Can shareholders be creditors of an Australian company in administration? The Sons of Gwalia appeal and related cases

Senior Associate Della Stanley and Lawyer Gabi Crafti consider the implications of an unsuccessful appeal by the administrators and a creditor of a company in administration from a primary judge’s decision that a shareholder who acquired his shares on-market was entitled to be treated as a creditor of that company.

On 27 February 2006, the Full Court of the Federal Court of Australia (the Full Court) dismissed an appeal by administrators and a creditor of Sons of Gwalia Limited against a decision of a single Federal Court judge handed down in September last year. The issue at the centre of the appeal was, in the words of Justice Finkelstein (one of the appeal judges), ‘a point which of late has attracted some excitement within the commercial community’, namely, ‘whether a purchaser (as opposed to an allottee) of shares can in a winding up prove for damages against the company for the misrepresentation which induced the purchase.’

Section 563A of the Corporations Act 2001 (Cth) (the Act) provides that the payment of a debt owed by a company to a person, in their capacity as a member of the company, is to be postponed until all debts owed to, or claims made by, persons otherwise than as

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members of the company have been satisfied. The finding by the Federal Court at first instance (that a shareholder’s claim based on misleading conduct by the company and non-disclosure is not subject to be postponed under s563A and, therefore, will rank on an equal basis with the claims of other creditors) is what has captured the attention of the commercial community. Before the decision in the Sons of Gwalia proceeding (which has now been upheld on appeal), claims made by shareholders based on the value of their shares were liable to be postponed under s563A until the claims made by other creditors were satisfied. Unless the Full Court’s decision is overturned by the High Court or there is legislative intervention, this will no longer be the case.

**Revisiting the decision at first instance**

In AAR’s Focus: Insolvency, October 2005, we reported that Justice Emmett of the Federal Court of Australia held in Sons of Gwalia Limited (administrator appointed) v Margaretic that a transferee shareholder with a misleading conduct claim against the company (and related claims, including a claim relating to an alleged breach of the company’s continuous disclosure obligations) is a creditor who is entitled to vote and to receive information about the administration in his capacity as a creditor.

His Honour also held that s563A of the Act did not operate to postpone the shareholder’s claim until after the debts and claims of non-shareholder creditors had been satisfied.

Following the decision of Justice Emmett, the administrators of Sons of Gwalia and a non-shareholder creditor of the company lodged an appeal with the Full Court.

**Johnston v McGrath**

A week before the hearing of the Sons of Gwalia appeal, Justice Gzell of the New South Wales Supreme Court delivered judgment in Johnston v McGrath & Ors, in which he considered the following issues:

- whether in fact a company’s misleading and deceptive conduct caused one of its shareholders the loss in the value of his shares; and
- if it did, whether the shareholder’s claim was postponed to the claims of other creditors.

Having held that the shareholder had not made out his misleading conduct claim, his Honour provided his *obiter* views on the question of postponement.

Justice Gzell expressed disagreement (*in obiter*) with Justice Emmett’s decision in Sons of Gwalia regarding the postponement of transferee shareholders’ claims. He also disagreed with the comments of Justice Finkelstein in *Media World* earlier in 2005.

In Justice Gzell’s view, the claims of transferee shareholders against the company for damages in respect of misleading and deceptive conduct are postponed under s563A to the claims of non-shareholder creditors.

Justice Gzell found that:

- he was bound by the High Court decision in *Webb Distributors (Aust) Pty Ltd v State of Victoria* (Webb), which, in his view, established that:
  - damages payable by a company to a shareholder with a successful misleading conduct claim are owed to the shareholder in his or her capacity as a member of the company; and
  - postponement of shareholders’ misleading conduct claims applies to both subscribing shareholders and transferee shareholders;
- accordingly, the shareholder’s claim, if it had been made out, would be postponed under s563A until all debts of other creditors had been satisfied; and
- a shareholder with a misleading conduct claim may prove in the winding up of the company and be treated as a creditor, even if as a creditor whose claim is postponed.

**The Full Court’s decision in the Sons of Gwalia appeal**

The Full Court (Justices Finkelstein, Gyles and Jacobson) heard the Sons of Gwalia appeal on 1 December 2005 and delivered three separate, but concurring, judgments on 27 February 2006.

Essentially, there were two questions before the court:

- Is the effect of *Webb* that transferee shareholders are barred from proving in an administration in relation to their claims of misleading conduct against the company (as Justice Gzell held)?

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• If transferee shareholders are not barred from proving, are their claims postponed until the debts and claims of non-shareholder creditors are paid out?

What is the effect of the Webb case?
The Full Court had to consider the Webb case because the administrators and the creditor argued that the Full Court was bound by the High Court’s decision in Webb to find that the claims of transferee shareholders should be postponed to the claims made by other creditors.

Their Honours noted that the High Court majority in Webb had held that subscriber shareholders could not, in a winding up, prove for damages against the company for the misrepresentation that induced their share purchase so long as they remained shareholders. However, all three judges of the Full Court found that the majority in Webb had not made the same decision about transferee shareholders. Justice Finkelstein methodically listed the reasons why after a ‘good deal of consideration’ he had reached the ‘firm conclusion’ that Webb is confined to subscribing shareholders:

• First, the only issue before the High Court in Webb was whether subscribing shareholders could prove for damages in deceit or for misrepresentation. Furthermore, the majority had confined their ruling to the position of subscribing shareholders. In a passage that was also referred to by Justices Gyles and Jacobson, the High Court majority had commented that the legislative equivalent of s563A would not ‘prevent claims by members for damages flowing from a breach of contract separate from the contract to subscribe for their shares’7.

• Secondly, Justice Finkelstein could find no support for a contrary argument in the established company law authorities: Houldsworth v City of Glasgow Bank8, Oakes v Turquand9 and In re Addlestone Linoleum Company10.

• Thirdly, all the leading company textbooks refer to Houldsworth’s and treat it as being confined to subscribing shareholders.

• Finally, the English Court of Appeal in Soden v British & Commonwealth Holdings Plc11 had decided that the High Court’s judgment in Webb did not apply in the case of transferee shareholders. Justice Finkelstein found that to find otherwise would be contrary to authority.

Justice Gyles also agreed with the analysis of Webb made by Justice Emmett at first instance and by the House of Lords in Soden. Justice Jacobson focused on the questions stated in the originating process in Webb and how it was dealt with by the High Court, and reached the same view as Justices Finkelstein and Gyles.

His Honour commented that to approach the matter in the way suggested by the creditor, which would involve looking at affidavit and other material before the court and analysing the factual situation that was before the court, would lead to ‘unending arguments about the scope and application of a judgment’.

Unconstrained by the Webb case, the Full Court found that there was no bar on transferee shareholders proving in a winding up in relation to their misleading conduct claims against the company.

Are the claims made by transferee shareholders to be postponed?
There being no bar on the transferee shareholder’s claim, the Full Court went on to consider the issue of postponement and whether s563A, which reflected the principle that the capital of the company should be maintained, applied to the claim brought by Mr Margaretic.

Justice Finkelstein said that, in relation to s563A, he would adopt the test articulated by the House of Lords in Soden, namely that sums due to a member ‘in his capacity as a member’ are only ‘those sums the right to which is based by way of cause of action on the statutory contract’.

Membership of the company is not the foundation of the transferee shareholders’ cause of action.

Justice Gyles added that the nature of the claims that Mr Margaretic wanted to bring against Sons of Gwalia (ie a claim against a company for misleading conduct in connection with the acquisition of fully paid shares from a third party) ‘has nothing to do with the return of capital which has been subscribed by that third party or

8. (1880) 5 App Cas 317.
9. (1867) LR 2 HL 325.
10. (1887) 37 Ch D 191.
its predecessors’. Nor does his action have ‘any relevant connection with the rescission of any contract with the company, as the operative contract is with a third party’.

Justice Jacobson also found support for this view in Soden and agreed with Justice Gyles, saying further that Mr Margaretic’s action in misleading conduct was not based upon the rights of a member contained in the Act.

It followed that Mr Margaretic, as a transferee shareholder, was not bringing his claims in his capacity as a member of the company and, accordingly, the claims were not subject to the postponement effect of s563A.

**Last avenue of appeal**

Given the significance of these issues, it is likely that the administrators and the non-shareholder creditor will apply to the High Court of Australia for special leave to appeal.

If special leave is granted, a hearing before the High Court might not occur for six to 12 months, and judgment may not be delivered for up to a further 12 months after the hearing.

It has also been suggested that there could be moves for legislative reform if Mr Margaretic ultimately succeeds in establishing his position as a creditor. In the meantime, external administrators are bound to apply the Full Court’s findings.

**Shareholders must still make out their claims on the merits**

The issue that the Federal Court was not asked to consider in making its determination was whether, leaving aside the issue of postponement, the administrators should accept or reject the proof of debt submitted by Mr Margaretic on its merits.

The Full Court’s decision (and that of the court at first instance) does not touch on the merits of Mr Margaretic’s claim. The parties agreed that the court should be asked to assume that the claim could be made out.

The Full Court’s decision, while obliging administrators to deal with claims made by shareholders on the same basis as claims made by other creditors, does not mean that shareholders’ claims will necessarily be made out entitling them to have their claims admitted to proof.

Shareholders who submit proofs of debt based on claims of misleading conduct by the company or non-disclosure must satisfy the administrators that there has been actionable misleading conduct or non-disclosure, and that such conduct or non-disclosure caused them quantifiable loss.

Justice Gzell’s decision in Johnston v McGrath, where the merits of the shareholder’s claims were considered as the central issue in the proceeding following a rejection of the shareholder’s proof by the liquidators of HIH, highlights that shareholders face significant hurdles in making out their claims.

**With the Full Court endorsing the findings of Justice Emmett, and with the prospect of a High Court appeal many months away, the shareholder claimants’ newly found status will mean that some administrators and unsecured creditors may be on unfamiliar ground.**

Even though for the purposes of that proceeding the liquidators of HIH admitted that the statements allegedly relied upon by the shareholder were misleading, Justice Gzell dismissed the shareholder’s claim on the grounds that he could not demonstrate that he relied on the statements in purchasing his shares and not disposing of them before HIH went into liquidation.

**Impact of the findings in the Sons of Gwalia appeal**

Following the Full Court’s findings, it is now clear that, unless and until such time as the High Court makes a different finding, claims made by transferee shareholders must be treated on the same basis as the claims of other creditors in a winding up or deed of company arrangement.

In AAR’s Focus: Insolvency, October 2005, we listed the implications of Justice Emmett’s decision, which has now been upheld, as follows:

- First, the decision could prejudice the ability of listed companies to raise unsecured debt finance, on the basis that such financiers may be reluctant to extend finance to a company if there was a risk that claims by transferee shareholders may ultimately have
equal ranking to all other unsecured debt claims. It is difficult to see how such claims could be the subject of an adequate due diligence exercise by a financier.

• Secondly, provided that the shareholders are able to make out their claims (which may not be a straightforward matter as highlighted by Johnston v McGrath), the admission of proofs of debt lodged by numerous transferee shareholders could significantly reduce the return under a deed of company arrangement to external unsecured creditors.

• Thirdly, recent experience has shown that litigation funders are willing to promote and fund class actions against companies in connection with their continuous disclosure obligations13.

To date, the ability of shareholders to make claims arising out of the loss of the value of their shares in a corporate collapse scenario has been constrained by the operation of s563A, on the basis that those claims were liable to be postponed until the claims made by other creditors have been satisfied. The decision in Sons of Gwalia might encourage plaintiffs and litigation funders in connection with such claims.

• Fourthly, the receipt of numerous proofs of debt from shareholders has the potential to require significant further time and expense to be incurred by administrators in connection with the determination of the merits of those proofs and may inevitably cause delays in making distributions to creditors.

• Finally, as we have previously noted, there could be calls for legislative reform if the status of shareholders as creditors survives a High Court appeal.

With the Full Court endorsing the findings of Justice Emmett, and with the prospect of a High Court appeal many months away, the shareholder claimants’ newly found status will mean that some administrators and unsecured creditors may be on unfamiliar ground.

In the meantime, unsecured debt financiers, insolvency practitioners and litigation funders will be looking on with interest.

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