CASE NOTES

SONS OF GWALIA LTD v MARGARETIC*

THE SHIFTING BALANCE OF SHAREHOLDERS' INTERESTS IN INSOLVENCY: EVOLUTION OR REVOLUTION?

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[In Sons of Gwalia*, the High Court of Australia found that shareholders who had been allegedly induced into purchasing shares in a company shortly prior to its insolvency by misrepresentations and inadequate market disclosure were able to lodge claims as creditors in the company's voluntary administration. The High Court interpreted the statutory subordination provisions in the* Corporations Act 2001 *(Cth) narrowly, with the result that many shareholders will be permitted to stand alongside non-shareholder creditors (as contingent creditors) in corporate insolvencies. Whilst this has the effect of diluting the returns to unsecured creditors, it also reinforces the importance of corporate disclosure and other consumer protection laws by providing misled shareholders with a remedy during the company's insolvency. This case note discusses the High Court's decision and comments on where the ruling fits into the broader corporate insolvency landscape. The case note then looks to the future to comment on where the law of shareholder subordination may be headed.]*

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* (2007) 232 ALR 232 ('*Sons of Gwalia*').

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I INTRODUCTION

The classic decision in *Salomon v Salomon & Co Ltd* (‘*Salomon*’)[1] is authority for the proposition that a properly registered company is a separate legal entity from its owners (the shareholders) and managers (the directors and executive officers). Despite the longstanding place of *Salomon* in Australian corporate law,[2] the ramifications of the separate legal entity principle have still not yet been fully absorbed by the business or legal communities. One of the important consequences of *Salomon* is that shareholders, regardless of their control through share ownership, are not to be equated with the corporate entity.[3]

This separation between the corporation and the shareholders has been facilitated by the legislative protection of limited liability for shareholders and the increasing size and importance of equity capital markets. The limited liability of shareholders allows the creation of diversified investment portfolios, which, when combined with the increasing activity of share market trading, has greatly contributed to a dispersed share ownership in most publicly traded corporations.[4]

The social, economic and legal climate has, since the first general private corporations legislation in 1862,[5] undergone dramatic transformation.[6] In recent times, government policies have favoured encouraging even greater private investment in businesses through the large pools of investments accumulated in superannuation and the ‘Future Fund’.[7] As part of the changing economic landscape, the superannuation industry has become a ‘permanent and essential’ feature of the Australian financial system.[8] The Chairperson of the Australian Securities and Investments Commission (‘ASIC’) has recognised that ‘[n]ow, more than ever before, consumers must have confidence in the market in which they are investing and must be in a position to make informed decisions about what to invest in.’[9]

1 [1897] AC 22.

2 See, eg, *Hamilton v Whitehead* (1988) 166 CLR 121; *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424.

3 *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424, 444–6 (Gleeson CJ, McHugh, Gummow, Hayne and Heydon JJ); *Lee v Lee's Air Farming Ltd* [1961] AC 12.

4 Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 41–4.

5 *Companies Act 1862*, 25 & 26 Vict, c 89. This is the legislative ancestor of the modern *Corporations Act 2001* (Cth) in Australia. Certain provisions in Australian company law can be traced back to this legislation. In particular, s 563A dealing with shareholder subordination developed out of *Companies Act 1862*, 25 & 26 Vict, c 89, s 38.

6 For judicial observation of substantial legal changes relating to corporate responsibility over the last century: see *Re Pyramid Building Society (in liq)* (1991) 6 ACSR 405, 408–9 (Vincent J).

7 The Future Fund was established by the *Future Fund Act 2006* (Cth) to assist future Australian governments to meet the cost of public sector superannuation liabilities by delivering investment returns on contributions to the Fund. Total assets, as at August 2007, amounted to $60 billion: see Australian Government, *Future Fund* (2007) <http://www.futurefund.gov.au/>.

8 Jeffrey Lucy, ‘ASIC's Super Strategies: 2006–07’ (Speech delivered to The Association of Superannuation Funds of Australia Ltd, Sydney, 6 September 2006) 1.

9 Ibid.

However, if equity capital markets are to operate efficiently, market investors must possess accurate information about the companies traded on the market. Indeed, the efficient market hypothesis involves the principle that market prices reflect the value of companies based on all of the available information.[10] Therefore, Australian corporate laws have generated a plethora of corporate disclosure requirements to ensure that price-sensitive information is released to the market in a timely manner and remains accurate. These requirements include continuous disclosure[11] and transaction-specific disclosure obligations.[12] The rules formulated in these disclosure laws are enforceable by a range of both public and private remedies.[13]

However, the creation of private remedies for defective disclosure generates a tension with longstanding priority rules in insolvency. Where a company enters insolvent administration, the law has a well-established system of priorities that favours unsecured creditors over members of the company (that is, shareholders).[14] Members of a company are prohibited from lodging proofs of debt if they have outstanding amounts owed to the company.[15] Furthermore, s 563A of the *Corporations Act 2001* (Cth) prohibits the payment of debts owed to members, in their capacity as members, before creditors' claims have been fully satisfied. If the company is insolvent, it is therefore likely that debts owed to members will not be repaid, because an insolvent company is, by definition, unable to satisfy all of its creditors' claims with its assets.

There is an inherent tension involved in granting investors' rights to enforce proper disclosure practices and compensatory remedies for breach of those disclosure requirements on the one hand, with the subordination of debts owed to shareholders in insolvency on the other. After all, it is during the company's insolvency that shareholders misled into buying into a failing company by inaccurate, or even fraudulent market disclosure practices, will require protection as their investments will be lost as a result of the company's insolvency.

Several recent decisions have examined the scope of the rules subordinating shareholder claims in insolvency. The pinnacle of these developments has been the recent decision of the High Court of Australia in *Sons of Gwalia*.[16] That case decided that shareholders claiming damages for statutory misrepresentation which induced their purchase of shares over the secondary market were not owed a debt in their 'capacity as a member'[17] and therefore were not subordinated by

[10] Eugene F Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383, 383.
[11] *Corporations Act 2001* (Cth) ch 6CA.
[12] See, eg, *Corporations Act 2001* (Cth) ch 6D.
[13] For public enforcement, ASIC has general administration of the *Corporations Act 2001* (Cth): at s 5B. ASIC may seek remedies for breaches of the Act, including injunctions (s 1324), pecuniary penalties (s 1317G), compensation orders (ss 1317H, 1317HA) and disqualification orders (ss 206C, 206F). For private enforcement: see, eg, *Corporations Act 2001* (Cth) ss 729 (defective disclosure documents under ch 6D), 1317H, 1317HA (compensation orders), 1324 (injunction and/or damages).
[14] *Corporations Act 2001* (Cth) s 556.
[15] *Corporations Act 2001* (Cth) s 553A.
[16] (2007) 232 ALR 232.
[17] *Corporations Act 2001* (Cth) s 563A.

s 563A. This decision allows shareholders of companies that breach corporate disclosure requirements to claim status as contingent creditors in corporate insolvency.

The implications of the High Court's decision in *Sons of Gwalia* are immense and are discussed below in Part IV. While the elevation of the status of shareholders to that of unsecured creditors where they have claims in certain circumstances for damage caused by defective disclosure practices has been welcomed by shareholder groups, it has drawn adverse reactions from other sectors of the commercial community.[18] Certainly, loud calls have been made in the media for law reform that models Australian insolvency law along the lines of § 510(b) of the United States *Bankruptcy Reform Act*[19] with its clear emphasis on a 'members come last' policy. The polarised reaction to *Sons of Gwalia*, together with the strong dissent of Callinan J, further demonstrates that parliamentary intention regarding the appropriate delineation between the rights of creditors and investors during insolvency remains unclear. This has led to the matter being referred to the Corporations and Markets Advisory Committee ('CAMAC'), which has been asked to consider what should be the appropriate balance between investor and creditor rights in insolvency, and will be discussed below in Part V.

The aim of this case note is to examine the High Court's reasoning in *Sons of Gwalia* and to discuss the possible impact of the decision on Australian corporate law. Furthermore, we will comment on the possible future development of the law regarding the treatment of shareholder claims in insolvency. However, first it is appropriate to discuss briefly the decisions of the lower courts leading to *Sons of Gwalia*, and other related cases, in order to properly contextualise the High Court's decision.

II Background to the Decision

A *The Facts*

The *Sons of Gwalia* litigation involved a damages claim made by a shareholder (Luka Margaretic) of the Sons of Gwalia Ltd gold mining company, a publicly listed company on the Australian Stock Exchange ('ASX'). The damages claim was based upon allegedly misleading or deceptive conduct and a failure to comply with the company's continuous disclosure obligations. The relevant conduct involved statements made by the company's management to the ASX regarding the level of the company's gold reserves. The accuracy of this information was relevant in the following way. The company had entered into a number

[18] See, eg, Christopher Dalton, *Executive Comment:* Sons of Gwalia *Decision Undermines Clarity for Debtholders and Wider Australian Debt Market* (7 February 2007) Standard & Poor's <http://www2.standardandpoors.com/portal/site/sp/en/ap/page.hottopic/sons_of_gwalia_viewpoint_2_12_hottopic/3,1,1,0,0,0,0,0,0,0,0,0,0,0,0,0.html>.

[19] *Bankruptcy Reform Act*, 11 USC § 510(b) (2000 & Supp V, 2005) ('*Bankruptcy Code*'). See, eg, Australian Bankers' Association, 'Australian Bankers' Association Supports CAMAC Examination of *Sons of Gwalia* Ruling' (Press Release, 8 February 2007). Cf ABC News Online, *Shareholders' Group Welcomes High Court Win* (31 January 2007) ABC News Online <http://www.abc.net.au/news/newsitems/200701/s1837183.htm>.

of gold forward contracts, which required the company to supply gold to various parties in the future. However, the price of gold had risen dramatically. This would result in the company suffering substantial losses if it had to buy gold on market to satisfy its forward gold delivery contracts. The company, with its gold reserves being inadequate, found itself in this worst case scenario. The company subsequently announced that its statements regarding the gold reserves were incorrect. The share price collapsed, with disastrous consequences. The company could no longer continue as a going concern, prompting the directors to appoint a voluntary administrator. Subsequently, the ASX removed the company's shares from the official trading list, which reduced the value of Margaretic's share investment to zero.

Margaretic lodged a proof of debt with the company's administrators, claiming that the company's incorrect statements breached market disclosure laws,[20] including the obligation not to engage in misleading or deceptive conduct,[21] and had induced him to purchase shares in the company. His compensation claim sought to recover the cost of his shares plus brokerage (approximately $20 000). Margaretic's claim was supported by the publicly listed litigation funder, IMF Ltd.

The administrators rejected Margaretic's proof of debt and sought court declarations in the Federal Court that his claim was either prohibited by the rule in *Houldsworth v City of Glasgow Bank* ('*Houldsworth*'),[22] or was otherwise subordinated by s 563A of the *Corporations Act 2001* (Cth). Margaretic filed a cross-claim seeking a declaration that he was a creditor for the purposes of the company's voluntary administration and was therefore entitled to vote at the creditors' meeting. The administrators' actions were part of a test case to decide on the status of close to 1000 shareholders in a position similar to that of Margaretic. The findings of the trial judge and the appeal court in the *Sons of Gwalia* litigation in the Federal Court are outlined below.[23]

B *A Short History of the Legal Issue*

The High Court's decision in *Sons of Gwalia* is significant because it overturns the conventional view that shareholders should not be permitted to prove in a winding up in competition with the rights of non-shareholder creditors. This view is encapsulated in the rule in *Houldsworth* which prohibits shareholders who have not rescinded their shares and removed themselves from the register of members prior to the winding up from proving in a winding up until creditors' claims are fully satisfied.[24] The rule in *Houldsworth* had been accepted in Australia for the past 120 years, and was applied in the past by a differently constituted High Court in *Webb*. In that case, the majority of the High Court

20 *Corporations Act 2001* (Cth) s 674.
21 See *Corporations Act 2001* (Cth) s 1041H; *Australian Securities and Investments Commission Act 2001* (Cth) s 12DA; *Trade Practices Act 1974* (Cth) s 52.
22 (1880) 5 App Cas 317.
23 See below Part II(B)(2), (4).
24 *Webb Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR 15, 31–3 (Mason CJ, Deane, Dawson and Toohey JJ) ('*Webb*').

ruled that subscribing shareholders involved in the collapse of the Pyramid Building Society could not lodge proofs of debt in the company's liquidation due to the equivalent of s 563A, which the Court said embodied the rule in *Houldsworth*.[25]

However, in 2004, doubts began to develop among some members of the judiciary about the continuing application of *Houldsworth* in Australia. The doubts arose out of obiter comments made by Finkelstein J in *Re Media World Communications (admin apptd)* ('*Media World*'),[26] where his Honour stated that *Houldsworth* only applied to shareholders who subscribed for shares from the company, and did not apply to transferee shareholders who purchased their shares over the secondary market. These comments were soon picked up in the subsequent *Cadence Asset Management Pty Ltd v Concept Sports Ltd* ('*Concept Sports*')[27] class action and ultimately the *Sons of Gwalia* litigation.

In order to better appreciate the significance of the High Court's reasoning in *Sons of Gwalia*, it is appropriate to highlight the case law developments that preceded the High Court's decision.

1 *The* Media World *Decision*

In this case, the voluntary administrator of the Media World Communications technology company sought directions in the Federal Court in relation to subscribing shareholders who claimed damages as a result of alleged misrepresentations made by the company in its prospectus. The administrator applied for directions that the shareholders were precluded from lodging proofs of debt as a result of the rule in *Houldsworth*.[28] Finkelstein J granted declarations that the subscribing shareholders were not 'creditors' of the company and could not, therefore, lodge a proof of debt in the company's administration.[29] The rationale for the decision was founded on the rule in *Houldsworth* which prevents a shareholder from seeking damages without first rescinding their shareholdings (which is impossible once the company becomes insolvent).[30]

Having granted the declaration, Finkelstein J then addressed a further question raised by the administrator regarding the status of transferee shareholders. This was, of course, strictly obiter given the initial order was already granted, and there were in fact no transferee shareholders that had sought to lodge proofs of debt. However, his Honour stated that any transferee shareholders that may come forward would not fit within the scope of the rule in *Houldsworth*, and would not therefore be prevented from lodging a proof of debt.[31] This was based on the fact that a transferee shareholder could not rescind their share purchase because their contract was not with the company, but with another shareholder. Secondly, the rule in *Houldsworth* is based (at least in part) on the maintenance of capital doctrine, and (so stated his Honour) a claim for damages by a transferee share-

[25] Ibid 31–6 (Mason CJ, Deane, Dawson and Toohey JJ).
[26] (2005) 216 ALR 105, 111–12.
[27] (2005) 55 ACSR 145, 151 (Finkelstein J); revd (2005) 147 FCR 434.
[28] *Media World* (2005) 216 ALR 105, 107 (Finkelstein J).
[29] Ibid 107–11.
[30] Ibid 109–10 (Finkelstein J).
[31] Ibid 111.

holder does not involve a reduction of capital so the company's creditors are not prejudiced. This point drew support from the House of Lords' decision in *Soden v British & Commonwealth Holdings plc* ('*Soden*'),[32] where it was held that a transferee shareholder is not subordinated under the English equivalent of s 563A.

The decision in *Media World* created a storm of controversy, with major corporate debt providers arguing that allowing transferee shareholders to claim as unsecured creditors would substantially dilute returns.[33] This, they alleged, would make unsecured lending more risky and would raise the cost of corporate debt in Australia, particularly from US lenders because the US *Bankruptcy Code* strictly subordinates both transferee and subscribing shareholders in insolvency.[34] The controversy that followed *Media World* intensified when Margaretic succeeded in the *Sons of Gwalia* case.

2 Sons of Gwalia Ltd (admin apptd) v Margaretic

At first instance, Emmett J dismissed the administrators' application and granted the shareholder's cross-claim.[35] This allowed Margaretic to prove (and vote) as an unsecured creditor in the company's voluntary administration. His Honour's reasons were based on his view that the rule in *Houldsworth* and its subsequent application by the High Court in *Webb* were restricted to cases where the shareholder was, in effect, seeking to rescind their contract with the company.[36] As the High Court in *Webb* had stated that the rule in *Houldsworth* was incorporated into the predecessor of s 563A, the phrase 'debt owed in his or her capacity as a member' in s 563A was limited to shareholders claiming amounts under a direct contract with the company.[37]

This interpretation effectively restricted the statutory subordination provision to subscribing shareholders purchasing shares through a prospectus. Furthermore, Emmett J considered that a right to damages arising from the breach of statutory misrepresentation provisions (such as s 1041H of the *Corporations Act 2001* (Cth)) is not a 'debt owed in his or her capacity as a member', but is rather a debt arising because of statutory consumer protection provisions.[38] Clearly, in his Honour's view, the Parliament had made a choice to favour investor protection over established priority rules in insolvency law. This issue was raised in the *Concept Sports*[39] class action, which involved an allegedly defective prospectus

32 [1998] AC 298, 326 (Lord Browne-Wilkinson).
33 Luke Bentvelzen, Belinda Bible and Elisabeth McDermott, '*Media World*: Using a Pocket Watch in the Digital Age' (2006) 24 *Companies and Securities Law Journal* 161, 165.
34 Stephen Bartholomeusz, 'Court Ruling Sends Shock Waves through Global Investment', *The Age* (Melbourne), 12 February 2005, Business 1; David Clifford and Kenneth Tang, 'Over-Reaction to the *Media World* Case' (March 2005) *Focus* 1.
35 *Sons of Gwalia Ltd (admin apptd) v Margaretic* (2005) 55 ACSR 365, 378.
36 Ibid 376.
37 Ibid 376–7 (Emmett J).
38 Ibid. Similar statements were made in obiter in *Johnston v McGrath* (2005) 195 FLR 101, 112 (Gzell J).
39 (2005) 55 ACSR 145; revd (2005) 147 FCR 434.

and was decided at the same time as the original decision in *Sons of Gwalia Ltd (admin apptd) v Margaretic*.[40]

3 *The* Concept Sports *Litigation*

In this case, the shareholders claimed damages under ss 728 and 729 of the *Corporations Act 2001* (Cth) on the basis of an allegedly defective profit forecast contained in the company's prospectus. The company had failed to reach its profit forecasts by a considerable margin and the share price had plunged well below the issue price. Cadence Asset Management Pty Ltd (through a trustee) had sold shares in the company that it had subscribed for through the prospectus and claimed, as damages, the difference between the subscription price and the sale price. As part of its case, Concept Sports Ltd argued that the shareholders could not sue for damages as a result of the rule in *Houldsworth*. As noted above, the rule prohibits a shareholder who has not rescinded their share contract with the company from suing for damages for misrepresentation.

At first instance, Finkelstein J held that the rule in *Houldsworth* limited the scope of ss 728 and 729 and, therefore, the shareholders could not pursue their claim.[41] This result followed from the fact that Cadence Asset Management Pty Ltd had sold their shares and could no longer rescind the contract. This finding was consistent with his Honour's earlier decision in *Media World*, discussed above.

On appeal, a unanimous decision of the Full Federal Court upheld the appeal and refused to limit ss 728 and 729 by the rule in *Houldsworth*. Their Honours' reasoning on this point was based on the absence of any express incorporation of the rule in *Houldsworth* in the ch 6D fundraising provisions.[42] Their Honours held that the mischief that *Houldsworth* sought to avoid — that is, shareholders claiming back the company's capital to the detriment of creditors — was still addressed by s 563A.[43] Thus, the Court concluded that it should not read down the plain words of ss 728 and 729 which allow a claim to be brought against the company for misrepresentation inducing the purchase of shares, even where the shareholder had not rescinded their share contract with the company. Significantly, their Honours did state that s 563A would have subordinated the shareholder's claims if Concept Sports had been in liquidation, but the company was solvent.[44]

Thus, the appeal decision in *Concept Sports* accepted that s 563A applied to subscribing shareholders, but only where the company was in liquidation. Their Honours held that the rule in *Houldsworth* had been modified by ch 6D, which allowed subscribing shareholders to claim damages for a defective disclosure document even where they had not rescinded their shares.

40 (2005) 55 ACSR 365.
41 *Concept Sports* (2005) 55 ACSR 145, 150–1.
42 *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434, 446 (Merkel, Weinberg and Kenny JJ).
43 Ibid 446–7 (Merkel, Weinberg and Kenny JJ).
44 Ibid 447 (Merkel, Weinberg and Kenny JJ).

4 Sons of Gwalia Ltd v Margaretic

The administrators' appeal from Emmett J's decision to the Full Federal Court was unsuccessful.[45] All three judges delivered separate reasons for dismissing the appeal, but their reasons were largely consistent, with Finkelstein J's decision being the most detailed.

All three judges agreed that the High Court's decision in *Webb*, and therefore its construction of the predecessor of s 563A, only applied to subscribing shareholders and not shareholders who bought on market.[46] This conclusion was supported by the House of Lords' decision in *Soden*,[47] which distinguished between subscribing and transferee shareholders and treated *Webb* as a decision on the former, not the latter.[48]

Their Honours also approved of the finding in *Soden* that a claim for damages by a transferee shareholder because of statutory misrepresentation did not represent an illegal return of capital.[49] Significantly, and consistent with the subsequent High Court majority, it was held that such a claim did not fall within one of the primary foundations of the rule in *Houldsworth*.[50]

Finkelstein J also adopted the test propounded by Lord Browne-Wilkinson in *Soden* which is concerned with whether the damages arise out of the statutory contract contained in the company's constitution. Finkelstein J found that where the damages arise separately from the statutory contract, it would not be a debt owed 'in the capacity as a member' and therefore would not be subject to s 563A.[51] His Honour was fortified in this conclusion by the majority's statement in *Webb* that the predecessor to s 563A 'will not prevent claims by members for damages flowing from a breach of a contract separate from the contract to subscribe for the shares'.[52] In this case, Margaretic's claims for damages arose from general misrepresentation and market disclosure provisions and were not dependent upon his rights under the corporate constitution. Therefore, his claim was not subordinated by s 563A. This reasoning was to be influential in the High Court's decision, discussed below.[53]

Finkelstein J was also highly critical of the previous decision of the Full Federal Court in *Concept Sports*, on the basis that s 563A could not, as stated by the Full Court, modify *Houldsworth*.[54] This was because the subordination provision had existed in corporate law statutes relatively unchanged since before the

[45] *Sons of Gwalia Ltd v Margaretic* (2006) 149 FCR 227.

[46] Ibid 239–40 (Finkelstein J), 243 (Gyles J), 251 (Jacobson J). Cf *Johnston v McGrath* (2005) 195 FLR 101, 113 (Gzell J), although Gzell J's comments are merely obiter.

[47] *Soden* [1998] AC 298, 326 (Lord Browne-Wilkinson).

[48] *Sons of Gwalia Ltd v Margaretic* (2006) 149 FCR 227, 239 (Finkelstein J), 244 (Gyles J), 253–4 (Jacobson J).

[49] Ibid 241–3 (Finkelstein J), 244–5 (Gyles J), 254 (Jacobson J).

[50] Ibid 244–5 (Gyles J), 253–4 (Jacobson J). Whilst Finkelstein J did not expressly state this in his reasons, it is submitted that his Honour's acceptance of this position taken by the House of Lords in *Soden* [1998] AC 298 represents an implicit acceptance that Margaretic's claim did not involve a reduction of capital: at 239–43.

[51] *Sons of Gwalia Ltd v Margaretic* (2006) 149 FCR 227, 242–3.

[52] *Webb* (1993) 179 CLR 15, 35 (Mason CJ, Deane, Dawson and Toohey JJ).

[53] See below Part III.

[54] *Sons of Gwalia Ltd v Margaretic* (2006) 149 FCR 227, 238 (Finkelstein J).

decision in *Houldsworth*. The question as to whether *Houldsworth* continued to define shareholder subordination in light of the modern legislative scheme was a central issue for the High Court on appeal.[55]

A review of the case law thus far demonstrates that the decisions of the Federal Court appeared to involve an inconsistent approach to the rule in *Houldsworth* and its subsequent application in *Webb*, with the *Sons of Gwalia* litigation adopting a broader application compared with *Concept Sports*. The former decisions prohibited a subscribing member from proving in competition with general creditors, whilst the latter allowed subscribing members to prove their claims under ch 6D. This distinction between subscribing and transferee shareholders was later abolished by the High Court, for reasons discussed below.

It is against this legal backdrop of uncertainty on the intersection between shareholders' and creditors' rights in insolvencies that we now turn to a detailed consideration of the High Court's judgment in *Sons of Gwalia*, its implications for corporate stakeholders, the policy considerations raised, and the need for law reform, if any.

III THE HIGH COURT DECISION

The High Court dismissed the appeal by a majority of 6:1 with each judge giving separate reasons and Callinan J dissenting. The leading majority opinions were given by Gleeson CJ and Hayne J, with whom the rest of the majority substantially agreed.[56]

Both Gleeson CJ and Hayne J allowed the appeal for essentially the same reason, namely, that the defective disclosure provisions that Margaretic relied upon to lodge his proof of debt were not limited in any way to shareholders. Statutory protective provisions such as s 1041H of the *Corporations Act 2001* (Cth) are open to any person who suffers loss as a result of misleading or deceptive conduct in financial services. Once this point was reached it became inevitable that such claims could not be said to create debts in the claimant's capacity 'as a member' and, therefore, s 563A had no operation. The point is best captured by Hayne J, who stated:

> In the present case, the obligation which Mr Margaretic seeks to enforce is not an obligation which the 2001 Act creates in favour of a company's members. The obligation Mr Margaretic 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

[55] See below Part III(A).

[56] *Sons of Gwalia* (2007) 232 ALR 232, 247 (Gummow J), 268 (Kirby J), 302 (Heydon J), 302–3 (Crennan J).

> 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 Mr Margaretic.[57]

Importantly, this finding entailed a rejection of the distinction made in the lower courts (and by the House of Lords in *Soden*) that the subordination provisions applied only to subscribing shareholders, not transferee shareholders. The above reasoning means that any shareholder (regardless of how their shares were purchased) who sought damages as a result of defective market disclosure would not be subordinated because their claims were not based upon causes of action exclusively available to shareholders (such as rights to payment accruing under the statutory contract).[58] The majority consistently stated that their task was not one of determining whether shareholders should be subordinated or whether *Houldsworth* was right or wrong. Rather, in their view it fell upon them simply to determine whether Margaretic's claimed damages were owed to him in his 'capacity as a member'. For the reasons outlined above, the majority held that they were not.[59]

The majority also addressed several significant points regarding the relationship between shareholders and creditors under the *Corporations Act 2001* (Cth), which are discussed thematically below.

A *Should Section 563A Be Limited by* Houldsworth*?*

The High Court's decision involved a number of important issues concerning the effect of *Houldsworth* on the proper interpretation of s 563A.

The majority found that the rule in *Houldsworth* did not have the same operation as s 563A. Whilst the rule operates to prohibit claims by members that are 'inconsistent' with their contract of membership, s 563A merely subordinates (or defers) the payment of those claims until after the non-member debts are fully satisfied. The majority recognised that s 563A operates on the presumption that a member is able to lodge a proof of debt even for a debt owed in their capacity as a member.[60] It is not the fact that the debt is owed to a member that attracts the operation of s 563A. Rather, it is the characterisation of the debt as one that is owed 'in the capacity as a member' that mandates subordination.[61] As noted above, the majority relied upon the fact that the claims raised by Margaretic were not limited to members of the company and therefore did not give rise to 'debts

57 Ibid 286 (emphasis in original). See also at 244 (Gleeson CJ).

58 See ibid 243 (Gleeson CJ), 248 (Gummow J). Gummow J referred to the distinction between claims by subscribing shareholders and claims by transferee shareholders as being a 'fruitless' one: at 248. Similarly, Gleeson CJ stated that such distinctions involved 'little difference': at 243.

59 Ibid 240 (Gleeson CJ), 264 (Kirby J), 269 (Hayne J). Gummow, Heydon and Crennan JJ all agreed with Hayne J on this point: at 259–60 (Gummow J), 302 (Heydon J), 305 (Crennan J).

60 Ibid 237 (Gleeson CJ), 247 (Gummow J), 265–6 (Kirby J), 278 (Hayne J), 287 (Callinan J), 302 (Heydon J). Crennan J did not decide this point specifically, but generally agreed with the reasons given by Gleeson CJ, Gummow and Hayne JJ: at 302–3.

61 Ibid 236–9 (Gleeson CJ).

owed … in [his] capacity as a member'.[62] Therefore, the majority refused to apply the rule in *Houldsworth* to the interpretation of s 563A.

Furthermore, several members of the majority were clearly unimpressed with the idea that *Houldworth* was of continuing relevance to modern Australian corporate law. Gleeson CJ stated that the principle underpinning the decision was 'elusive'.[63] Gummow J specifically rejected the notion of a common law rule arising out of *Houldsworth* that prohibited members claiming for misrepresentation damages in the company's liquidation.[64] As his Honour said, '[n]either the "principle" attributed to *Houldsworth*, nor *Houldsworth* itself, had anything to do with the presently relevant provisions of the Act'.[65] This sentiment reflects a deep-seated doubt about the majority's reasoning in *Webb*, which had found that the statutory subordination provision 'recognised' the policy of *Houldsworth*.[66] As Gleeson CJ said, such a statement involves a 'chronological curiosity' given that the wording of the provision pre-dates *Houldsworth*.[67] Thus, in the majority's view, the previous decision in *Webb* did not require the subordination of transferee claims by members in insolvency.

B *The Maintenance of Capital Doctrine*

All members of the Court agreed that the reluctance to allow members to compete with general creditors in insolvency was based, at least partly, on the maintenance of capital doctrine.[68] That longstanding principle prevented companies from reducing their capital to the detriment of creditors.[69] However, the doctrine has been criticised[70] and, in recent times, onerous restrictions on capital reductions have been relaxed under modern legislation.[71]

The majority determined that the maintenance of capital doctrine was not infringed by allowing Margaretic's claims in insolvency. In their Honours' opinion, the misrepresentation damages claim by a transferee member did not involve a claim on the company's capital.[72]

62 Ibid 286 (Kirby J).

63 Ibid 239.

64 Ibid 247–8. His Honour also specifically criticised the 'inconsistency' argument raised in *Houldsworth* (1880) 5 App Cas 317 by analysing the history of rescission for misrepresentation: at 249–55.

65 *Sons of Gwalia* (2007) 232 ALR 232, 257.

66 *Webb* (1993) 179 CLR 15, 31–3 (Mason CJ, Deane, Dawson and Toohey JJ).

67 *Sons of Gwalia* (2007) 232 ALR 232, 239. See also at 257, 260 (Gummow J), largely approved by Kirby J: at 262. Hayne J was not prepared to directly criticise the reasoning in *Webb*, but distinguished the decision on the basis that it concerned subscribing members: at 281–2. Heydon J agreed with Hayne J: at 302.

68 Ibid 236 (Gleeson CJ), 279, 281 (Hayne J), 295 (Callinan J).

69 See the discussion in R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (13th ed, 2007) 1289–91.

70 See ibid 1289, where the learned authors refer to the principle as 'defective' as a measure of creditor protection. See also John Armour, 'Legal Capital: An Outdated Concept?' (2006) 7 *European Business Organization Law Review* 5, 5.

71 Cf *Corporations Act 2001* (Cth) ch 2J with the stricter statutory equivalent in *Corporations Act 1989* (Cth) s 195, prior to the Corporate Law Economic Reform Program reforms of 1998 to share capital transactions.

72 *Sons of Gwalia* (2007) 232 ALR 232, 243 (Gleeson CJ), 262 (Kirby J), 281 (Hayne J), 305 (Crennan J).

Some members of the majority also doubted that the maintenance of capital doctrine reflected the value of modern corporations or was indeed even necessary for the protection of creditors.[73] This may be contrasted with the approach taken by Callinan J who placed great emphasis (albeit in dissent) on the protection of the company's paid-up capital. His Honour noted 'the continuing importance, relevance, indeed sanctity, of the capital, as opposed to any clearly ascertainable profits generated by it.'[74]

C *The Role of Investor Protection Laws*

Of the seven judges, three (Gleeson CJ, Kirby and Callinan JJ) paid attention to the modern trend towards enhanced investor protection in the contemporary Australian corporate landscape and the competing policy issues arising from the treatment of shareholder and creditor claims in insolvency.[75] The judgment of Gleeson CJ recognised the intersection between the rights of shareholders and creditors in insolvency and observed 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.[76]

More significantly, Gleeson CJ was alive to the resultant policy issues and the tensions that were caused by such competing interests, but was content to leave it to Parliament to resolve the following issues identified by his Honour:

> On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The spectre of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding up. Such an increase normally will 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 investors often arises only in the event of insolvency, *such protection may be illusory* if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.[77]

As the passage above demonstrates, Gleeson CJ saw the need for legislative clarification regarding where the line should be drawn to accommodate competing shareholder and creditor interests in insolvencies. In his Honour's view, s 563A did not provide for a policy of blanket subordination where all member claims must be deferred to non-member creditors in insolvency. Furthermore, if Australia were to adopt a model of blanket subordination similar

[73] Ibid 236 (Gleeson CJ). Crennan J doubted that *Houldsworth* (1880) 5 App Cas 317 supported the notion that the shareholder's claim should be subordinated so as to preserve a guarantee fund for the creditors. Her Honour stated that the decision merely acted to clarify the rights between members (as *Houldsworth* involved an unlimited company): at 303–5.

[74] *Sons of Gwalia* (2007) 232 ALR 232, 295.

[75] Ibid 262 (Kirby J). See generally at 286–301 (Callinan J).

[76] Ibid 240.

[77] Ibid (emphasis added).

to the US position,[78] Parliament would need to consider what the practical effect would be upon the rights conferred on investors in circumstances similar to those of Margaretic.[79]

The ink in the judgment was barely dry before the policy concerns flagged by Gleeson CJ were addressed by the federal government. Indeed, within a week of the High Court's decision the matter was referred to the CAMAC for 'consideration and advice'.[80]

Kirby J, in agreement with Gleeson CJ, also concluded that s 563A does not evidence any intention of adopting a 'members come last' policy (discussed further below). In support of his decision, Kirby J drew specific attention to the policy aim, rather than merely the content or operation, of the continuous disclosure laws under s 674 of the *Corporations Act 2001* (Cth). According to his Honour, one of the principal reasons for the establishment of such a law

> was the provision of protection, in circumstances such as arose in [Margaretic's] case, to persons like him. The obligation of continuous disclosure … was specifically designed and enacted to protect shareholders and potential shareholders from losses that might be suffered from undisclosed facts and to afford a foundation that would prevent, compensate for and reduce the incidence of such losses.[81]

Similarly, his Honour offered a rationale for the federal Parliament to offer shareholders a remedy for misleading or deceptive conduct. Kirby J held that such new remedies are 'designed, ultimately, to improve the protection of (and remedies available to) Australian shareholders'.[82]

Therefore, it may be said that the majority's decision reinforces the investor protection regime operating under the *Corporations Act 2001* (Cth) in times when protection measures are needed most — in insolvency. Where this might operate to reduce the return to non-member creditors, the majority's view (particularly that of Gleeson CJ and Kirby J) was that Parliament had acted to protect investors' interests, even at the expense of contract creditors.

D *Policy Issues*

In discussing policy issues involved with the allocation of risk between shareholders and creditors, and the priorities between them upon insolvency, Kirby J was sympathetic to the position of creditors and favoured subordination.

78 *Bankruptcy Code*, 11 USC § 510(b) (2000 & Supp V, 2005) provides for a 'members come last' policy by subordinating all claims for damages by shareholders arising from the purchase or sale of securities. For further discussion of subordination in the US: see Anil Hargovan and Jason Harris, '*Sons of Gwalia* and Statutory Debt Subordination: An Appraisal of the North American Experience' (2007) 20 *Australian Journal of Corporate Law* 265.

79 *Sons of Gwalia* (2007) 232 ALR 232, 240 (Gleeson CJ).

80 Chris Pearce, Parliamentary Secretary to the Treasurer, 'Pearce Asks CAMAC to Examine the *Sons of Gwalia* Ruling' (Press Release, 7 February 2007). In this press release, the Parliamentary Secretary to the Treasurer announced the referral of issues arising from the High Court decision in *Sons of Gwalia* (2007) 232 ALR 232 to CAMAC for 'consideration and advice' on the need for law reform. The three issues that CAMAC has been requested to examine can be found in the press release.

81 *Sons of Gwalia* (2007) 232 ALR 232, 262.

82 Ibid.

However, his Honour ultimately felt constrained, on the basis of statutory interpretation of s 563A, to find in favour of Margaretic's claim. Notwithstanding this conclusion, his Honour openly declared his finding to be counter-intuitive and queried whether the outcome of his judgment was surprising.[83]

This rather unorthodox approach was prompted by the speculative answer to an issue raised by his Honour, namely, what is the presumed — as opposed to the actual — general policy of the *Corporations Act*? If one were to approach the meaning of s 563A based on a presumed general policy of 'members come last' in an insolvency due to the inherent risks undertaken by a investor, Kirby J opined that it would be unsurprising if both a textual and contextual analysis of the Act favoured subordination of Margaretic's claim.[84] This view was expressed after his Honour distinguished between the different (and unequal) risks undertaken by creditors compared with investors. For such reasons, it was readily apparent to his Honour that strong policy arguments could be mounted for Margaretic's claim to be postponed to claims made by the general creditors of the insolvent company.[85]

Standing in the shoes of general creditors, for the purposes of this hypothetical, Kirby J offered the following likely inferential response to the concern that an investor was a victim of misleading and deceptive conduct and therefore deserving of protection in insolvency:

> 'By purchasing your shares in a gold mining venture, you engaged in an inescapably risky and speculative operation. Now you claim to have been deceived. But that kind of risk is one that is inherent in the very acquisition of shares in a company by which you become a member of it. You can make your claim for deception; but it ranks after the general creditors have recovered their proved losses. Your claim or "debt", if owed at all, is owed to you in your capacity as a member of the company'.[86]

Despite adopting a nuanced approach to s 563A and allowing Margaretic's claim, by rejecting the view that s 563A is premised on a 'members come last' policy, it appears that Kirby J has foreshadowed the prospect of law reform. His Honour went so far as to offer a possible amendment to redress the imbalance between shareholder and creditor rights in insolvency should Parliament think that a wrong balance was struck by the majority judgment. His Honour proposed that the phrase 'a debt owed by a company to a person in the person's capacity as a member of the company' be changed to 'a debt owed by a company to a person who is a member of the company'.[87]

Callinan J, in dissent, was prepared to allow Margaretic to prove in the administration of Sons of Gwalia Ltd as a creditor but, contrary to the majority's position, not on par with the other unsecured creditors. Callinan J was unimpressed with this outcome, principally on the grounds that the majority's

[83] Ibid 261.
[84] Ibid 263.
[85] Ibid 261–2.
[86] Ibid.
[87] Ibid 267.

construction of s 563A, and their decision, did not promote legal coherence or fairness as between the *ex ante* bargaining position of shareholders and creditors.[88]

Of the seven judges, only Callinan J placed principal emphasis on existing shareholders' rights and set out to chart the 'ample and superior statutory rights' enjoyed by shareholders to demonstrate the advantages they have over creditors.[89] For example, shareholders have the right to receive information from the company, attend and vote at company meetings, vote for or against directors, and take action against the company for oppression or against the directors under a statutory derivative action.

Callinan J, in a manner consistent with some aspects of Kirby J's analysis, gave attention to the inherent risks of investing in securities. His Honour also drew support for his view regarding the policy of s 563A from the maintenance of capital provisions in the *Corporations Act 2001* (Cth).[90]

On the basis of these considerations, Callinan J concluded that to uphold Margaretic's claim would 'sit uncomfortably' with the notion that s 563A gives shareholders equal billing with other unsecured creditors upon insolvency.[91]

Of course, the majority (particularly Gleeson CJ and Hayne J) responded by finding that s 563A was not giving 'shareholders' equal billing at all. On the contrary, Margaretic was not claiming in his capacity as a shareholder, but rather as a market participant with statutory rights to damages for improper disclosure practices. As Gleeson CJ said:

> His claim would have been the same if he had sold his shares (for example, to crystallise his loss for tax purposes) before he made the claim, or if for some reason his name had never been entered on the company's register of members.[92]

The appellants accepted in this case that s 563A would not have applied had Margaretic been able to sell his shares before he made his claim.[93] It is difficult to characterise the claim as being one owed to him 'in his capacity as a member' if membership is not an essential requirement for bringing the action.

E *Alternative Legislative Models*

Although not determinative in any way of the law as it stands in Australia, it is useful to consider and compare legislative models on debt subordination rules in other jurisdictions with a similar economic and statutory framework, to ascertain the manner in which the allocation of risk between shareholders and creditors and the priorities between them upon insolvency, have been apportioned. In common with Australia, the US, Canada and the United Kingdom have disclosure laws designed for shareholder protection with the right to sanctions

88 Ibid 300–1.
89 Ibid 295.
90 See above Part III(B).
91 *Sons of Gwalia* (2007) 232 ALR 232, 295.
92 Ibid 238.
93 Ibid 237–8 (Gleeson CJ).

for inadequate disclosure of price-sensitive information to the market. Each of those jurisdictions also has statutory or common law rules subordinating shareholder claims in insolvency.[94]

Of the seven High Court judges, three considered differing legislative schemes with reference to the experience in the US[95] and the UK.[96] Gleeson CJ, Gummow and Kirby JJ focused on the US *Bankruptcy Code*[97] which eschews shareholder claims in bankruptcy. This provision, which is underpinned by policy considerations favouring blanket subordination of shareholder claims for damages in circumstances similar to those of Margaretic, states that:

> a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such a security … shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.[98]

Gummow J examined the rationale for this legislative provision, gleaned from consideration of the legal principles underpinning the leading decision in *Re Telegroup Inc* ('*Telegroup*'),[99] delivered by the US Court of Appeals for the Third Circuit.[100] His Honour noted that Congress adjudged that shareholders should bear the risk of illegality in the issue of shares over general unsecured creditors should the company enter bankruptcy. According to *Telegroup*, it is impermissible for disappointed shareholders to use fraud and other claims 'to

[94] The US has the strongest current subordination laws in the *Bankruptcy Code*, 11 USC § 510(b) (2000 & Supp V, 2005). For discussion: see Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78. Canada has proposed amendments to its insolvency legislation to introduce even stronger subordination laws by deferring all 'equity claims' in insolvency, including preventing shareholder claimants from voting at creditors' meetings: see 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*, 1st Sess, 38th Parl, 2005 (assented to 25 November 2005, c 47). At the time of writing, Bill C-55 had been passed by the Canadian federal Parliament but not proclaimed: see Legisinfo, *Status of Bill C-55* (25 July 2007) Parliament of Canada <http://www.parl.gc.ca/LEGISINFO/index.asp?Language=E&Chamber=N&StartList=A&EndList=Z&Session=13&Type=0&Scope=I&query=4514&List=stat>. On the other hand, whilst the UK has a provision substantially similar to *Corporations Act 2001* (Cth) s 563A, *Insolvency Act 1986* (UK) c 45, s 74(2)(f) was read down by the House of Lords in *Soden* [1998] AC 298, 324 (Lord Browne-Wilkinson), in light of the statutory abolition of the rule in *Houldsworth* (1880) 5 App Cas 317 by *Companies Act 2006* (UK) c 46, s 655. See also Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78; Anil Hargovan and Jason Harris, '*Sons of Gwalia*: Policy Issues Raised by the Subordination of Shareholder Claims' (2006) 7(7) *Insolvency Law Bulletin* 1.

[95] For a comprehensive and critical review of the experience in the US and Canada: see Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78.

[96] Paul L Davies, *Gower's Principles of Modern Company Law* (6th ed, 1997) 435–42; Roy Goode, *Principles of Corporate Insolvency Law* (3rd ed, 2005) 198–200.

[97] 11 USC § 510(b) (2000 & Supp V, 2005); *Sons of Gwalia* (2007) 232 ALR 232, 240 (Gleeson CJ), 245–6 (Gummow J), 267 (Kirby J).

[98] *Bankruptcy Code*, 11 USC § 510(b) (2000 & Supp V, 2005).

[99] 281 F 3d 133 (3rd Cir, 2002).

[100] See further Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78, for discussion of *Telegroup*, 281 F 3d 133 (3rd Cir, 2002), and other leading US cases.

bootstrap their way to parity with general unsecured creditors'.[101] In reliance upon the seminal article written by law professors John J Slain and Homer Kripke,[102] the Court in *Telegroup* 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.'[103] Relying on another US academic, Gummow J found that § 510(b) 'effectively precludes an equity holder with a securities fraud claim from recovering damages from the debtor's estate for that claim.'[104]

After reviewing the wording of s 563A, Gummow J concluded that Australian law did not manifest any clear legislative policy seen in the modern legislation in the US, nor did it evidence any close legislative consideration of the ends sought to be achieved.[105]

Similarly, Gleeson CJ contrasted the clear legislative policy of the US with the absence of such clarity in the equivalent Australian provision and, without hesitation, concluded that s 563A

> does not embody a general policy that, in an insolvency, 'members come last'. On the contrary, by distinguishing between debts owed to a member in the capacity as a member and debts owed to a member otherwise than in such a capacity, it rejects such a general policy. If there ought to be such a rule, it is not to be found in s 563A.[106]

Kirby J was persuaded by this argument and endorsed the reasoning of Gleeson CJ and Gummow J on this issue. In rejecting a wider interpretation of s 563A, Kirby J[107] was also influenced by the fact that Parliament did not choose to copy a form of drafting that embodied the provisions of the *Bankruptcy Code*.[108]

Gummow and Kirby JJ also went further, in varying degrees, by reflecting on the contrasting legislative position in the UK.[109] Section 111A of the *Companies Act 1985* (UK) c 6, in direct contrast to the US position, rejects a policy of blanket subordination by providing 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.[110]

101 *Telegroup*, 281 F 3d 133, 142 (Becker CJ) (3rd Cir, 2002).

102 John J Slain and Homer 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.

103 *Telegroup*, 281 F 3d 133, 140 (Becker CJ) (3rd Cir, 2002).

104 *Sons of Gwalia* (2007) 232 ALR 232, 246. See also Zack Christensen, 'The Fair Funds for Investors Provision of *Sarbanes-Oxley*: Is It Unfair to the Creditors of a Bankrupt Debtor?' [2005] *University of Illinois Law Review* 339, 348–9.

105 *Sons of Gwalia* (2007) 232 ALR 232, 246–7.

106 Ibid 240–1.

107 Ibid 267.

108 11 USC § 510(b) (2000 & Supp V, 2005).

109 *Sons of Gwalia* (2007) 232 ALR 232, 246 (Gummow J), 266–7 (Kirby J).

110 *Companies Act 1985* (UK) c 6, s 111A.

A review of these competing models of statutory debt subordination in the US and the UK fortified the conclusions reached by Gummow and Kirby JJ that s 563A was intended to effect only a limited subordination of shareholder claims.

Hayne J, delivering the leading judgment, came to the same conclusion but did not see much value in considering other forms of statutory scheme.[111] Heydon and Crennan JJ, in endorsing the judgment of Hayne J, said nothing about the broader issue of comparative legislative models and the allocation of risk between shareholders and creditors. Callinan J addressed the latter but not the former issue.

IV IMPLICATIONS

The impact of *Sons of Gwalia* is potentially very significant.[112] The decision clears the way for all shareholders to claim in corporate insolvencies by relying upon general statutory market disclosure and misrepresentation provisions. At a minimum, the decision demands law reform to address efficiency implications on the processing of claims in insolvency. The High Court's elevation of shareholder claims against an insolvent company so that they rank equally with unsecured creditors may impact adversely on the efficient handling of damages claims for two significant reasons.

First, the practical difficulties facing insolvency administrators as a consequence of the *Sons of Gwalia* decision are unlike any difficulties that are currently raised by contingent creditors claiming damages for misrepresentation unrelated to share purchases. The reason is that *Sons of Gwalia* recognises that *all shareholders* who allegedly suffer loss as a result of the company's defective disclosure practices may be permitted to lodge a proof of debt. Whilst usual misrepresentation claims typically involve individual business claimants, shareholder misrepresentation claims may involve thousands of claimants. The administrators' experience of mass shareholder claims in Sons of Gwalia Ltd (5304 shareholders asserting aggregate damages of $242 million)[113] and in ION Ltd (3000 proofs of debt in excess of $110 million lodged by shareholders)[114] is testament to such developments impacting on the efficient administration of the insolvency regime. The resultant delays and expense offends one of the key goals of an effective insolvency system.[115]

As a result, without law reform addressing procedural issues, *Sons of Gwalia* is likely to hinder the ability of external administrations to process claims against the company efficiently and hamper the smooth administration of our insolvency laws with the least possible delay and expense.[116] Even in the absence of future reform of s 563A, it is submitted that the impact of *Sons of Gwalia* requires a

[111] *Sons of Gwalia* (2007) 232 ALR 232, 284.

[112] This Part draws on the authors' earlier article: see Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78.

[113] Ferrier Hodgson, *Report to Creditors: Sons of Gwalia Limited* (24 November 2006) 11.

[114] McGrathNicol, *Deed Administrators' Update* (15 March 2007) 5–6.

[115] Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) vol 1, 15.

[116] Elisabeth Sexton, '*Gwalia* Ruling to Delay Ion Payouts', *The Sydney Morning Herald* (Sydney), 2 February 2007, 19.

better framework for dealing with mass contingent claims in insolvency. The present law, which requires proof of causation and damage, is ill suited to the task of efficiently managing thousands of contingent claims that have not been confirmed by a court judgment.[117] Under current law and practice, which requires proof of causation in mass securities litigation,[118] liquidators and administrators will have to assess each shareholder claim individually, adding to the length and cost of external administration.[119]

Secondly, some commentators have raised the threat of the floodgates opening up for mass shareholder claims in insolvency.[120] This prospect arises because shareholders, as contingent creditors, do not actually have to prove their claim in order to take part in the distribution. Contingent creditors merely have to estimate the value of the claim and submit a proof of debt. It is therefore claimed that the modern phenomenon and growth of litigation funding in Australia may influence the growth of mass shareholder class actions.[121] In situations where the insolvent company has substantial assets, the shareholders are likely to be backed by professional litigation funders who are entitled to control litigation on behalf of the shareholders.[122]

Of course, insolvency administrators may deny all or part of the shareholder claims, but they must first consider each of the claims and may then face strong resistance (in the form of court appeals)[123] from shareholders who would otherwise have nothing to lose given the worthless value of their shares in insolvency. If successful in their claims, mass shareholder actions have the potential to dilute the assets available for distribution to other non-shareholder creditors. This prospect was recognised by Callinan J, perhaps in a more

[117] This was recognised by John Walker, writing before the High Court judgment: John Walker, '*Sons of Gwalia*: Shareholders as Creditors' (2005) 17 *Australian Insolvency Journal* 4.

[118] In contrast with the Australian position, shareholders in the US benefit from the 'fraud on the market' theory of presumed reliance. The US Supreme Court in *Basic Inc v Levinson*, 485 US 224, 241–2 (Blackmun J) (1988), accepted and explained the 'fraud on the market' theory in the following way:

> [it] is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business … Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. … The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Judicial acceptance of the theory was based on 'fairness, public policy … as well as judicial economy' resulting from a rebuttable presumption of reliance: at 245 (Blackmun J). The 'fraud on the market' theory is examined in Michael 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.

[119] In the Ion administration, the deed administrator has noted that he will need to conduct officer examinations in order to verify the facts alleged in the shareholder claims: see McGrathNicol, above n 114, 7.

[120] See, eg, Rebecca Keenan, 'High Court Hands Big Victory to Sons of Gwalia Investors', *The West Australian* (Perth), 1 February 2007, Metro 1.

[121] Cf Bernard Murphy and Camille Cameron, 'Access to Justice and the Evolution of Class Action Litigation in Australia' (2006) 30 *Melbourne University Law Review* 399, 410–11: 'A realistic appraisal of the evolution of class actions since 1990 strongly suggests that there has been no flood of litigation in Australia … the ALRC [2000] has confirmed that [such] concerns … have not materialised.'

[122] See *Campbells Cash & Carry Ltd v Fostif Pty Ltd* (2006) 229 ALR 58.

[123] *Corporations Act 2001* (Cth) s 1321.

dramatic way, when his Honour warned of claims by a large body of shareholders diluting the creditors' rights 'to less than a trickle.'[124]

We submit that it is premature to judge whether the recurring fears concerning the opening of the litigation floodgates are justifiable. However, in our opinion, the following factors mitigate the floodgate concern. Litigation funders are unlikely to commit to cases which are trivial or have little prospect of success. Furthermore, unlike the US, the 'costs follow the event' rule in Australia and the vast expense of conducting a class action will act as disincentives to pursuing unmeritorious claims.[125] Such structural differences between civil litigation practices in the US and Australia make it unlikely that Australia would experience mass class action litigation on the scale and magnitude observed in the US.

Furthermore, the decision is unlikely to be relevant to the vast majority of companies for two key reasons. First, many corporate insolvencies occur for commercial reasons simply as a result of the business risk that faced the insolvent corporations, unaccompanied by deceptive practices. *Sons of Gwalia* has no impact on such 'innocent' corporate failures. The decision does not provide a general safety net for shareholder loss occasioned by investment risk.

Secondly, the High Court's refusal to subordinate shareholder claims depended upon the statutory market disclosure and misrepresentation provisions in the *Corporations Act 2001* (Cth). It is worth remembering that one of these legislative provisions, dealing with continuous disclosure, only applies to disclosing entities (mainly listed public companies).[126] Fortunately, compared with the incidence of insolvencies experienced by proprietary companies, it is relatively rare for these large publicly listed companies to go into insolvency (HIH Ltd and One Tel Ltd being notable exceptions).[127] Even if publicly listed companies were to become insolvent with increasing frequency, shareholder claims would only be valuable if the company had substantial unsecured assets. If a company had all of its assets secured to the full value of the secured loan, the company's general creditors (including shareholders such as Margaretic) would receive nothing. In such circumstances, there would be little, or no, incentive for collective enforcement action against the company by litigation funders.

Although provisions dealing with misleading or deceptive conduct in financial services, such as *Corporations Act 2001* (Cth) s 1041H and *Australian Securities and Investments Commission Act 2001* (Cth) s 12DA, could be used against proprietary companies, again, it may not be worth shareholders claiming unless the company has substantial unsecured assets. It should be noted that controlling shareholders of proprietary companies may have difficulty establishing a cause of action for misrepresentation given that they are likely to have been involved

124 *Sons of Gwalia* (2007) 232 ALR 232, 301.
125 Murphy and Cameron, above n 121, 409.
126 *Corporations Act 2001* (Cth) s 674.
127 For example, in 2004 there were 16 376 companies in some form of external administration (with many of those companies moving from one type to another). Of those companies only 616 were public companies. Given that the ASX list contains approximately 1700 companies, it is a reasonable assumption that publicly listed companies are only a small proportion of the total corporate insolvencies. The data used for these calculations was purchased from ASIC as part of an empirical study currently being undertaken by the authors.

in the process leading up to the information being disclosed. This reduces the pool of claimants to minority shareholders, but in a proprietary company there is likely to be only a small number of those aside from employees.[128] Furthermore, both employee shareholders and any significant shareholders of proprietary companies who have been misled may prefer to refrain from pursuing their misrepresentation claims and pressure the company's directors to put the company into a voluntary administration.[129] This is to facilitate a restructuring deed of company arrangement in order to save the business.

Lastly, and perhaps most significantly for the floodgates argument, the commercial reality is that litigation funders are unlikely to support shareholder claims against proprietary companies because of the small numbers of shareholders involved.

Thus, situations where the High Court's decision may potentially cause substantial adverse effects are effectively limited to a small number of public companies. Based on the discussion above, those limited circumstances will require large, dispersed numbers of shareholders with holdings in public companies with substantial unsecured assets. Stripped of the hype and hysteria generated in the press by the *Sons of Gwalia* decision, it is legitimate to query whether the frequency and magnitude of shareholders' claims will have a revolutionary effect in Australian corporate law in the circumstances described.

Aside from the impact of the decision on insolvency administrators, the ruling may have potentially adverse effects for Australian debt capital markets, specifically the pricing of corporate debt.[130] The Australian Bankers' Association has warned that lenders, including domestic banks and offshore providers of credit, could either reduce or decline loans or increase credit margins at the cost of borrowers.[131] Evidence of early research on the impact of the *Sons of Gwalia* litigation suggests that the credit spread on unsecured debt for Australian companies could increase substantially.[132] Only data and evidence over time, however, will tell if such findings and concerns are sustainable and distinguishable from the situation in the UK. The removal of *Houldsworth* does not seem to have affected investment in the corporate debt market in that country.[133] Mean-

[128] *Corporations Act 2001* (Cth) s 113(1) requires proprietary companies to have no more than 50 non-employee shareholders.

[129] *Corporations Act 2001* (Cth) s 436A.

[130] See Greg Peel and Chris Shaw, '*Sons of Gwalia*: A Frightening Decision' (2005) 78 *Australasian Investment Review* 20; William Ryback, 'Aussie Miner Ruling Fuels Fear' (20 September 2005) The Standard <http://www.thestandard.hk/news_print.asp?art_id=1685&sid=4647845>; Elisabeth Sexton, 'Shareholders Move Up Queue', *The Sydney Morning Herald* (Sydney), 1 February 2007, 23; Leon Zwier and Justin Vaatstra, 'Implications of the High Court Decision in *Sons of Gwalia*' (2007) *ABL Article* 1.

[131] See, eg, Australian Bankers' Association, '*Sons of Gwalia* Decision' (Press Release, 2 February 2007).

[132] Christine Brown and Kevin Davis, 'Credit Markets and the *Sons of Gwalia* Judgement' (2006) 13 *Agenda* 239, 249–50.

[133] David Clifford and Gareth Lewis, 'The *Sons of Gwalia* Decision: A Lender's Perspective' (October 2005) *Focus* 1. Of course, we should not assume that the capital markets in the UK are identical to those that operate in Australia. Therefore, the lack of an adverse reaction to removing subordination in the UK does not necessarily translate to a similar reaction on Australian debt capital markets.

while, at least one major credit rating agency does not expect *Sons of Gwalia* to have any major impact on Australian debt markets in the short term.[134]

V COMMENTARY

The High Court, perhaps unintentionally given that all seven judges adopted differing approaches, has articulated a policy of limited shareholder subordination based on extant law. In jettisoning the rule in *Houldsworth* and respecting the statutory consumer protection provisions in *Sons of Gwalia*, albeit based primarily on the rationale of statutory interpretation, the High Court has telegraphed the evolution of the law on shareholder subordination.

Notwithstanding these observations, *Sons of Gwalia* has generated a remarkable degree of heat and has been generally branded as revolutionary. We disagree if, by revolution, it is meant the unauthorised making of new law through disrespect of Parliament's will. Instead, we see the result as part of the substantial evolution in statutory law, in particular, relating to investor protection and remedies for wrongdoing. However, before substantiating this view, we turn our attention to the policy considerations underpinning subordination issues, followed by recommendations as to the way forward for future law reform.

A *Observations on Law and Policy*

The corporate insolvency provisions of the *Corporations Act 2001* (Cth) are arguably the most important provisions of the Act and the most important set of laws governing the corporate sector.[135] This is because the cost of capital for corporations is determined in the shadow of the risk of insolvency, and the distributional rights and priorities that flow out of the formal insolvency process. The formulation of priority rules in insolvency, and indeed the specific shareholder subordination provisions, are as old as the first modern corporate law statute in 1862.[136] They were therefore created long before the modern trend of investor protection and mandatory market disclosure laws. Despite its long heritage, it is surprising that there has been a dearth of judicial authority discussing the rationale of s 563A prior to the High Court's judgment in *Sons of Gwalia*.

Although *Sons of Gwalia* was decided on grounds of statutory interpretation, that did not prevent three of the High Court judges (Gleeson CJ, Kirby and Callinan JJ) straying into areas of policy considerations on statutory debt subordination. Both Kirby and Callinan JJ engaged in similar analysis, with Kirby J's judgment appearing to be more in sympathy with Callinan J's than with the other members of the majority.

134 Fitch Ratings, *Gwalia Shareholder Case Decision Unwelcome for Debt Markets: But No Major Impact Likely* (1 February 2007) Fitch Ratings <http://www.fitchratings.com.au/show_featart.asp?rel_id=464>.

135 Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Improving Australia's Corporate Insolvency Laws: Issue Paper* (2003) 2.

136 *Companies Act 1862*, 25 & 26 Vict, c 89, s 38. The subsequent history of this provision is discussed at length in *Sons of Gwalia* (2007) 232 ALR 232, 272–6 (Hayne J).

Sons of Gwalia highlights the inherent tension that arises from the conflict between a misled shareholder seeking damages in circumstances similar to those of Margaretic and the claims of unsecured contract creditors against insolvent companies. Some of the High Court judgments, either expressly or implicitly, raise policy questions regarding the optimal risk allocation between shareholders and creditors in insolvency. The juxtaposition of the competing views expressed in *Sons of Gwalia*, in particular by Callinan J and Gleeson CJ described below, goes to the heart of the debate on whether insolvency law should mandate a blanket shareholder subordination of securities law claims.

Callinan J, in dissent, argued unequivocally that the ample and superior rights enjoyed by shareholders preclude them from sharing on par with unsecured creditors in insolvencies. His Honour's objections rested principally on the fact that shareholders enjoy 'statutorily mandated limited liability … and their rights to participate in the bounty of any [corporate] successes'.[137] Such an approach echoes the arguments advanced by Slain and Kripke, the architects of blanket subordination in the US who also saw no obvious reason for reallocating the risk to corporate insolvency from shareholders.[138] Slain and Kripke argued that shareholders, as investors, should justifiably bear the risk of fraudulent or misleading conduct in relation to securities as they had the most to gain from the company's success.[139] This policy position was also recognised in the inferential response given by Kirby J, on behalf of general creditors discussed earlier, to the shareholder victim of misleading and deceptive conduct.[140]

Such judicial remarks by Callinan and Kirby JJ go to the core of Slain and Kripke's thesis.[141] It reflects a policy:

> to 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, when the shareholders assumed the risk of business failure by investing in equity rather than debt instruments.[142]

In contrast, Gleeson CJ presented an alternate framework for analysis which represents the opposite of the views espoused by Callinan J. The Chief Justice neatly captured the counter-argument to blanket shareholder subordination with the following observation:

> On the other hand, since the need for the protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.[143]

Significantly, the concern expressed by Gleeson CJ is similar to those expressed two decades earlier by Kenneth B Davis, a trenchant critic of the policy of

137 *Sons of Gwalia* (2007) 232 ALR 232, 295.
138 Slain and Kripke, above n 102, 287.
139 Ibid.
140 *Sons of Gwalia* (2007) 232 ALR 232, 263.
141 See Slain and Kripke, above n 102, 267–8.
142 *Telegroup*, 281 F 3d 133, 140–1 (Becker CJ) (3rd Cir, 2002), noted in *Sons of Gwalia* (2007) 232 ALR 232, 246 (Gummow J).
143 *Sons of Gwalia* (2007) 232 ALR 232, 240.

blanket shareholder subordination in the US. Davis also argues that it is in insolvency cases in which fraud is likely to be the most acute and the resultant losses to shareholders the greatest.[144]

The juxtaposition of these competing views in *Sons of Gwalia* goes to the heart of the debate on whether insolvency law should mandate a blanket shareholder subordination of securities law claims. If not, where should the line be drawn in the delineation of shareholder and creditor rights in insolvencies? The discussion below comments on these issues.

B *The Way Forward*

The way forward is for Parliament to heed the cry for certainty by clearly articulating a legislative policy which addresses the competing shareholders' and creditors' interests in insolvency. The appointment of CAMAC to explore policy options and to advise Parliament is a step in the right direction. CAMAC has been asked by the government to consider and report on the following matters:

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 unsecured creditors 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?[145]

In formulating future legislative policy, we do not advocate a general principle of postponing to the claims of general creditors all claims by disappointed shareholders against an insolvent company.

C *Rejection of Blanket Subordination*

We have argued elsewhere that a policy of blanket subordination of shareholder interests, modelled on § 510(b) of the US *Bankruptcy Code*, is undesirable from a policy perspective.[146] It is a blunt instrument that would, inter alia, frustrate the raison d'être of consumer protection laws and ignore Australia's modern corporate milieu with its increased focus on investor protection. There is a real risk, as recognised by Gleeson CJ in *Sons of Gwalia*, that current investor protection laws may be 'illusory' if the claims of those who are given the apparent benefit of legislative protection are subordinated to the

[144] Kenneth B Davis Jr, 'The Status of Defrauded Securityholders in Corporate Bankruptcy' [1983] *Duke Law Journal* 1, 3.

[145] See Letter from Chris Pearce (Parliamentary Secretary to the Treasurer) to Richard St John (Convenor of the CAMAC), 6 February 2007 <http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/$file/Ref_Sons_of_Gwalia.pdf>.

[146] Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78, 291–2.

claims of ordinary creditors.[147] A policy of blanket shareholder subordination would make a mockery of the importance of our continuous disclosure laws, with their emphasis on a preventative and compensatory role. Blanket subordination of shareholder interests, cautions Davis,[148] would strike at the heart of the compensatory objective embodied in the various securities remedies. Furthermore, a policy of blanket subordination would make insolvent companies judgment-proof in respect of securities claims, as demonstrated by the Enron and WorldCom experiences in the US,[149] and increase the risk of moral hazard through deceptive and misleading practices.

By the same token, an unfettered policy of shareholder parity with creditors' claims in insolvency would unjustifiably give shareholders the best of both worlds — gains when the company prospers and participation with creditors if it fails. Kirby J appropriately recognised the resultant unfairness in transferring shareholder investment risks to creditors in the following observation:

> investors … are not involved in the provision of goods and services to the company, as ordinary creditors generally are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks … [and] the purchase of shares will commonly entail a measure … of speculation. Such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risks.[150]

D *Limited Shareholder Subordination*

Between the two extremes of blanket subordination and total shareholder parity discussed above, we see a viable middle path which adopts a more nuanced approach to subordination that combines features of both policy options. In addressing the future shape of Australia's insolvency laws, we advocate the need for a targeted, distinctive and consequently, limited approach to shareholder subordination.

In advocating this policy option, we distinguish clearly between two types of risk. It is readily accepted that the risk of business failure not involving misleading conduct falls on the shareholder as the quid pro quo for limited liability. To that extent, we agree with the general remarks made by Callinan and Kirby JJ on the unfairness for creditors to underwrite the shareholders' speculative investment risk. In such instances, the case for shareholder subordination is justified. However, we draw a line at the risk of shareholders being misled into purchasing their shares and the policy of blanket subordination in such instances.

Within this model of limited shareholder subordination, we draw a further distinction. In particular, we advocate that newly defrauded shareholders, as

147 *Sons of Gwalia* (2007) 232 ALR 232, 240.

148 Davis, above n 144, 3.

149 See Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78, 282 for a discussion of: *Re Enron Corp*, 341 BR 141 (SD NY, 2006); *Re WorldCom Inc*, 329 BR 10 (SD NY, 2005).

150 *Sons of Gwalia* (2007) 232 ALR 232, 262–3.

opposed to existing shareholders, should not have their claims subordinated. At first blush, this model appears to be inconsistent and unfair in its treatment of defrauded shareholders. The justification for this distinction, however, arises from the informational asymmetries that exist between existing and future shareholders and general unsecured creditors.[151] As we note elsewhere,[152] new shareholders investing in the company do not, *ex ante*, have the rights and powers of existing shareholders and depend upon publicly available information to price their risk in purchasing shares. In this regard, they are in a similar position to small contract creditors (such as trade suppliers) who are unable to bargain for security rights and must rely upon publicly available information to price their risk in providing goods or services on credit.

We therefore advocate the formulation of a statutory rule that would subordinate existing shareholders from claiming misrepresentation damages in insolvency, but would allow new 'outside' shareholders to maintain such claims as unsecured creditors. Such an approach, we believe, has the added benefit of striking an appropriate balance between encouraging investor confidence in contributing additional capital to equity markets, and allaying some of the concerns in the debt capital markets because the large number of existing shareholders will be subordinated to their position.

E *The Need for Law Reform*

The effectiveness of the subordination model advocated depends on other significant accompanying reforms. First, 'process' reform will be required to maintain the principal objectives of external administration discussed above in Part IV. As part of that reform, attention needs to be focused on the optimal manner of determining 'proof' of the claim. Secondly, the civil liability provisions for involvement in the company's contravention of the continuous disclosure laws will require revisiting to achieve optimal deterrence in fraudulent conduct. This is an important consideration which underpins the limited subordination model advanced in this case note.

From a policy perspective, it is arguable that the current legal framework for statutory liability is defective. It wrongly places the emphasis on corporate liability rather than on the individuals involved in a contravention of the continuous disclosure provisions. Although the *Corporations Act 2001* (Cth) provides for liability for both parties,[153] our concern is that the current law signals a bias towards the burden of damages claims for fraudulent conduct falling onto the company, and thus in effect, on most of its innocent shareholders

[151] See further Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78, 297.

[152] Ibid.

[153] *Corporations Act 2001* (Cth) ss 674 (continuous disclosure obligation), 1317HA (compensation order may be made against a person for breach of, inter alia, s 674) allow an investor to sue both a corporation and/or a person involved in the contravention for damages for failure to maintain proper disclosure to the market. Similarly, s 1041I allows an investor to sue both a corporation and/or a person involved in the contravention for damages for misleading or deceptive conduct in relation to financial services.

rather than the managerial actors who are truly culpable.[154] This concern arises from what we see as a lacuna in the legal treatment of sanctions for directors involved in the company's failure to make mandatory disclosure.

The current law under-deters securities fraud in the following way. A breach of s 764(2A) by a director attracts the financial services civil penalty provision. In turn, this means that a defaulting director may be subjected to either a pecuniary penalty order under s 1317G or a compensation order under s 1317HA. Crucially, notwithstanding the director's involvement in the breach of the Act and subsequent defrauding of innocent shareholders who may have purchased securities, the director still enjoys the freedom to manage the corporation. Remarkably, from a deterrence perspective, the *Corporations Act 2001* (Cth) offers no protection against future fraudulent conduct for this offence through a disqualification order. The court may only disqualify a director from managing a corporation if they have breached a 'civil penalty/scheme provision'.[155] Continuous disclosure provisions, however, are 'financial services civil penalty provisions' (under s 1317DA) which means a disqualification order could not be made.[156] Furthermore, statutory misleading or deceptive conduct provisions are neither civil penalty nor financial services civil penalty provisions. Their remedies are restricted to damages,[157] which whilst offering a compensatory remedy, provide inadequate protection against future breaches.

In this way, current regulatory policy undermines the deterrence objective against fraudulent conduct by directors and consequently, to some degree, blunts the effectiveness of the model we propose. To fulfil the deterrence promise and threat, the way forward is to refocus the statutory liability provisions onto directors and other culpable insiders.[158]

This reform would go some way to ensure that the costs of fraudulent conduct in securities actions do not fall on innocent shareholders via large penalties being imposed on corporations. Instead, ideally, the cost of such fraudulent conduct, both through court penalties and also through the business cost of increased directors' and officers' insurance premiums in securities claims, should fall primarily on the perpetrators to promote a sound policy result. In advancing these views, we do not reject the role of corporate liability. It has a residual role to play in a scheme which shifts the primary liability on managers and insiders.

[154] For discussion on how enterprise liability imposes costs of fraud upon innocent shareholders: see Jennifer H Arlen and William J Carney, 'Vicarious Liability for Fraud on Securities Markets: Theory and Evidence' [1992] *University of Illinois Law Review* 691, 698–700; Donald C Langevoort, 'Capping Damages for Open-Market Securities Fraud' (1996) 38 *Arizona Law Review* 639, 648–50; John C Coffee Jr, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation' (2006) 106 *Columbia Law Review* 1534.

[155] *Corporations Act 2001* (Cth) s 206C(1).

[156] See Austin and Ramsay, above n 69, 573, where the learned authors refer to the omission of disqualification orders as 'odd'.

[157] *Corporations Act 2001* (Cth) s 1041I.

[158] Coffee, above n 154.

F *Evolution or Revolution?*

The surprising lack of judicial consideration of the rationale of s 563A (and its predecessors) prior to the High Court decision in *Sons of Gwalia* does not necessarily mean that the judicial interpretation afforded by the High Court is revolutionary. The conclusion reached by the High Court in *Sons of Gwalia* was not written from a clean slate. It is based on existing precedent (particularly the House of Lords' decision in *Soden*) and reflects, rightly or wrongly, a particular view of the implicit parliamentary intention regarding the intersection between shareholder and creditor rights in insolvency.

The majority decision in *Sons of Gwalia*, through principles of statutory interpretation, construed s 563A in a way that does not cut down or reduce the availability or effectiveness of consumer protection remedies conferred by statute. Whether intentional or not, the majority decision maintains the practical efficacy of these provisions. Viewed in this context, devoid of the hysteria, the decision in *Sons of Gwalia* is far from revolutionary. It is underpinned by protective statutory provisions which, as observed by Gleeson CJ, have now armed investors with statutory rights. Significantly, there has been judicial recognition of this trend since at least 1991.[159]

Based on the authoritative decision in *Sons of Gwalia*, and subject to CAMAC's law reform recommendations, it appears that Australian company law is evolving to a position where shareholders' protective rights are valued and enforced, albeit at the expense of unsecured creditors, in corporate insolvencies. This raises the pertinent question of whether such values are, or ought to be, permissible.

Elizabeth Warren, a respected US bankruptcy scholar notes that, '[b]y definition, the distributional issues arising in bankruptcy involve costs to some and benefits to others.'[160] It is trite to observe that enforcing the collection right of secured creditors often comes at a cost of defeating the collection rights of unsecured creditors whose claims are discharged without payment. Similarly, a priority payment to one unsecured creditor, such as an employee, necessarily leaves less for remaining creditors. Such values exist in the *Corporations Act 2001* (Cth) distributional scheme and have been given credence by Parliament.[161] Should Parliament take the next step by explicitly endorsing the value espoused by the majority judgment in *Sons of Gwalia*?

On one hand, it is arguable that the High Court's decision in *Sons of Gwalia* is sufficiently clear to render legislative amendment aimed at clarifying the position of shareholder claims unnecessary, as they currently fit within the broad notion of 'contingent creditors' for the purposes of the Act. However, on the other hand, it may be advisable (at least for the purposes of greater legislative certainty) that s 563A be amended for two reasons.

First, to explicitly confirm that the focus of shareholder subordination under s 563A is on the nature of the claim rather than on the person bringing the claim.

159 *Re Pyramid Building Society (in liq)* (1991) 6 ACSR 405, 409 (Vincent J).

160 Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 *University of Chicago Law Review* 775, 789.

161 Employee entitlements and personal injury claims have been given priority ranking in insolvency above other general creditor claims: *Corporations Act 2001* (Cth) ss 556, 560.

The seeming acceptance by the majority of the position taken in *Soden*, as well as the general tenor of the majority judgments, lends support for the view that the only claims subordinated by s 563A are those that are exclusively given to shareholders either under the Act or by the statutory contract embodied in the corporate constitution. Secondly, in support of the limited subordination model we propose, to draw a further distinction in the compensation claims between new and existing misled shareholders for the reasons advanced earlier.

VI CONCLUSION

Sons of Gwalia goes to the heart of the different philosophies underpinning risk allocation in insolvency law. The judicial uncertainty on the interpretation of s 563A has now been resolved by the High Court in favour of limited subordination of shareholders claims in insolvency. The majority High Court decision, whether intentionally or not, has exposed the hitherto buried legal path towards a legislative policy of limited shareholder subordination. Uncertainty, however, remains in some quarters of the commercial community as to whether the decision in *Sons of Gwalia* represents a sound legislative policy outcome.

We have argued for legislative amendment to ensure an appropriate balance in the allocation of risk between investors and creditors and the priorities between them upon insolvency. The approach advocated here, and elsewhere by the authors,[162] in the treatment of defrauded shareholders' claims adopts this yardstick for law reform. In advocating a policy of limited shareholder subordination, a variant on that in *Sons of Gwalia*, we aim to strike a delicate balance without resulting in a massive shift of power from creditors to shareholders in insolvencies. Simultaneously, we acknowledge the serious role that the current statutory landscape and public and private remedies, discussed earlier,[163] plays for investor protection. This is particularly significant in light of the fact that Australians have among the highest recorded levels of share ownership in the world.[164]

For the law reform model advocated to be viable and efficient, however, it must be accompanied by two other reforms. First, 'process' reforms dealing with administrative burdens and procedural matters in external administration are essential. This must be done to resolve current uncertainty and efficiency concerns, discussed above in Part IV. Until then, the absence of clear legislative intent on how to deal efficiently with the intersection of creditor and shareholder

[162] Hargovan and Harris, '*Sons of Gwalia* and Statutory Debt Subordination', above n 78; Jason Harris and Anil Hargovan, '*Sons of Gwalia*: Navigating the Line between Membership and Creditor Rights in Corporate Insolvencies' (2007) 25 *Company and Securities Law Journal* 7; Hargovan and Harris, '*Sons of Gwalia*: Policy Issues Raised', above n 94.

[163] *Corporations Act 2001* (Cth) s 553A; *Webb* (1993) 179 CLR 15, 31–3 (Mason CJ, Deane, Dawson and Toohey JJ).

[164] Australian Stock Exchange Ltd, *Australia's Share Owners: An ASX Study of Share Investors in 2004* (2005).

rights upon insolvency will remain problematic for all stakeholders (shareholders, the credit market and insolvency practitioners). Secondly, to achieve the optimal deterrence value of the policy objective advocated in this case note, it is essential for law reform to go further in transferring the burden of damages claims for fraudulent conduct from the company, and in effect its shareholders, onto the managerial actors who are truly culpable.