LAW COUNCIL OF AUSTRALIA INSOLVENCY AND RECONSTRUCTION COMMITTEE SUBMISSION TO THE CORPORATIONS AND MARKETS ADVISORY COMMITTEE: SONS OF GWALIA SEPTEMBER 2007 DISCUSSION PAPER

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

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

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

3. A United States commentator has noted *"[a]n almost axiomatic principle of business law is that, because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the businesses' collapse up to the full amount of their investment."*[1]

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

4. A similar point was made by the Canadian Parliament's Standing Senate Committee on banking, trade and commerce in November 2003,[2] which stated (at p 159):

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

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

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

   (a) buying shares with a view of profit carries concomitant benefits and risks of a character entirely different to those assumed by a trader

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

expecting payment from a company for the supply of goods and services; and

(b) a company is an artificial creation of which all the shareholders are owners and therefore, in that sense, not in an external relationship with the company.

7. Allowing shareholder claims is unfair. The unfairness is not only as between shareholders and ordinary trade creditors (who are not taking risks in order to make capital profits) but also, as Callinan J pointed out in *Sons of Gwalia*[3] as between shareholders themselves. As Callinan J pointed out, purchasers in Mr. Margeretic's position were not the only ones to have suffered by reason of the company's failure to comply with its continuous disclosure obligations. If claims of the type allowed in *Sons of Gwalia* are to be allowed, where is the line to be drawn? What is the difference between a person in the position of Mr. Margeretic who purchases his shares soon before the appointment of administrators, and long term shareholders who have held on to their shares in ignorance of the true position? If all such shareholders can claim, corporate cannibalism will be the consequence: shareholders suing the company – in ultimate effect, themselves – to obtain compensation for a "loss" which they have all suffered.

8. In addition to the point already made concerning relative assumption of risk, a compelling reason for preventing shareholder claims is that the delays, increased complexity, increased costs and increased Court involvement, which are their inevitable consequence, are antithetical to the efficient administration of an insolvency regime. In particular, the bringing of such claims is inconsistent with the efficient working of Part 5.3A of the *Corporations Act*, which is almost universally regarded as a successful mechanism for reorganising insolvent corporations. The Committee submits that when Parliament enacted the corporate reconstruction regime which is now in Part 5.3A of the *Corporations Act*, it did so on the assumption that shareholder claims could not be brought. The ability to bring such claims is also

[3] At para [256].

inconsistent with the worldwide trend towards seeking to rehabilitate corporations, and the enactment of legislation to enable this to occur readily. The only people likely to benefit in practice from shareholder claims are lawyers and accountants, who will be able to generate considerable fees from prosecuting and dealing with them, to the detriment of ordinary trade creditors.

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

10. In cases where a *Sons of Gwalia*-type claim is made, the cost and time involved in the process of assessing and admitting proofs of debt will increase, with a corresponding reduction in the amount available for distribution among creditors.[4] An administrator or liquidator is responsible for assessing and adjudicating upon creditors' claims. The scope of the duty extends beyond dealing with claims which are volunteered to the practitioner and requires him or her to invite proofs from persons who may have claims which have not been lodged.[5] The practitioner is duty bound to examine the books of the company and to notify creditors who otherwise come to his or her attention.[6] There is a boundary beyond which practitioners need not tread: an

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

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

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

administrator need not take "active steps to seek out non-obvious creditors … who had suffered economic loss only".[7] As far as shareholder claimants are concerned, the register of members provides the obvious starting point for the practitioner's inquiry, but how far back must he or she go in identifying shareholders who might assert a claim against the company? In what circumstances might it be said that such a duty arises? The individual circumstances of particular shareholders may give rise to a wide variety of dates at which the relevant cause(s) of action against the company arose.

11. The difficulties faced by practitioners in determining whether and in what circumstances there might be an obligation to notify potential claimants might be said to be minor compared to the task they face in assessing and determining claims once made. Once details of a claim are determined and a proof is lodged, the administrator's or liquidator's duty is to act "quasi-judicially" and according to standards no less than those required of a court.[8] It is in the nature of the collapse of such companies that many such claims are likely to emerge. For example, as at June 2007, some 5,344 shareholder claims had been made in the Sons of Gwalia administration, claiming a total of $250.5 million.[9] The administrators of a deed of company arrangement in the administration of Ion Ltd have reported that more than 3,200 shareholder proofs have been lodged in that administration, totalling $122 million.[10]

12. The complexity involved in "acting judicially" in determining each shareholder's claim imposes a heavy burden on practitioners. One practitioner has said that the burden "threatens the objective" of s.435A of the Corporations Act of maximising the chances of the company or its business continuing in existence, and undermines speed, which is another of the foundational objectives of Part 5.3A.[11]

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

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

9 Ferrier Hodgson, *Deed Administrators' Report: Sons of Gwalia and Certain of Its Subsidiaries*, 14 June 2007, 25. <http://www.ferrierhodgson.com.au/download.cfm?section=case_profile&objectID=2480>

10 McGrath + Nicol, *Ion DOCA Group Deed Administrators' Update*, 20 September 2007, 2. <http://www.mcgrathnicol.com/currentprojects/ion/Documents/Creditors%20Information/Creditor%20Updates/D.14-070920-ION-Deed%20Administrators%20Update.pdf>

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

13. The obligation to act judicially in the determination of such claims means that the practitioner must assess the circumstances of each individual (according natural justice to the claimant where necessary).[12] In claims for misleading and deceptive conduct such as those the subject of *Sons of Gwalia*, the shareholder must convince the liquidator or administrator that relevant conduct occurred; that the conduct caused some loss (usually loss connected with the purchase or sale of securities at prices affected by that misconduct); and of the quantum of loss suffered. The nature of such claims means that each shareholder will invariably rely on different circumstances. The shareholders' task is not necessarily an easy one: the decision of Gzell J in *Johnston v McGrath*[13] provides an example of a shareholder who was unable to prove the necessary causation. Those difficulties offer no comfort for the practitioner who must create, administer and execute a regime which accords the appropriate level of analysis and determination to each individual claim. It is not unforeseeable that the cost of adjudication may in some cases exceed the value of the claim itself.[14] Absent some "fraud on the market" mechanism, it might be difficult to determine claims on a group basis, as matters of causation and reliance will differ in every case. Even if a fraud on the market rule were in place, breaks in the chain of causation might emerge from the facts of an individual case, requiring the issue of causation to be considered by the liquidator or administrator. With those difficulties in mind, the prediction that the Sons of Gwalia ruling might cause a year's delay in making a distribution to creditors in the Ion Group administration[15] seems optimistic.[16] It seems likely that alternative compromise-based solutions to resolving high volume, low-quantum claims (such as that now proposed by the Sons of Gwalia deed administrators[17]) will become prevalent pending any legislative intervention.

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

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

14 More than 75% of the shareholders' claims made in the Sons of Gwalia deed administration are for amounts of $20,000 or less. Almost 30% of the claims are for $5,000 or less: Ferrier Hodgson, *Deed Administrators' Report: Sons of Gwalia and Certain of Its Subsidiaries*, 14 June 2007, 26. <http://www.ferrierhodgson.com.au/download.cfm?section=case_profile&objectID=2480>

15 Sexton, 'Gwalia ruling could set Ion payout back a year', *The Age*, 2 February 2007.

16 See generally McGrath + Nicol, *Ion DOCA Group Deed Administrators' Update*, 20 September 2007, 2. <http://www.mcgrathnicol.com/currentprojects/ion/Documents/Creditors%20Information/Creditor%20Updates/D.14-070920-ION-Deed%20Administrators%20Update.pdf>

17 Ferrier Hodgson, *Deed Administrators' Report: Sons of Gwalia and Certain of Its Subsidiaries*, 14 June 2007, 26-27. <http://www.ferrierhodgson.com.au/download.cfm?section=case_profile&objectID=2480>

14. The Committee supports a change in the law to reflect what it described as "option 2" in the Discussion Paper.[18] This is broadly consistent with the law as generally understood prior to *Sons of Gwalia*, which was that such claims were excluded from proof but could be taken into account for the purposes of the final adjustment of rights of contributories amongst themselves and, to that extent, a member with a claim of this kind, against the company occupied a preferred position to other members: *Webb Distributors* at pp 35, 38-39. Members having such claims would not be entitled to lodge a proof of debt or otherwise participate in the insolvency unless and until all creditors had been paid in full. It perhaps goes without saying that the Committee would not support the introduction of a "fraud on the market approach" as suggested in paragraph 9.2 of the Discussion Paper if the law were changed to option 2. The Committee agrees that if option 2 were adopted, "equity-linked claims" should also be subordinated.[19]

15. 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.[20] The point is that shareholders should not be entitled to, in economic effect, sue themselves. The Discussion Paper notes that the potential for such claims against directors may give shareholders indirect access to corporate assets, given that directors may, subject to various statutory restrictions, have indemnity rights against the company which may in turn have insurance covering its liabilities to the directors. This may or may not be so. However, in the event that it were to be a problem in practice, it would be open to insurance companies to change the wording of new policies.

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[18] At para [7.5].
[19] See para [7.4.2] of the Discussion Paper.
[20] See para [2.4.1] of the Discussion Paper.

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

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

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

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

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

    (a) the enactment of Part 6CA of the Corporations Act/Law which created an obligation upon publicly listed companies to givve continuous disclosure; and

(b) the enactment of section 1041H which created a statutory cause of action for misleading and deceptive conduct with respect to financial products with the Corporations Act.

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

21. A person's ability to prove as a creditor should not depend upon issues of luck or timing, which would be the consequence if shareholder were unable to prove. For example, Mr A and Mrs B are both shareholders in and sellers of shares in X Ltd. At the same time, they place sell orders for their shares. X Ltd has failed to inform the market that six months ago a major contract had fallen through and it is likely to become insolvent unless the contract is replaced. Had they known this, both A and B would have cancelled any reserve on their shares in X Ltd. Shares in X Ltd are the subject of a trading halt and the company is subsequently placed into voluntary administration. Prior to the trading halt, Mrs B's sell order is satisfied, but Mr A's is not. Why should A not he able to seek compensation for the loss which Mrs B, by luck alone, has been able to avoid?[21]

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

23. As to the conduct of insolvency administrations, there is no difference between shareholder claims for misleading conduct and other claims that an

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

insolvency practitioner must adjudicate which arise out of similar causes of action, particularly where they involve consumer claims eg class actions.

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

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