as well off as under the current legal position
- if the cap is sufficiently material, it may still give aggrieved shareholders an incentive to act against an insolvent company that engaged in misleading or deceptive conduct affecting them, while preserving most of the net realisable assets of the company for conventional unsecured creditors, thereby avoiding the possibility that the financial interests of those other creditors could be overwhelmed
- it would expedite the external administration process by enabling an external administrator to quarantine a proportion of realisable assets as the maximum available for aggrieved shareholders, and distribute the remainder to conventional unsecured creditors, before having to resolve the legal and practical issues that may arise in determining aggrieved shareholder claims
- it seeks to limit any adverse impact of the current legal position on capital raising and debt markets, as well as on the capacity of companies to devise or implement formal or informal turnaround schemes
- the concept of capping claims for allowable recoveries is adopted in some other areas, including workers' compensation legislation.

It has also been suggested that a cap could apply to claims by aggrieved shareholders against solvent, as well as insolvent, companies. However, this raises broader questions about shareholder claims against solvent companies, which are beyond the scope of this review.

Arguments against a cap

Arguments that might be put forward include:

- there is no justification for treating aggrieved shareholders as second class unsecured creditors
- it purports to accept the principle of *Sons of Gwalia*, but then says that the creditor rights recognised in that case should be limited
- any percentage cap would be arbitrary
- if a company has small current liabilities and potentially large aggrieved shareholder claims, a cap could result in a much lower proportional return for aggrieved shareholders compared with conventional unsecured creditors
- a liquidator may still have to deal with a range of complex matters when considering aggrieved shareholder claims within the cap, thereby reducing any administrative cost and time benefits from having a cap
- any argument in support of a cap by analogy with arbitrary caps in some other legislation needs to recognise that other limits often arise in no fault schemes (and are based, for instance in the case of workers' compensation, on what government has estimated as necessary to maintain a certain standard of living), whereas aggrieved shareholder claims arise from corporate fault.

How a cap would work

A cap would limit the total pool of funds available to all aggrieved shareholders in a liquidation. It would not necessarily limit *each claim* by aggrieved shareholders to the prescribed percentage. As outlined below, aggrieved shareholders might in some instances receive up to the same proportionate return in a liquidation as conventional unsecured creditors.

A cap would permit a liquidator to distribute the bulk of the net realisable assets to conventional unsecured creditors without first having to determine the claims of aggrieved shareholders. However, a liquidator may still have to deal with a range of complex matters when considering aggrieved shareholder claims within the cap. This

process may extend the time, and therefore the cost, of completing a liquidation, and to that extent reduce the pool of net realisable assets.

Payments within the cap

The liquidator could set aside 10% of the value of the estimated net realisable assets for aggrieved shareholders. Alternatively, the liquidator could choose to set aside, for aggrieved shareholder claims, 10% of any payment to unsecured creditors. This latter approach could be useful in the earlier stages of a liquidation if some assets are available for distribution but it is not possible for the liquidator to make a final determination of the company's net realisable assets.

Equitable returns

The proportional return to each aggrieved shareholder should not exceed that to each conventional unsecured creditor. To achieve this outcome:

- the liquidator could estimate the proportional return to conventional unsecured creditors, assuming that 10% of the net realisable assets are set aside for aggrieved shareholder claims
- any surplus remaining from that 10% of assets, after all eligible aggrieved shareholder claims have been paid at no higher rate than the proportional return given to conventional unsecured creditors, could be distributed rateably amongst all unsecured creditors, including aggrieved shareholders, up to the amount of their claims
- any surplus remaining from the 90% of assets set aside for conventional unsecured creditors, after those creditors have been paid in full, could be distributed rateably to aggrieved shareholders up to the amount remaining on their claims.

Depending on various factors (including the realisable assets available, the number and value of aggrieved shareholder claims and the number and value of conventional unsecured creditor claims), aggrieved shareholders may in some instances receive a proportional return the same as, or close to, the proportional return to conventional unsecured creditors.

Indemnity for breach by directors

As previously indicated, in some circumstances, aggrieved shareholders may have remedies against directors and other parties, such as promoters, underwriters or auditors, as well as the company, for misconduct.

Generally speaking, amounts recovered by aggrieved shareholders from persons other than the company would not be taken into account for the purposes of the statutory cap.

However, in particular circumstances, directors or others who have been sued by aggrieved shareholders may have rights to claim an indemnity from the company, thereby giving those investors indirect access to corporate funds.¹⁰⁰

Any money that the company is obliged to pay under an indemnity would reduce the pool of funds otherwise available to unsecured creditors generally. Indemnity payments by the company to aggrieved shareholders should be counted within the cap.

By contrast, any funds that the company could recover from an insurance company to cover an indemnity claim are not part of the realisable assets available for unsecured creditors generally. They should be available to aggrieved shareholders separately from, and in addition to, funds available to them under the cap.

Equity interests affected

As with the postponement option, it would also be necessary to consider the range of shareholding and other equity-linked interests that should be subject to any capping of claims.

3.3.4 Outright prohibition on shareholder claims

Another option, which was not included in the discussion paper but was put forward in a submission, is that all claims by aggrieved shareholders against a company, whether solvent or insolvent, should be prohibited.

The starting point is that when shareholders successfully sue a solvent company, or reach an out-of-court settlement with it, the

¹⁰⁰ Indemnity rights are regulated by ss 199A and 199C.

persons who indirectly bear the financial loss are the remaining shareholders. They may suffer loss to the market value of their shares or reduced dividends if the company suffers reputational loss or the claim is met in whole or part from corporate funds. Class actions and litigation funding may encourage this form of shareholder litigation.

On this approach, with the barring of claims by aggrieved shareholders against a solvent company, it would be difficult to justify their being reinstated, or initiated, if a company goes into insolvent liquidation (even if those claims are postponed behind those of conventional unsecured creditors).

This view is reflected in the majority submission of the Law Council Insolvency Committee:

The Committee submits that the reasoning which would prohibit shareholders from bringing such claims against an insolvent company also applies when the company is not insolvent. Shareholders should not be able to sue the company of which they are a member at either time. This is not to deny that shareholders may be able to take action against the individual directors (or advisors) involved in a breach of the continuous disclosure regime. The point is that shareholders should not be entitled to, in economic effect, sue themselves.

The effect of this option would be to confine claims by shareholders under investor protection provisions to actions against persons other than the company, for instance, directors, advisers or other involved professionals. However, an issue would arise whether, or in what circumstances, to continue to permit internal corporate arrangements that provide directors and others with rights of indemnification out of company funds.

3.4 Advisory Committee position

The issue that came to a head in *Sons of Gwalia*—how claims for damages by aggrieved shareholders should rank in a voluntary administration or liquidation—is one that called for resolution.

The issue arose in consequence of the move over recent years to provide shareholders and others with direct rights of action against a company, as well as against officers and others involved in the

company's affairs, in relation to various forms of corporate misconduct. As shareholder claims of that kind emerged in relation to companies that became financially distressed, it was not clear whether those claims should rank alongside the claims of ordinary unsecured creditors or should be postponed in accordance with the provision—s 563A—which manifests the established principle that shareholders rank behind creditors in a winding up.

This is an area where certainty is required. The decision of the High Court—while it may have surprised some and given rise to legitimate concerns—has provided a useful measure of certainty about the legal position. While recognising a tension in underlying policy considerations, the Court held as a matter of statutory construction that claims by aggrieved shareholders for damages were not claims 'in their capacity as a member' that should be postponed. It followed that they should be treated on a par with the claims of ordinary unsecured creditors. Shareholders and those who extend credit to companies now know the position that will apply in the event of aggrieved shareholder claims in an external administration.

The question is whether the legal position as laid out by the High Court is appropriate as a matter of policy or whether overall it has adverse consequences that call for legislative intervention. The views of interested parties on this policy question are polarised. Strong arguments have been put forward for maintaining the current position on the one hand or postponing or limiting the claims of aggrieved shareholders in an external administration on the other.

Maintain the current position

While members were not of the one view, the Advisory Committee as a whole is not persuaded of the need for change.

The Committee notes that the issue has arisen in the context of a significant shift in Australian corporate regulation. The provision to shareholders and others over recent years of direct rights of action in respect of corporate misconduct, and the strengthening of the regime for timely and reliable corporate reporting, reflect clear legislative objectives.

The High Court itself noted that:

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.¹⁰¹

In effect, the facilitation of private remedies has added to the enforcement armoury, encouraging self-help by affected parties to complement the enforcement role of the regulators.

While there has not been a rash of private litigation, we are now seeing cases emerge, such as *Sons of Gwalia* itself, in which shareholders seek to bring a company to account for failures in disclosure or other corporate misconduct. Claims by aggrieved shareholders can serve as a market-based deterrence, enforcement and recovery mechanism in support of required standards of corporate conduct.

Any move to curtail the rights of recourse of aggrieved shareholders where a company is financially distressed could be seen as undermining the apparent legislative intent to empower investors.

Given the rights of recourse that have been conferred on shareholders, among others, the view put in some submissions that shareholding includes as one of its elements acceptance of the risk of being misled as a result of corporate misconduct is contestable. Likewise, as a practical matter, arguments that shareholders, unlike ordinary creditors, have it within their means to avert corporate misconduct are not clear-cut.

While the distinction between shareholder and creditor is of course important, there may be some overlapping of interests in particular circumstances. Where corporate regulation seeks—including through the provision of private rights of recourse—to enhance the

¹⁰¹ Gleeson CJ in *Sons of Gwalia* at [18].

timeliness and reliability of corporate disclosures, shareholders and creditors may share an interest in the promotion of an efficient and informed market.

The Committee is cognisant of the significant implications of *Sons of Gwalia* for providers of debt finance to companies, as well as for other unsecured creditors, and for the conduct of external administrations of companies in financial distress.

While these issues will only arise in a limited number of cases—where there is scope for claims by aggrieved shareholders—those cases will tend to involve public listed companies and may be large in scale.

The Committee acknowledges the views put forward in various submissions about the possible consequences of *Sons of Gwalia* for companies seeking funds in the unsecured debt market. Lenders can be expected to factor into their assessment of the risk of lending to Australian companies, particularly listed public companies, the possibility that aggrieved shareholders may compete with conventional unsecured creditors in the event that the company goes into external administration. This may influence the readiness of lenders to advance funds or the terms on which they will do so, and this against the current background of a tight credit market following global financial market developments. While it may not be easy to quantify these effects, some respondents indicated that lenders were taking steps to protect their position having regard to *Sons of Gwalia*. It is likely that changes have already occurred as the corporate finance market has adapted to the legal environment following *Sons of Gwalia*.

The Committee also understands that difficulties could arise in attracting investors to assist in the rehabilitation of financially stressed companies. However, prospective investors in these companies may have other ways to protect their financial interests, including through creditors' schemes of arrangement whereby aggrieved shareholders agree to restrictions on their claims in return for the injection of further capital.

The Committee is aware of the concerns raised in submissions about possible complexities and delays in the conduct of external administrations, with implications for conventional unsecured creditors, given the possible growth in class actions by aggrieved

shareholders. The procedures involved in the conduct of external administrations are not without their challenges in any event. In cases where there are claims by aggrieved shareholders, administrators will face additional challenges and possible delay and expense.

In cases where claims by aggrieved shareholders are forthcoming, external administrators now have to estimate the likely number and size of those claims and the proportion of those claims that will prove to be successful. However, it needs to be kept in mind that, even with the assistance of class actions and litigation funding, aggrieved shareholders will still have to substantiate their claims, with significant evidential and procedural issues to face, including establishing reliance on corporate misconduct. The fact that a claim is asserted does not mean that it will succeed or should be accorded weight in the external administration process.

The Committee outlines elsewhere in this report (Chapter 4) some possible ways to facilitate the efficient conduct of external administration proceedings involving claims by aggrieved shareholders. The position should continue to be monitored with a view to identifying difficulties in insolvency administrations that cannot satisfactorily be resolved by administrators or the courts and may require some legislative initiative.

Postpone claims

The Committee next considered issues that would arise if, notwithstanding its view, a decision is taken to change the law to postpone all or some aggrieved shareholder claims.

One matter for consideration is whether any move to postpone shareholder-based claims should distinguish, in some way, between purchasers, sellers, and continuing holders, of shares.

The Committee notes that the *Sons of Gwalia* decision, and the terms of reference, related to claims by purchasers of shares. While it would be possible to confine any postponement of claims to claims by purchasers, such an approach may be too narrow. It may seem anomalous, for instance, to postpone claims by purchasers of shares, but not by holders of shares, given that in both instances the claim would be based on corporate misconduct affecting the value of the shares. Likewise, it is arguable that any postponement should extend to a claim by a seller of shares, although the Committee notes that,

even before *Sons of Gwalia*, such a claim by a former shareholder would not have been postponed, as it would not have been made in the capacity of member within the meaning of s 563A.

One proposal put forward in submissions would be to postpone all shareholder claims, other than by persons who had no shareholding in the company at the time they purchased the shares to which their claim related. The argument put forward was that new investors had no capacity, prior to the purchase, to exercise the voting or other controls available to shareholders. By contrast, registered shareholders have certain powers, including to attend and vote at company meetings, to seek court approval to inspect books of the company, to sue for oppression, or to enforce company rights through a derivative action.

The Committee is not persuaded that these differences justify a carve-out of new investors from any postponement. In practice, existing shareholders may have little or no real day-to-day capacity to monitor or control corporate disclosures or other corporate conduct and may be as misled as new investors by corporate misconduct.

The Committee also considered a proposal put forward in submissions that any postponement of shareholder claims should include claims relating to other equity-linked interests, such as options over shares, units in managed investment schemes and equity derivatives. The US and Canadian postponement provisions seek to include at least some equity-linked interests going beyond shareholders.

The Committee notes that it was clear, even before *Sons of Gwalia*, that claims relating to this broader category of equity-linked interests did not fall within the class of member claims that were postponed. If, notwithstanding the Committee's view, it is decided to postpone shareholder claims, the Committee would not favour an attempt to extend the postponement to this broader category of equity-linked interests. It would be difficult to devise a definition that included all equity interests, including complex derivatives that combine elements of equity and debt.

The Committee notes that shareholders may also have remedies against individual directors and others involved in a corporate breach. Directors and other officers may have indemnity rights

against the company, thereby giving shareholders indirect access to corporate assets. In effect, even if claims by shareholders against a company are postponed, it is possible that some corporate funds could still be available through the indemnity. To the extent that this might appear anomalous, it has always been the position, including before *Sons of Gwalia*. Any attempt to interfere with indemnity rights in this regard would be unduly harsh on directors and other officers and, in effect, treat them as personal insurers of a company's conduct or liabilities.

Cap on claims

The Committee also considered whether, if a decision is taken to ameliorate the current position, a cap on shareholder claims may be a better compromise compared with the postponement of all such claims.

A cap might be seen as a pragmatic solution. It would maintain the voting and other participation rights of aggrieved shareholders and provide them with access to some part of the available corporate assets, while affording a liquidator the means to distribute most of the available funds to conventional unsecured creditors without first having to resolve claims by aggrieved shareholders. An early return can be particularly important for small trade creditors.

While a cap would have practical attractions in ameliorating concerns about the effects of *Sons of Gwalia*, it would be arbitrary in effect and difficult to justify in principle. The position of aggrieved shareholder claimants would be largely undermined—assuming their potential recovery would be capped at a relatively low percentage of available assets—without overcoming all of the complexities of external administrations. The Committee as a whole is not persuaded of the merits of capping as a compromise approach.

Prohibit claims

One proposal put forward in submissions was that all claims by aggrieved shareholders against a company, whether solvent or insolvent, should be prohibited. It was argued that, when shareholders successfully sue a solvent company, the persons who indirectly bear the financial loss are the remaining shareholders. On this approach, claims by aggrieved shareholders against a solvent company would be barred, and there would be no question of allowing them if a company went into insolvent liquidation.

An argument might be developed in conceptual terms against allowing claims against a company by aggrieved shareholders. Such an argument presumably underlies the Canadian legislation by which the liability of solvent companies is capped in relation to such claims. However, this would raise issues going well beyond *Sons of Gwalia* and the Committee has not considered this question further in the context of shareholder suits against insolvent companies. The Committee also notes that a general prohibition of claims by aggrieved shareholders would fly in the face of recent legislative initiatives to provide greater remedies for shareholders against corporate misconduct.

4 Reforms if shareholder claims not postponed

This chapter considers possible ways to facilitate the efficient conduct of external administration proceedings involving claims by aggrieved shareholders if the current ranking of those claims is maintained.

4.1 Question for consideration

The second question in the terms of reference is, assuming the current legal position is maintained:

are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims?

4.2 Possible reforms

In those external administrations where they arise, claims by aggrieved shareholders will add to the administrative burden, including the time and cost involved.

The discussion paper raised a range of possible reforms to the external administration process to help deal with these claims.

Respondents also put forward suggestions to streamline or otherwise facilitate the handling of claims by shareholders in the conduct of external administration proceedings.¹⁰²

4.3 Identifying and communicating with aggrieved shareholders

Administrators are currently required to give written notice of creditors' meetings to as many of the company's creditors as reasonably practicable.¹⁰³ They do not have a duty to seek out

¹⁰² Chapter 8 of the *Collated submissions*.

¹⁰³ s 436E(3)(a).

non-obvious creditors, whether located in Australia or elsewhere, such as retailers and consumers who suffered economic loss only.¹⁰⁴

A question was raised in the discussion paper about the position of an administrator who knows, or has reason to believe, that one or more shareholders have commenced, or intend to make, an aggrieved shareholder claim.

The following legislative initiatives were suggested:

- an administrator need not search the share register or take other steps to identify possible aggrieved shareholders 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
- an administrator should only be required to communicate with an aggrieved shareholder where the administrator has received notice of a claim that identifies the claimant and supplies the claimant's details for service of notices
- where a group of aggrieved shareholders is being represented by one person (for instance, the legal adviser in a class action), the information need only be provided to that representative.

The Advisory Committee recognises that there would be procedural and cost benefits if external administrators only had to send reports and other information to aggrieved shareholders who have lodged a claim. However, the Committee does not consider that legislation is necessary to achieve this outcome. The Committee does not consider that an administrator would currently be under an obligation to search the share register to notify all shareholders merely because a *Sons of Gwalia* type claim had been lodged by one or more persons. Rather, the onus would be on the shareholders to identify themselves and substantiate their claims.

An administrator might choose to send information to all shareholders, or notify shareholders by public advertisement, if the administrator thought that that was appropriate in the circumstances of the particular administration. However, administrators should not have any statutory obligation in this regard. Furthermore, an

¹⁰⁴ *Selim v McGrath* (2003) 47 ACSR 537 at [126].

administrator could reach an agreement with a representative of particular shareholders about the provision of information to them.

Some other matters involving ongoing communication between an external administrator and unsecured creditors, which would include aggrieved shareholders, are dealt with in the CAMAC report *Issues in external administration* (November 2008), including a recommendation that an external administrator have the right to inform creditors in the initial notice to them that all subsequent information will be made available on a designated website, with creditors having the right to request printed copies of that information.¹⁰⁵

4.4 Time and place of creditors' meeting

A creditors' meeting must be held at a time and place that the external administrator considers is the most convenient to the majority of creditors.¹⁰⁶ Determining an appropriate location, which may be difficult when only conventional unsecured creditors are concerned, may be further complicated by the existence of claims by shareholders.

A question was raised whether a legislative initiative was required:

- to allow insolvency practitioners to have regard only to conventional creditors when determining the time and place of meetings, in effect excluding aggrieved shareholders in considering this matter, or
- to require insolvency practitioners to hold meetings at the place of incorporation of the company, or
- to give external administrators a greater discretion in these circumstances.

The Advisory Committee does not consider that there is a need for legislative change to ensure suitable flexibility in the requirements for the conduct of creditors' meetings, taking into account the increasing availability of video-conferencing. A requirement that creditors' meetings be held at the place of incorporation of the

¹⁰⁵ Recommendation 16.

¹⁰⁶ Corp Reg 5.6.14.

company may be too restrictive in some circumstances. The exclusion of aggrieved shareholders altogether from the consideration of an appropriate time and place would detract from their position as ordinary unsecured creditors.

4.5 Determining aggrieved shareholder claims

An external administrator will need to make decisions on the merits of claims by aggrieved shareholders:

- for the purpose of determining voting rights
- for the purpose of making a distribution to creditors.

These judgments are not unique to aggrieved shareholder claims. Administrators and liquidators have always faced the problem of having to deal with alleged, but as yet unsubstantiated, creditor claims. Aggrieved shareholder claims may simply add to this problem.

4.5.1 Voting rights

Unsecured creditors have a key voting role in a voluntary administration and a more limited voting role in a liquidation.¹⁰⁷ There are questions about how aggrieved shareholders should put forward their claims, for the purpose of being given voting rights, and whether there should be any restrictions on their voting rights.

Procedure for lodging claims

A person may not vote at a meeting of creditors unless he or she has lodged particulars of the 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.¹⁰⁸ Also, a creditor may not vote on an unliquidated or contingent debt or claim or a debt

¹⁰⁷ 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). See further Section 2.3.

¹⁰⁸ Corp Reg 5.6.23(1)(b).

whose value is not established unless a ‘just estimate’ of the value has been made.¹⁰⁹

An administrator may choose to prepare a proof of debt form for shareholders to complete to lodge a claim. That option should remain.

A possible means to achieve greater certainty in other circumstances would be to amend the relevant regulation¹¹⁰ to be more specific about what is required for the making of a ‘just estimate’ of the value of a claim by a shareholder for damages in connection with that person’s shareholding. The regulation could require that, subject to an administrator using his or her own proof of debt form, 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 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 administrators, including for the purpose of determining voting rights and making a ‘just estimate’ of the value of aggrieved shareholder claims, without depriving the chair of the current discretion to accept or reject shareholder proofs of debt, or admit a claim for a nominal amount.¹¹¹

¹⁰⁹ Corp Reg 5.6.23(2).

¹¹⁰ Corp Reg 5.6.23(2).

¹¹¹ Corp Reg 5.6.26.

Exercise of voting rights

The discussion paper raised for consideration various options for dealing with aggrieved shareholder claims, including:

- excluding them from voting in a voluntary administration or an insolvent liquidation, or
- capping their combined voting power in some manner.

Either option would aim to overcome concerns, reflected in some submissions, about the possibility of aggrieved shareholders dominating the voting in creditors' meetings.

The Advisory Committee is not convinced that a statutory change to exclude or cap voting by shareholder claimants is necessary for the efficient conduct of external administrations.

Administrators may choose to admit persons with claims that have not yet been established, including aggrieved shareholder claims, either for the full amount of their claims or for a nominal amount (say, one dollar).¹¹² Persons who are admitted for a nominal amount only 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 full by value. In practice, the meeting is not delayed by any such objection.

The effect of admitting shareholder claimants for a nominal amount is that they 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 value¹¹³ and defeated by a vote against by a majority in number and value.¹¹⁴ In the event that votes by number and value differ, the administrator may exercise a casting vote.¹¹⁵ This ensures that aggrieved shareholders cannot, by themselves alone, determine the outcome of creditors' resolutions.

¹¹² 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.

¹¹³ Corp Reg 5.6.21(2).

¹¹⁴ Corp Reg 5.6.21(3).

¹¹⁵ 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).

For these reasons, the Committee does not support either excluding or capping the votes of aggrieved shareholders.

4.5.2 Distribution to creditors

The greater challenge for external administrators, if the current priority of shareholder claims is maintained, is likely to be the adjudication of proofs of debt by shareholders to determine the size of their claims compared with other unsecured creditor claims, for the purpose of distributing any net realisable assets to unsecured creditors.

Time limit for lodging claims

There is no statutory cut-off period for the lodgement of claims against a company prior to completion of its liquidation. This raises the question whether the liquidation process would be assisted by imposing a time limit following the appointment of a liquidator within which aggrieved shareholders, and possibly other creditors, should be required to lodge any claims.

Shareholders are likely to know when a company in which they have invested has gone into liquidation. A time limit for lodging shareholder claims may encourage them to decide whether to do so, while adding an element of certainty to the winding up process. However, similar arguments could be made about other creditors. The Committee considers that aggrieved shareholders should not be subject to time constraints on making claims that do not apply to other unsecured creditors in a liquidation. This report does not consider this broader question.

Establishing claims

There were differing views in submissions on whether to introduce changes to the causation, reliance and damages principles involved in establishing aggrieved shareholder claims against companies for misrepresentation.¹¹⁶

One view was that the requirements for proof of individual causation, reliance and damage can hinder the efficient management of multiple claims by shareholders for misrepresentation and thus increase the overall time, and therefore expense, of a liquidation.

¹¹⁶ Chapter 3 of the Collated submissions.

These problems could be reduced by, say, the introduction of a 'fraud on the market' concept that would do away with the need to establish, in addition to causation, that each claimant relied on the misrepresentation by the company (this concept is further discussed in Chapter 5).

A contrary view was that the current requirements constitute a check on inappropriate shareholder claims and that the rules for proving claims for misrepresentation should not differ from those applicable in other circumstances.

The Advisory Committee considers that the principles for establishing misrepresentation claims in litigation, including issues related to causation, reliance, and the quantum of damages, should not differentiate between claims by shareholders against solvent or insolvent companies or between claims by shareholders and claims by other persons. At this stage, these matters should remain as matters for judicial determination and development. Also, the Committee considers that it would be inappropriate to consider the fraud on the market concept only in the limited context of shareholder claims against insolvent companies. The broader effects of such a change would require careful analysis, separate from this review.

The Committee is also of the view that possible changes to the principles regarding the conduct of shareholder class actions or litigation funding, which could have considerable implications for aggrieved shareholder claims, raise broader policy issues going beyond the scope of this review.

Judicial powers

Single judicial determination

The discussion paper raised the possibility of providing for a single judicial determination of an issue common to shareholder claims, including through a single proof of debt and a requirement that aggrieved shareholders lodge their claims in court by a certain cut-off date, with appeals available from any decision of the external administrator to consolidate the proofs of debt in a single action. Also, there could be a rebuttable presumption that a judicial determination in one proceeding of a question of fact common to other aggrieved shareholder claims applies in any subsequent proceedings.

Further details of how these initiatives could be implemented within the context of current judicial rules and principles of practice are set out in Appendix 3.

Respondents generally supported these initiatives in principle, though there was a view that there is already a sufficient body of judicial rules and principles of practice to facilitate the consolidation of aggrieved shareholder claims, and that these matters might best be left to the courts to develop over time.

General power

A liquidator can apply for directions from a court about how to manage the liquidation process. There may be merit in going further and giving the courts a general power, equivalent to s 447A (which applies to voluntary administrations), to make orders in a liquidation. This could cover, for instance, meeting procedures and the determination of claims. The Committee recognises that an amendment of this nature would be of general application and not be confined to matters involving claims by shareholders.

Calculating loss

The Committee does not consider that it would be appropriate to prescribe in detail the method for calculating direct and consequential loss by shareholders. This process is best left to judicial development in the light of particular situations as they arise.

4.6 Exercise of proxy votes

The discussion paper noted that, under the then current law (September 2007), persons were prohibited from acting as a proxy if they were 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.¹¹⁷ This could preclude shareholders from appointing as their proxies law firms or others who are undertaking a class action on their behalf.

¹¹⁷ Corp Reg 5.6.33.

The relevant regulation was amended on 31 December 2007, pursuant to an Advisory Committee recommendation.¹¹⁸ In consequence, only persons acting under a general proxy are prohibited from voting in favour of any resolution that would directly or indirectly place them in a position to receive any remuneration out of assets of the company. The removal of the exclusion in relation to specific proxies has resolved the issue that the discussion paper raised.

4.7 Advisory Committee view

As indicated in this chapter, the Committee considers that administrators already have a range of powers and discretions that they can bring to bear in dealing with issues that may arise where there are claims by aggrieved shareholders.

The Committee also proposes:

- a standardised proof of debt form for claims by aggrieved shareholders, which administrators may choose to use to assist them in making a ‘just estimate’ of the value of those claims
- a rebuttable presumption that a judicial determination in one proceeding of a question of fact common to other aggrieved shareholder claims applies in any subsequent proceedings
- giving courts a general power to make orders in a liquidation, which would cover creditors’ meetings and the determination of shareholder claims.

In addition, the Committee has put forward recommendations in its report *Issues in external administration* (November 2008) to assist the communication process between external administrators and creditors, which would include aggrieved shareholders.

¹¹⁸ The reasons for the change are set out in the Explanatory Statement to Select Legislative Instrument 2007 No 325 at item [35], which includes a reference to the Advisory Committee report *Corporate Voluntary Administration* (1998) rec 17.

5 Reforms if shareholder claims postponed

This chapter discusses whether it is possible to protect aggrieved shareholders better in the event of a change in the law to postpone their claims.

5.1 Question for consideration

The third question in the terms of reference is, assuming the current legal position is changed:

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?

5.2 Fraud on the market

The discussion paper raised the question of a statutory amendment to introduce a ‘fraud on the market’ approach as a possible way to facilitate proof of aggrieved shareholder claims. 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 2.2.2). It would still be necessary, however, to demonstrate a link between the misconduct and the reduction in the share price.

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

The idea is 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.¹¹⁹ 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.

The US Supreme Court in *Basic Inc v Levinson* (1988)¹²⁰ held 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.

¹¹⁹ 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,
 - (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.

¹²⁰ 485 U.S. 224 (1988).

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.

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 has facilitated shareholder class actions in the USA.¹²¹

The fraud on the market concept has, in effect, been adopted in Australia for a solvent company in at least one regulatory context.¹²²

The introduction of the concept by legislation in Australia might reinforce shareholder rights by increasing the possibility of their succeeding in an action, and recovering, against a solvent ongoing company.

5.3 Advisory Committee view

A fraud on the market approach would assist investors to make out claims: it would not affect their priority in relation to conventional unsecured creditors in the distribution of funds of an insolvent company. In the event that the law was changed to postpone shareholder claims in an insolvency, the concept would only assist shareholders in those rare cases where a company in liquidation was able to pay the claims of all unsecured creditors and had funds remaining to meet aggrieved shareholder claims.

Wider questions also remain whether, in principle, the concept should be codified in legislation, including whether it should apply to actions against solvent as well as insolvent companies.

¹²¹ 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.

¹²² 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.

A number of submissions raised concerns that any move towards introduction of a fraud on the market concept would have very significant implications for recovery actions generally and that the concept should either not be adopted or should not be considered only in the limited context of *Sons of Gwalia* type claims.¹²³

The Advisory Committee acknowledges the concerns in those submissions. The Committee considers that it would be inappropriate to implement the fraud on the market concept in the limited context of shareholder claims against insolvent companies. Any consideration of whether to introduce the concept in a broader context would require careful analysis going beyond the scope of this review.

¹²³ Chapter 9 of the *Collated submissions*.

6 The rule in *Houldsworth's case*

This chapter considers the abrogation of the rule in Houldsworth's case.

6.1 The rule and its rationale

The rule in *Houldsworth's case*¹²⁴ 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].¹²⁵

The rule does not apply to shareholders who have purchased their 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.¹²⁶ 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.

¹²⁴ *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317.

¹²⁵ This statement of the rule is found in *Re Media World Communications Ltd (admin apptd)* (2005) 52 ACSR 346, 23 ACLC 281 at [10]. See generally *Ford's Principles* at [24.501].

¹²⁶ *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 ... it is inconsistent with his position as a shareholder, while he remains such, to claim back any 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.

6.2 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 provision. Statutory exceptions to the capital maintenance principle have long existed.¹²⁷

The High Court in *Sons of Gwalia* made some observations about the rule in *Houldsworth's case* (although they were not necessary for the decision, as the rule only applies to subscribers for shares from the company and the plaintiff in that case had purchased his shares on the ASX).

Following the High Court decision, the status of the rule in *Houldsworth's case* in Australia may be summarised as follows:¹²⁸

- 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*¹²⁹)
 - subscriber claims against a company under a specific statutory provision, such as s 729, which gives a remedy for

¹²⁷ 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).

¹²⁸ *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*.

¹²⁹ See footnote 4.

misleading or deceptive statements or omissions in a prospectus¹³⁰

- 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, subscriber shareholders 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 party¹³¹
 - the company is in voluntary administration, unless the court otherwise orders,¹³² though the subscriber claim may revive once the voluntary administration is finished.¹³³

In the United Kingdom, the rule is excluded in all cases.¹³⁴

¹³⁰ *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*.

¹³¹ 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.

¹³² s 437F, as applied in *Re Media World Communications Ltd (admin apptd)* (2005) 52 ACSR 346, 23 ACLC 281 at [14].

¹³³ *Ford's Principles* at [24.503], taking into account observations in *Re Media World Communications Ltd (admin apptd)* (2005) 52 ACSR 346, 23 ACLC 281 at [15].

6.3 Retain or abrogate

Possible arguments for retaining the rule are:

- the residual capital maintenance principles should be retained
- the rule may reduce the range of claims by shareholders 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 be able to participate 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,¹³⁵ without any apparent concern about the implications for capital maintenance.

6.4 Advisory Committee view

The Committee notes that there were differing views in submissions on whether the rule in *Houldsworth's case* should be abrogated.¹³⁶ One view was that it still performs a function relating to maintenance of capital. Another view was that express abrogation was unnecessary, as recent case law effectively excluded its

¹³⁴ UK *Companies Act 2006* s 655 (previously UK *Companies Act 1985* s 111A).

¹³⁵ 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.

¹³⁶ Chapter 2 of the *Collated submissions*.

operation in the vast majority of cases.¹³⁷ The predominant view saw no clear rationale for retaining the rule in the limited circumstances where it still applies, taking into account the changes to the maintenance of corporate capital principle which allow a company's equity base to be diminished in various respects.

The Committee considers that any rationale for the rule has been considerably weakened since its original formulation in the 19th century. The rule now applies in very limited contexts and appears to serve little or no real purpose, other than to place restrictions on some, but not all, shareholder actions against companies. The Committee supports its abolition, which would remove any distinction between different types of shareholder claim against companies, based on whether the shareholder acquired shares from the company or a third party.

¹³⁷ The respondent referred to *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434; [2005] FCAFC 265.

7 Member claims

This chapter considers whether shareholders who have claims against a company in their capacity as members, which are postponed by s 563A, should still be entitled, by virtue of those claims, to participate as creditors in a voluntary administration or liquidation.

7.1 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.

The discussion paper raised 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 the 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.

Claims of this type are relatively rare in an external administration. However, where they exist, those claimants can exercise voting rights, together with other creditors. This could be significant in 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 role.

7.2 Member claims as 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.¹³⁸

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 7.3.2) is also premised on shareholders with member claims having a debt owed to them by the company.

¹³⁸ *Brash Holdings Ltd v Katile Pty Ltd* (1994) 13 ACSR 504 at 514–515.

7.3 Legislative history

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

7.3.1 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,¹³⁹ in the 1981–1990 co-operative scheme uniform national law¹⁴⁰ 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 amongst themselves.

¹³⁹ For instance, *Companies Act 1961* (NSW) s 218(1)(g).

¹⁴⁰ *Companies Act 1981* s 360(1)(k) and the equivalent provisions 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.¹⁴¹

To achieve this, the Harmer Report proposed the following provision:

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.¹⁴²

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.

7.3.2 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.¹⁴³ 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.

¹⁴¹ Australian Law Reform Commission (ALRC), *General Insolvency Inquiry*, Report No 45 (1988), vol 1, para 750.

¹⁴² Australian Law Reform Commission (ALRC), *General Insolvency Inquiry*, Report No 45 (1988), vol 2, cl P4.

¹⁴³ 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.¹⁴⁴

Section 563A maintained the postponement of member claims under the pre-1992 position. 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’).¹⁴⁵

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?¹⁴⁶

7.4 Canadian proposal

An amendment to the Canadian *Companies’ Creditors Arrangement Act*, awaiting proclamation, will prevent shareholders claiming as members from voting at creditors’ meetings under that Act unless the court orders otherwise.

¹⁴⁴ para 957.

¹⁴⁵ Gleeson CJ at [1].

¹⁴⁶ Hayne J at [135].

7.5 Advisory Committee view

The current position in regard to member claims in an external administration may be an unintended anomaly. It gives shareholders voting power on issues affecting general unsecured creditors whose claims have a higher priority. It could result, for instance, in shareholders having an influence on decisions whether to adopt proposals affecting general unsecured creditors.

There was general support in submissions for a legislative amendment to provide expressly that shareholders with members' claims should not, by reason of those claims, have rights to receive information, or vote, as creditors. Various submissions noted that the Canadian legislation, referred to in the discussion paper, could be an appropriate model to achieve this outcome.¹⁴⁷

The Advisory Committee supports a legislative amendment to make clear, in voluntary administrations and liquidations, that shareholders are not entitled to exercise voting rights, in the capacity of creditors, by reference to any members' claims that they may have against the company. Also, it would impose a significant administrative and cost burden, for no purpose in regard to voting, if members continued to receive the information to be provided to creditors.

¹⁴⁷ Chapter 10 of the *Collated submissions*.

Appendix 1 International comparisons

This appendix summarises the legal position of aggrieved shareholder claims in some other jurisdictions. It is referred to in Section 3.2.5 of the report.

A1.1 Overview

There are differing approaches in the overseas jurisdictions examined in this review to the treatment of claims by aggrieved shareholders:

- UK law is consistent with the *Sons of Gwalia* approach
- the USA and Canada subordinate all claims by shareholders relating to their shares to those of conventional unsecured creditors.

A1.2 United Kingdom

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

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.¹⁴⁸

Subsequently, in *Soden v British and Commonwealth Holdings plc*,¹⁴⁹ the House of Lords, in interpreting the UK equivalent of s 563A, decided that claims by an aggrieved shareholder that it was induced by a company's misrepresentation to acquire the company's shares ranked equally with conventional unsecured creditor claims.

¹⁴⁸ 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.

¹⁴⁹ [1997] UKHL 41; [1998] AC 298; [1997] 4 All ER 353; [1997] 3 WLR 840; [1997] BCC 952.

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 can govern commercial transactions in other jurisdictions through reference to UK law in 'choice of law' clauses in contracts.

The issue of the status of aggrieved shareholder 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* in Australia.¹⁵⁰

A1.3 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,¹⁵¹ specifically postpones claims arising from the purchase or sale of securities behind those of unsecured creditors in a liquidation.¹⁵² This 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.

¹⁵⁰ 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.

¹⁵¹ 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.

¹⁵² §510(b). The relevant part of the provision states 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 ...

A1.3.1 Rationale for the rule

The legislation adopted the recommendations of a Commission on the Bankruptcy Laws, established in 1973, which proposed 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,¹⁵³ 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.¹⁵⁴

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

¹⁵³ 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.

¹⁵⁴ *id* at 286–287.

business failure by investing in equity rather than debt instruments.¹⁵⁵

In *In re Telegroup, Inc* (2002),¹⁵⁶ 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.¹⁵⁷

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.¹⁵⁸

A1.3.2 Securities covered by the rule

Section 510(b) has an extended application. It is expressed to apply not only to shareholders, but to any ‘claim arising from rescission of a purchase or sale of a security of the debtor’. It would also appear to subordinate any claim that was a derivative action,¹⁵⁹ or a claim against an affiliate of the company.¹⁶⁰

¹⁵⁵ id at 267–268.

¹⁵⁶ 281 F 3d 133 (3rd Cir, 2002).

¹⁵⁷ id at 140.

¹⁵⁸ 329 BR 10 at 14 (Bankr SDNY, 2005).

¹⁵⁹ According to the submission by the Australian Bankers’ Association:

For example, if shareholders sued a third party (i.e. an auditor, promoter, director) for an aggrieved investor claim, and that third party then cross claimed against the insolvent company for contribution, then that contribution claim by the third party would be caught by section 510(b).

¹⁶⁰ According to the submission by the Australian Bankers’ Association:

Section 510(b) purports not only to attach to claims against the company in which the claimant is a shareholder, but also any such claim against an affiliate of that company. As we understand it, this would for example subordinate claims of shareholders against an operating company which is a subsidiary of the listed entity, in circumstances where a claim is made against that subsidiary that it participated in the provision of misleading information which is said to have caused the shareholder loss.

A1.3.3 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.

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.¹⁶¹

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.¹⁶²

¹⁶¹ 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.

¹⁶² 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.

In *Re Geneva Steel* (2002),¹⁶³ 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 sell, the shares, which subsequently lost value. The Court considered that this shareholder claim should be subordinated under s 510(b).¹⁶⁴

A1.4 Canada

A1.4.1 Common law

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

In a leading case, *Re Blue Range Resource Corp* (2000),¹⁶⁵ 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 investors.

The Court confirmed that a shareholder's claim against a company that is unrelated to the shareholding is not subordinated.¹⁶⁶ However, in this case the claim was directly related to the status of the claimant as a shareholder.¹⁶⁷ As such, it was subordinated to the claims of non-shareholder creditors, on the basis that it was, in effect, a return of capital and therefore ranked last in the insolvency:

¹⁶³ 281 F 3d 1173 (10th Cir, 2002).

¹⁶⁴ 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.

¹⁶⁵ *Re Blue Range Resource Corp* (2000) 15 CBR (4th) 169; 259 AR 30.

¹⁶⁶ 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.

¹⁶⁷ 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 of [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 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.¹⁶⁸

The Court also referred to some other general factors that it considered supported the principle of subordinating aggrieved shareholder 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.¹⁶⁹

In a subsequent case, *National Bank of Canada v Merit Energy Ltd* (2001),¹⁷⁰ 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.¹⁷¹

A1.4.2 Proposed legislation

Corporate restructurings under Canada's insolvency regime are governed by the provisions of the *Bankruptcy and Insolvency Act* (BIA)¹⁷² relating to proposals between insolvent persons and their

¹⁶⁸ id at [23].

¹⁶⁹ id at [29] ff.

¹⁷⁰ [2001] 294 AR 15. This decision was affirmed at [2002] 299 AR 200.

¹⁷¹ 294 AR at [50].

¹⁷² Corporate liquidations are usually conducted under the bankruptcy provisions of the BIA.

creditors or by similar provisions in the *Companies' Creditors Arrangement Act* (CCAA).¹⁷³

There are as yet no provisions in either statute dealing specifically with the priority of shareholder claims. However, amendments to the BIA and the CCAA,¹⁷⁴ awaiting proclamation, will 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 will also be prevented from voting as creditors on any proposed reorganization.

¹⁷³ 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 Can\$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).

¹⁷⁴ Proposed amendments to the BIA would codify Canadian common law by enacting a wide-ranging shareholder subordination principle in a liquidation (Section 140.1):

A creditor is not entitled to a dividend in respect of an equity claim until all claims 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.

An amendment to the CCAA, awaiting proclamation, would prevent equity claimants from voting at creditors' meetings unless the court orders otherwise (Section 22.1). 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.

Appendix 2 Capping of shareholder claims in Canada

This appendix summarises the Canadian legislation, which imposes a cap on claims by aggrieved shareholders against solvent listed companies for disclosure breaches. It is referred to in Sections 1.4.2 and 3.3.3 of the report.

A2.1 Overview

Amendments to the Ontario Securities Act in 2005,¹⁷⁵ subsequently adopted in other Provinces, permit persons who have bought or sold a company's shares in the secondary market to sue the company, as well as other designated persons, for losses resulting from various disclosure breaches by the company, including breaches of the continuous disclosure requirements. Remedies are not provided for shareholders who retained their shares during the breach period.

The provisions only apply to shareholder claims against solvent companies. Shareholder claims against insolvent companies are postponed behind unsecured creditor claims (see Appendix 1 Section A1.4).

The provisions support compliance and provide a financial deterrent to aid enforcement of the disclosure obligations, while providing a limited level of recovery for investors affected by the breach.

This right of recovery is separate from, and does not interfere with, the right of shareholders to sue a company in relation to primary market transactions, for instance, where a company has issued shares to an investor pursuant to a false or misleading prospectus.

A2.2 Eligible claimants

Persons who buy or sell the company's shares in the secondary market during a disclosure violation period can bring a civil suit against the company, or various other persons, depending upon the

¹⁷⁵ Securities Act (Ontario) Part XXIII.1.

particular circumstances. Buyers would be prejudiced by any failure of the company to disclose material negative information at the time of purchase, while sellers would be prejudiced by any failure of the company to disclose material positive information at the time of sale. The legislation does not provide a remedy for persons who would have transacted in the company's shares if the market had been properly informed, or who retained their shares during the disclosure breach period.

A2.3 Elements of the claim

As in Australia, claimants must establish a causal link between the corporate misconduct and the loss incurred by them. However, the Canadian legislation assists shareholder actions by doing away with the need to prove reliance on the improper disclosure or non-disclosure, in effect adopting a 'fraud on the market' approach. In relation to 'core' disclosure documents, the plaintiff need only prove a relevant misrepresentation or other disclosure breach. The onus is then on the company, or other defendant, to establish one of the defences (which differ between different classes of defendants and different types of disclosure breaches, the principal defence for companies being reasonable investigation). For 'non-core' disclosure documents, such as press releases, the shareholder also has to establish knowledge, wilful blindness or gross misconduct by the defendant.

The limitation period on bringing civil actions is the earlier of three years after the date of the disclosure breach or six months after a press release is issued announcing that a court has granted leave to another shareholder to commence an action in respect of the disclosure breach.

A2.4 Class actions

Class actions are permitted, subject to prior court approval to prevent 'strike suits' or other unmeritorious or frivolous litigation. A court can grant leave for an action to proceed where it is satisfied that the action is being brought in good faith and that there is a reasonable possibility that the plaintiff will succeed, based on an initial review of the information from both sides. An action cannot be discontinued, abandoned or settled without the approval of the court.

A2.5 Calculation of damages

The legislation specifies rules for calculating damages, basically being the difference between the market price of the shares acquired or disposed of at a time when the public disclosure record of the company was inaccurate and the market price of the shares after the disclosure record had been corrected (discounted for any change in market price for reasons unrelated to the disclosure breach).

A2.6 Cap on damages

Damages may be recovered for the loss caused by breach of the disclosure obligation, subject to certain limits. The cap on the company's liability is the greater of 5% of its market capitalisation or Can\$1 million. There are also various caps on the liability of any other involved persons, including officers and directors, though these caps do not apply to individuals who knowingly make a false disclosure or fail to disclose. The court may apportion liability.

The rationale for having a cap on a company's liability for breach of the disclosure requirements in the secondary market, but no corresponding cap on a company for disclosure breaches in the primary market, as explained in the Report that led to the enactment of these provisions, is that:

in a primary offering, an issuer receives funds from the offering that can be used to compensate investors who have bought securities from the issuer and who have been prejudiced by a misrepresentation in a prospectus. In secondary market trading, an issuer receives no proceeds and it is ultimately the shareholders of the company who will bear the costs of a damages award against the issuer where there has been a misrepresentation in a continuous disclosure document.¹⁷⁶

¹⁷⁶ Five Year Review Committee Final Report *Reviewing the Securities Act (Ontario)* (March 2003), at 132.

Appendix 3 Powers to assist the handling of multiple claims

This appendix outlines possible judicial powers to assist the process of considering claims by aggrieved shareholders if the current priority of those claims is maintained. It is referred to in Section 4.5.2 of the report.

A3.1 Single determination of a common issue

An approach to assist the court in dealing with shareholder claims could involve:

- providing for a single proof of debt on behalf of all aggrieved shareholder 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 provision for employees¹⁷⁷)
- requiring aggrieved shareholders to lodge their claims by a certain cut-off date, with appeals from any decision of the external administrator on the proofs of debt being consolidated in a single action.

These initiatives would avoid the external administrator becoming involved in multiple court actions arising from similar shareholder claims. 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 shareholders 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 claimant has to prove reliance.

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

¹⁷⁷ Corp Reg 5.6.45(1).

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 defendants under the rules of the State Supreme Courts¹⁷⁸ and the Federal Court.¹⁷⁹

A3.1.1 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 group¹⁸⁰ where:

- the claims of group members arise out of, or are in respect of, the same, similar or related circumstances¹⁸¹
- there is a substantial common issue of law or fact.¹⁸² In the case of shareholder claims, this issue may be whether the 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).

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

- the specification of common questions,¹⁸³ the answers to which can be expected to be common to all the claims of the represented parties¹⁸⁴

¹⁷⁸ For instance, *Supreme Court (General Civil Procedure) Rules 2005* (Vic) Order 9, *Uniform Civil Procedure Rules 2005* (NSW) Part 6 Division 5.

¹⁷⁹ Federal Court Rules Order 6 Rule 2.

¹⁸⁰ s 33C(1)(a).

¹⁸¹ s 33C(1)(b).

¹⁸² s 33C(1)(c). See *Symington v Hoechst Schering Agrevo Pty Ltd* (1997) 78 FCR 164.

¹⁸³ s 33H(1)(c).

¹⁸⁴ *Bright v Femcare Ltd* (2002) 195 ALR 574; [2002] FCAFC 243 at [14] per Lindgren J.

- 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 party¹⁸⁵ (though once the litigation develops past the initial common questions, the matters may need to become more particularised¹⁸⁶)
- 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 subgroups¹⁸⁷ or orders fragmenting the proceedings into individual hearings once the common issues have been determined¹⁸⁸
- a requirement to notify group members of an application for court approval of a settlement.¹⁸⁹ As settlements bind all plaintiffs, the court, when presented with a proposed settlement for approval,¹⁹⁰ must ascertain whether it represents a fair and reasonable compromise of the claims made on behalf of the group members.¹⁹¹

A3.1.2 Joinder of multiple parties

The Rules of the Federal Court allow for an order for the joinder of claimants in an appropriate case.¹⁹² The 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.¹⁹³ It has been held¹⁹⁴ that the court, when exercising its discretion, should be satisfied that:

- joinder is unlikely to result in unfairness to any party

¹⁸⁵ 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]; *Williams v FAI Home Security Pty Ltd (No 2)* [2000] FCA 726 at [17].

¹⁸⁶ *Bright v Femcare Ltd* (2002) 195 ALR 574; [2002] FCAFC 243 at [52]-[55], [60]-[64].

¹⁸⁷ s 33Q.

¹⁸⁸ s 33R.

¹⁸⁹ s 33X(4).

¹⁹⁰ s 33V.

¹⁹¹ *Lopez v Star World Enterprises Pty Ltd* [1999] FCA 104 per Finkelstein J.

¹⁹² Order 6 Rule 2.

¹⁹³ *Bishop v Bridgelands Securities Ltd* [1990] FCA 410 per Wilcox J.

¹⁹⁴ *ibid.*

- 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,¹⁹⁵ or otherwise where the court grants leave.¹⁹⁶

A3.2 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 deceive) in one proceeding constitutes a rebuttable presumption in subsequent proceedings that involve a determination of the same question of fact.¹⁹⁷

¹⁹⁵ 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.

¹⁹⁶ Leave was required in *Dean-Willcocks (as liquidator) v Air Transit International Pty Ltd* (2002) 42 ACSR 328 per Austin J.

¹⁹⁷ cf s 588E.