CASE NOTES

MEMBERS AS CREDITORS: *SONS OF GWALIA LIMITED* FEDERAL COURT APPEAL UNSUCCESSFUL.

Sons of Gwalia Limited (Administrators Appointed) v Margaretic (2005) 55 ACSR 365; ***Sons of Gwalia Limited (Subject to Deed of Company Arrangement) v Margaretic*** [2006] FCAFC 17 ("Gwalia").

Corporations – priority of claims –- claims against company by shareholders for misrepresentation inducing purchase of shares – whether shareholders entitled to bring such a claim – whether entitlement is postponed under s 563A Corporations Act

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1. APPEAL UNSUCCESSFUL

Sons of Gwalia Limited is currently the subject of a deed of company arrangement. An investor, Mr Margaretic had purchased Gwalia shares on the market some 11 days prior to Gwalia going into administration. He claimed he was misled by that company, and that as a consequence he had claims against the company in damages.

At first instance[1] Emmett J ruled that, if the allegation was established, Mr Margaretic was to be regarded as a creditor in the administration of Gwalia, that his claim was not to be postponed to other ordinary creditors of the company, and that even if he were to be postponed, he could still attend and vote at meetings of creditors of Gwalia. The appeal from the decision of Emmett J was unsuccessful.[2]

By judgment delivered on 27 February 2006 the Full Court of the Federal Court agreed that Mr Margaretic was a creditor and that his claim was not to be postponed. Having formed this view, it was unnecessary for the Full Court to consider the rights of Mr Margaretic to attend and vote at meetings of creditors as a creditor with postponed entitlements.

The case confirms that purchasers of shares have been given extra rights where the company in which they invest engages in misleading conduct, and that those rights have elevated their status from shareholder to creditor in the insolvent administration of a company.

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1 (2005) 55 ACSR 365, hereafter *Gwalia Appeal*.

2 [2006] FCAFC 17, hereafter *Gwalia*.

2. BACKGROUND

2.1 *Corporations Act*

The case centres around the interpretation of section 563A of the *Corporations Act 2001* (Cth) which provides as follows:

> **563A Member's debts to be postponed until other debts and claims satisfied**
> 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.

This provision is based on a provision inserted in English companies legislation in 1862.[3]

The effect of the section is that the claim of a shareholder against a company subject to winding up proceedings is postponed or subordinated to the claims of other creditors of the insolvent company, where the shareholder's claim is in that person's "capacity as a member of the company". However, subordination would not be required if the shareholder's claim against the company is not in that shareholder's "capacity as a member".

The words have been interpreted as being confined to rights of a member under a company's constitution as regulated by the companies legislation.[4] Thus they pick up dividends and analogous payments. The words do not include directors fees payable to a director who is also a member of a company and nor do the words cover a claim by a member against a company where the company undertook to find a purchaser of the member's shares but failed to do so.

2.2 English precedent

The capacity issue arose for decision in England in the 1998 case of *Soden and another v British & Commonwealth Holdings Plc and another*.[5] In that case British & Commonwealth Holdings acquired by a takeover for some £400m all the issued capital of Atlantic Computers. Subsequent to the takeover, both companies went into administration. In that administration, British & Commonwealth claimed rights as a creditor in the administration of what was its new subsidiary (Atlantic), on the basis of British & Commonwealth's claims against Atlantic for negligent misrepresentation. The claim was for £500m.

The House of Lords unanimously held, approving unanimous decisions of the judges in the lower courts,[6] that, on the assumption that British & Commonwealth Holdings could make out its claim for negligent misrepresentation, it was to be regarded as a creditor of Atlantic and, furthermore, that its claim was not subordinated but would rank equally in the administration of Atlantic with all its other unsecured creditors.

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3 *Companies Act 1862* (UK), 25 & 26 Vict c 89, s 38(7).

4 See, for example: *In re Cinnamond Park and Company, Limited* [1930] NI 47; *In re W H Eutrope & Sons Pty Ltd (in liq)* [1932] VLR 453; and *Re L B Holliday & Co Ltd* [1986] 2 All ER 367.

5 [1998] AC 298, hereafter *Soden*.

6 *Soden v British & Commonwealth Holdings plc* [1996] 3 All ER 951; *Soden v British & Commonwealth Holdings plc* (1995) 13 ACLC 3201.

2.3 Subscribing shareholders- procedural requirement to renounce shareholding

Even where a subscribing shareholder can assert that they have an entitlement other than in their capacity as a shareholder, they may not be able to press their claim without first renouncing their shareholding. Given that a shareholder is precluded from doing this where, for example, the company is being wound up, this procedural requirement can effectively be a bar to pressing a claim.

In January 2005, Finkelstein J alluded to *Soden* in his judgment in *Crosbie; Re Media World Communications Ltd v Naidoo.*[7] In that case, Justice Finkelstein said that section 563A did not apply to a company in voluntary administration. However, the Judge also held that subscribing shareholders could not bring a claim against a company in administration for fraud or misrepresentation unless they first renounced their shareholding, but that in a voluntary administration shareholders were prevented from renouncing their shareholding except to the extent a court authorised. No authorisation was given in that case. A procedural requirement thus prevented the subscribing shareholders in that case in pressing their claim and obtaining the status of creditors.

In the subsequent case of *Cadence Asset Management Pty Ltd v Concept Sports Limited,*[8] (14 September 2005), the same Judge held that subscribing shareholders were also prevented from bringing a statutory action under the Corporations Act for a false and misleading prospectus unless the contract was renounced.

The procedural requirement of renouncing the contract would not apply to a person who had bought shares on the open market. Even though none of the parties had alleged they were in such a position, the Judge, in his *Media World* judgment, said:

> …the decision of the House of Lords in *Soden v British & Commonwealth Holdings plc* [1998] AC 298 is against the administrator. There it was held that a claim for damages by a defrauded transferee shareholder is not of the same character as a claim by a defrauded subscribing shareholder. The claim of the latter is in substance a claim for the return of his capital. The claim of a transferee shareholder is the same as any other civil claim a person may have against a company, and will not either directly or indirectly produce a reduction of capital. As Lord Browne-Wilkinson, who delivered the principal speech, said (at 326): "The general body of creditors are in exactly the same position as they would have been had the claim been wholly unrelated to shares in the company". I see no error in that reasoning. Indeed, I agree with it.[9]

3. *GWALIA* AND SUBSEQUENT DECISIONS

3.1 The claims

The issue contemplated in *Media World* and *Cadence* came up squarely for decision in *Gwalia*.

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7 (2005) 216 ALR 105, hereafter *Media World*.
8 (2005) 55 ACSR 145, hereafter *Cadence*.
9 *Media World*, 111.

Mr Margaretic bought 20,000 shares in Gwalia on the open market only to discover 11 days later when the administrator was appointed that those shares were valueless.

Accordingly, Mr Margaretic alleged that Gwalia:

> had breached its continuous disclosure obligations under section 674 of the Corporations Act and ASX Listing Rule 3.1 at the time he purchased the shares, and/or

that by reason of the non-disclosure of information having a material effect on the price of the securities, Gwalia had engaged in misleading and deceptive conduct under:

> Section 52 of the Trade Practices Act (entitling him to damages under section 82 of that Act);
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> Section 1041H of the Corporations Act (with compensation payable under section 1041I of that Act if proved), and
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> Section 12DA of the Australian Securities and Investments Commission Act (which would allow damages under sections 12GF and 12GM of that Act).

By virtue of his claim, if proven, to monetary compensation, Mr Margaretic asserted that he was entitled to be treated as a creditor of the company and to all the rights of a creditor in the administration, including the rights to attend meetings of creditors of the company and to approve of Gwalia's deed of company arrangement.

He also asserted that his claim was not to be subordinated under section 563A of the *Corporations Act 2001* which was to be incorporated in the company's proposed deed of company arrangement by reference.

3.2 The decision in *Gwalia* at first instance

The administrators argued that Mr Margaretic's claim was not provable under the proposed deed of company arrangement or that, if it were so provable, it was to be postponed to the claims of ordinary creditors.

In a judgment delivered on 15 September 2005, Emmett J held that "I do not consider that the shareholder's claim is a debt owed by the company to the shareholder in the shareholder's capacity as a member of the company. If it is a debt at all, it is a debt arising as a result of the operation of the consumer protection provisions referred to above, which prohibit misleading and deceptive conduct in various circumstances."[10]

It followed from this conclusion that Mr Margaretic was to be regarded as a creditor. As a result, the incorporation of section 563A in the proposed deed of company arrangement would not require the postponement of the shareholder's claim in the course of the administration.

The Judge also ruled that all creditors (irrespective of whether or not their claim was postponed by provisions such as section 563A) were entitled to receive notice of, attend and vote at meetings of

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10 *Gwalia,* 377.

creditors of the company. The status of creditor still existed irrespective of whether or not a creditor was to be postponed to other creditors.

3.3 Cases following Emmett J's decision in *Gwalia*

In the case of *Johnson v McGrath and Ors*[11] Gzell J held that the plaintiff transferee shareholder in a company which was in liquidation had failed to establish an entitlement to damages under the *Trade Practices Act 1974*. As such it was unnecessary for him to consider the application of section 563A. Nevertheless he went on to say that the procedural requirement of shareholders having to renounce their shareholding applied equally to transferee and subscriber shareholders. As such, the transferee shareholder in that case would have been precluded from claiming his entitlement even if it could be proved. While recognising that this finding was contrary to the decision in Soden, Gzell J stated that he was bound by the decision of the High Court in *Webb Distributors (Aust) Pty Ltd v Victoria*[12] which he interpreted as applying to both subscriber and transferee shareholders.

A contrary view was taken in the appeal from the decision of Finkelstein J in Cadence,[13] which was heard by the Full Court after Emmett J had delivered his decision in Gwalia in September 2005. In a decision handed down on 16 December 2005, the Full Court overruled Finkelstein J's decision, holding that a subscribing shareholder in a company which was continuing to trade and not subject to insolvency proceedings was permitted to bring an action in relation to a false and misleading prospectus. This was despite the fact that the shareholder had sold its shares and thus could not renounce its contract of subscription with the company. The Court held that the protection to creditors afforded by the requirement that subscribing shareholders must first renounce their shareholding before they can bring a claim had been modified by section 563A. As section 563A postponed the entitlements of these shareholders, it was considered that there was no longer any need to qualify those entitlements by reference to procedural requirements. It was therefore considered that it would be inconsistent with the entitlement given to subscribing shareholders under section 563A to require them to renounce their shareholding prior to that entitlement arising. In this case no reference was made by the Full Court to the decision of the House of Lords in *Soden*.

3.4 The decision in *Gwalia* on appeal

The Full Court in *Gwalia* held that only subscribing shareholders were required to renounce their shareholding before they could bring their claim.[14] Consequently, Mr Margaretic was not precluded from bringing his claim. In response to the approach taken in the earlier Full Court's decision in *Cadence*, Finkelstein J (with whom Gyles J agreed) said:

> (t)here are, of course, several difficulties with this approach. For one thing s 563A cannot "modify" *Houldsworth's* case. Section 38(7) of the *1862 Companies Act,* which is the forerunner of s 563A, is one of the provisions that produced the rule in *Houldsworth's* case. Second, the approach is directly inconsistent with cases such as *In re Addlestone Linoleum* Co and *State of Victoria v Hodgson*, the reasoning in which was approved by the High Court in *Webb Distributors*. Finally, the result of the approach may be

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11 [2005] NSWSC 1183 (23 November 2005).
12 (1993) 179 CLR 15, hereafter *Webb*.
13 *Cadence Asset Management Pty Ltd v Concept Sports Ltd* [2005] FCAFC 265.
14 *Gwalia Appeal*, per Finkelstein J [42], Gyles J [58], and Jacobson J [111].

> capricious. It would give to a member of a company that is being wound up the ability to recover his subscription money while denying the same ability to a member of a company that is a going concern.[15]

In respect of Gzell J's decision in *McGrath*, the Full Court disagreed with the Judge's view that *Webb* applied to both subscriber and transferee shareholders. This was based in part on the statement in *Webb* that the analogous provision to section 563A "will not prevent claims by members for damages from a breach of a contract separate from the contract for the subscription for the shares."[16] Reference was also made to the subsequent analysis of *Webb* by the House of Lords in *Soden*, which confirmed the view that the decision in *Webb* applied to subscriber shareholders only.

Having established that transferee shareholders could bring a claim, the Full Court went on to hold unanimously that Mr Margaretic's entitlement, if proven, was not postponed by section 563A. His claim was not in the "capacity as a member", because membership is not a foundation of the cause of action.[17] On this basis, it was unnecessary for the Full Court to consider whether shareholders with postponed entitlements are permitted to attend and vote at meetings of creditors.

3.5 Appeal to the High Court of Australia

On the question of renunciation, one federal appeal court says the principle does not apply to either a subscriber or a transferee shareholder in a solvent company but that in either case the claim is postponed. By contrast another federal appeal court says that the restriction on renunciation of a shareholding does not apply to a transferee shareholder in an insolvent company and that the transferee shareholder's claim is not postponed if made out. Furthermore each decision is in part inconsistent with a decision of a State Supreme court. It is understood that the latest *Gwalia* decision will be the subject of an appeal to the High Court of Australia. In the absence of expedition, a decision in the High Court appeal is unlikely to be handed down before mid to late 2007.

4. PRACTICAL IMPLICATIONS

Press reaction has tended to suggest that this ruling constitutes a major change in the law, that it upsets the traditional balance between members and creditors, namely, that in the event of insolvency of a company, creditors are paid prior to the claims of members.[18] However, as a matter of statutory interpretation, the decision in *Gwalia* is not all that surprising when reviewed in the context of existing precedent.

Although shareholders have always been able to assert claims in insolvent administrations otherwise than in their capacity as shareholder, it seems that such claims are likely to be asserted more often than previously. More people are now aware of this option and if the facts support a case, litigation funders may be willing to support an appropriate class action by disgruntled shareholders.

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15 Ibid, [33].
16 *Webb*, 35.
17 *Gwalia Appeal*, per Finkelstein J [51], Gyles J [61], and Jacobson J [131].
18 See, for example: "Gwalia case pure gold for holders", *The Australian*, 28 February 2006; and "Hope lives for Gwalia shareholder after appeal", *SMH*, 28 February 2006.

The statutory damages regime in Australia is arguably more broadly based and easier to establish than the common law actions for deceit or negligent misstatement considered in the English cases, and this may also widen the circumstances in which such a claim may be brought in Australia. It may also be expected that listed insolvent companies such as Gwalia may be more susceptible to this type of action as distinct from non-listed companies which would not be subject to continuous disclosure obligations.

The decision has implications not only for new investors such as Mr Margaretic, but also for persons who retain their shares and who may argue that, but for the company's misleading conduct, they would have sold their shares earlier. Viewed in this light, it will be seen that the decision in theory could elevate to the status of creditor many shareholders who have purchased their shares on the market.

However, it should not be forgotten that each shareholder will have to make out the case that there has been misleading conduct or actionable non-disclosure, and that it caused them loss and then quantify their loss. Except for the clearest cases, the costs and evidence issues associated with this exercise may be a sufficient disincentive for disgruntled shareholders to take such cases forward to individual decision, litigation funders notwithstanding. That said, the mere existence of such a claim coupled with the right to vote at creditors meetings does vest in misled shareholders more practical power than was considered previously to be the case.

For current administrations it is conceivable that a disgruntled purchaser of shares may now request a place at the table to the extent there are any further distributions to be made out of the insolvent company's estate. The decision raises severe practical difficulties for administrations, not least because of the difficulty of valuing each of these individual claims and the delay in finalising administrations until such claims (especially if adjudicated on an individual basis) are properly determined.

The decision also has practical implications for issuers of subordinated debt. If proven, a claim by a shareholder on the basis of misleading conduct would mean that in certain insolvent administrations, the shareholder's claim as an unsubordinated creditor would rank in priority ahead of the claim of a subordinated creditor. In those circumstances, it would not be surprising if a subordinated creditor also attempted to elevate its position to that of an unsubordinated creditor, using arguments similar to those used by a misled shareholder.

5. LEGISLATIVE REFORM

Even though the English precedent of *Soden* does not appear to have had a significant impact on the English capital markets, a case can be made out for legislative clarification especially in light of the uncertainty and surprise which the *Gwalia* decision has generated. The decision involves the interpretation of a provision inserted into companies legislation in 1862 in a legislative and economic environment very different from that of today. When the Australian legislatures provided shareholders with additional remedies for misleading and deceptive conduct and, more recently, for breach of ASX continuous disclosure rules, no real consideration was given to the impact which these additional remedies would have on the priority of ordinary creditors in insolvent administrations.

Any proposal for reform should address the questions of:

- whether and in what circumstances, if at all, a shareholder (whether subscriber or purchaser) should be accorded the status of creditor in the insolvent administration of a company in which the shareholder has invested;
- the extent to which that shareholder may attend at and vote at meetings in the insolvent administration;
- the extent to which that shareholder's claim should rank equally with or be subordinated to the claims of ordinary creditors; and
- whether the answers to the above questions should be the same if a company is in voluntary administration, is subject to a deed of company arrangement or is being wound up.

In the United States shareholder claims associated with the acquisition of securities are subordinated to the claims of ordinary creditors in insolvent administrations. A provision was inserted into the US Bankruptcy Code in 1978[19] following a report authored by the Commission on Bankruptcy Laws created by the US Congress.[20] Prior to that time, such shareholder claims against insolvent companies were not necessarily subordinated to the claims of ordinary shareholders. However, in some circumstances shareholder creditors in the United States still have an opportunity to vote in insolvent administrations.

Following the November 2003 report of the Canadian Senate Committee on Banking Trade and Commerce,[21] a bill was introduced to the Canadian House of Commons in June 2005[22] the purpose of which was to introduce into the Canadian Bankruptcy and Insolvency Act and Companies' Creditors Arrangement Act provisions which on a winding up would subordinate a claim for damages arising from the purchase or sale of a share in a company until all other creditors had been satisfied. The Canadian bill also contemplated that shareholder creditors would not be permitted to vote in respect of a compromise or arrangement with respect to an insolvent company. The Canadian bill received royal assent on November 25, 2005, shortly before the Liberal Government fell on a non-confidence motion. As a result of the circumstances surrounding the passage of the bill, the Senate requested and received the then Liberal Government's assurances that the amendments would not be proclaimed in force prior to June 30, 2006 so that the relevant Senate committee had the opportunity to review the legislation and propose amendments. To date the bill has not been proclaimed in force. Many areas of Canada's companies legislation are based on the same English models as Australia's, so similar policy arguments in favour of legislative clarification are, in our view, applicable in Australia.

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19 *Bankruptcy Reform Act* 1978, pub. 1 no. 95-958, 92 Stat. 2549 (1978).

20 *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. DOC. NO. 93-197, 93d Cong., 1st Sess. (1973).

21 Senate of Canada, Banking, Trade and Commerce Committee, Fifteenth Report: *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangements Act* (4 November 2003).

22 Bill C-55: An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts.

6. WHAT SHOULD A CREDITOR DO IN THE MEANTIME?

Pending legislative clarification, it is suggested that financiers considering providing financial accommodation to both listed and unlisted companies consider taking security. Alternatively, such potential lenders should consider the provision of the financial accommodation at a level below the holding company level so that creditors of the holding company in respect of shares acquired in the holding company are structurally subordinated to the claims of direct lenders to subsidiaries. This could be supported by cross guarantees by other subsidiaries within the group.

In Australia, this approach may be of limited assistance if the group with which a creditor deals has given a class order guarantee. Class order guarantees involve each company in a corporate group guaranteeing to external creditors the obligations of other companies within the group, and are commonly provided in order to obtain relief from certain accounting provisions of the Corporations Act. If a shareholder has a claim against a holding company and if the holding company is a member of a group which has provided a class order guarantee, then it can be seen that this would be a means whereby those shareholders could obtain access to other companies' assets within the group and thereby destroy any structural priority accorded to financiers who had lent to subsidiaries within the group.