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LEGAL ASPECTS OF FINANCIAL DISTRESS

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In Sons of Gwalia Ltd v Margaretic the High Court allowed shareholders to rank equally with unsecured creditors in insolvency cases involving illegal or misleading behaviour. In spite of the conclusion of CAMAC that shareholders should be allowed to claim on par with unsecured creditors in such cases, the Australian government has recently decided to reverse the effect of the decision. In view of the government's decision, which undermines the protection afforded to aggrieved shareholders by the Corporations Act, it is timely to revisit the judgments delivered by the High Court in Sons of Gwalia with a view to appreciating the arguments for and against parity ranking of shareholder claims in such circumstances.

Field of Research: Business regulation, shareholder damages

1. Introduction

In *Sons of Gwalia Ltd (admin apptd) v Margaretic* [2007] HCA 1 the High Court considered the right of aggrieved shareholders to claim damages and rank on par with unsecured creditors in insolvency. In what was seen as a controversial decision, a 6:1 majority decided that shareholders could rank equally with unsecured creditors in cases of insolvency involving illegal or misleading behaviour inducing share purchase, thus ruling contrary to traditional perceptions of a distinction between debt and equity in cases of insolvency.

2. Literature Review

Appeals by Sons of Gwalia and ING (a creditor) from the decision of the FCFCA saw two arguments put to the High Court. ING argued that the rule in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 would apply to Margaretic's claim, meaning that in the absence of rescission the claim was not provable, and as such that s 563A would not be enlivened, as that section was not concerned with admissibility to proof but only dealt with subordination after a claim had been so admitted. The clearest expression of the rule in *Houldsworth's case* comes from Lindley LJ in *Re Addlestone Linoleum Co*

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(1887) 37 Ch D 191: 'a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that it is inconsistent with his position as a shareholder, while he remains such, to claim back any of that money – he must not directly or indirectly receive back any part of it. This is what has come to be known as the 'inconsistency with contract' argument and constitutes the basis of the 'rule' in *Houldsworth's case*. The second argument put to the court by both ING and SoG was that *Houldsworth* informed the reading of the relevant statute in s 563A, meaning that Margaretic's claim was made in his capacity as a member and would thus be postponed to the claims of creditors. SoG and ING pursued an all or nothing argument in contending that the reasoning in the judgments they relied upon did not make a distinction between subscribing and transferee shareholders, and that at any rate no such distinction should exist as the effect upon creditors would be the same in either case, and would result in a dimunition of available assets. Both of these arguments were rejected by all but Callinan J, their justices dealing with the validity and relevance of *Houldsworth* in the face of modern legislation in s 563A, the doctrine of capital maintenance, the effect of changes to legislation and the role of s 553(1), as well as the exact ambit and effect of s 563A, and whether transferee shareholders should be treated differently from subscribing shareholders.

3. Methodology and Research Design

Rather than allow the rule in *Houldsworth* to influence their decisions the members of the majority (Gleeson CJ, Gummow, Kirby, Hayne, Heydon and Crennan JJ) framed their judgments with the fact of SoG's failure to declare information that might have a material impact upon the price or value of its shares to the market according to its statutory responsibility to do so. Indeed, Hayne J, with whom Gummow and Heydon JJ largely agreed, began his judgment by stating that the resolution of the questions before the court did 'not depend upon any principle of judge-made law', notably the rule in *Houldsworth*. Gummow J derided arguments throughout his judgment that there were any general principles of company law applicable in insolvency proceedings to which the Act and its provisions must be reconciled, cautioning against using older case law in an attempt to deduce such principles, for the cases that were relied upon by the Appellants including *Houldsworth* were adjudged

> at a time of endeavours to "flesh out" the developing body of statute law by use of principles derived from a range of sources… (including) the law of agency, partnership, bankruptcy, and trusts. It later was recognised that some of those endeavours miscarried.

Gleeson CJ made special mention of the fact that the history and language of s 563A extended past *Salomon* 'to a time when the separateness of a corporation from its members had not been fully recognised, and when the difference between corporations and partnerships was not as distinct as it later became'. His Honour gave the simple reason for the inapplicability of

Houldsworth as being that legislation in the form of s 563A would not be able to be applied 'because it assumes, and subordinates, a liability of the kind which, according to this argument, does not exist'.

In marked distinction to the majority which focussed on SoG's failure to observe legislation requiring the disclosure of material information, Callinan J framed his dissenting judgment with the realities of modern investment in shares, the separation of management and ownership, and personal responsibility for interaction with the market and the risks therein. While investors may have many reasons for choosing to place their money under the charge of others, Callinan J made much of the undisputed fact that the end game is that investors 'are principally impelled by a wish to make as much money by way of income, capital gain, or both, as possible'.On this basis his Honour contrasted creditors to willing investors, whose decision to invest is made with a view to their own individual profit, and involved elements of risk: '[T]heir investment in the company involves risks, albeit risks increasingly informed by mandatory disclosures'. Accordingly, Callinan J chose to characterise Margaretic as attempting to avoid the risks of investment by claiming damages upon the failure of the company in which he invested in the hope of potential benefits.

In seeming more like a hymn to decisions past, after analysing the rights of members and their ability to influence the direction of the company Callinan J used religious imagery to characterise the importance of capital: 'It is also relevant that dividends may only be paid out of profits. That this is so serves to emphasise the continuing importance, relevance, indeed sanctity, of the capital, as opposed to any clearly ascertainable profits generated by it'. While early legislation in the form of the *Limited Liability Act 1855* UK may have given the impression that paid-up capital could be viewed by creditors as a fund through which they might gain satisfaction for debts owed to them, Gleeson CJ stated that 'it may be doubted that it reflects the reality of modern commercial conditions, where assets and liabilities usually are more significant for creditors than paid-up capital'. Callinan J argued for the importance of paid-up capital to claims made by creditors in the event of insolvency, asking what 'is the connexion between those two, other than that the latter is the product at any time of the *use* of the other, the paid-up capital of the company?' If this were the case however, how could it make sense to speak of or treat paid-up capital as if it represented a static fund to be maintained in the case of insolvency for creditors? His Honour stated that '[t]he difference between liabilities and assets, members' equity, is the product of, stands in place of, and assumes the importance of paid-up capital, and is the real measure of the worth of the company'. While equity may be the product of the use of paid-up capital, even if it was to be accepted that it stands in place of, or assumes the importance of that which made it possible, it is difficult to find any justification for treating it as an impenetrable fund reserved for creditors, and thus treating creditors differently to equally innocent shareholders who invested in a company on the basis of behaviour which contravened both market and statutory norms.

Gummow J demonstrated that the doctrine of capital maintenance and therefore the ideas voiced by Callinan J could not be maintained after changes to legislation in 1862 which made it possible to continue business after originally paid-up capital had been used up in the general course of business. As noted above, the *Limited Liability Act 1855* UK required that a company wind up its operations upon the loss of three-quarters of subscribed capital, however this provision was removed in subsequent legislation. Indeed, if paid-up capital was to function as such a protection, legislation which removed this requirement and allowed a company to legally continue trade until all of its capital had been lost would not have been enacted. Notwithstanding, Gummow J stated that the award of damages in such cases should not be seen as a reduction of capital, as '[t]he award of damages is not charged upon any fund representing capital. Large awards may adversely affect the market value of shares in the company, but they do not require any return of capital'.

4. Discussion and Findings

With the doctrine of capital maintenance having been dealt with by the majority, the interpretation of s 563A was the focus of their Honours' judgments. Gleeson CJ drew attention to the fact that modern legislation 'has extended greatly the scope for "shareholder claims" against corporations', resulting in competition between shareholders and creditors for the remaining assets of the company on insolvency. An important piece of legislation here is s 553(1), the terms of which remove any impediment to such claims by declaring all claims against the company admissible to proof so long as the circumstances giving rise to the claim occurred before the "relevant date". The 1992 legislative changes which enacted s 553(1) thus 'severed the connection between the statutory identification of debt and claims admissible to proof in a winding up, and the classes of debts admissible to proof in a bankruptcy'.

While s 553(1) assumes that a debt owed to a person in their capacity as a member is admissible to proof, s 563A deals with the subordination of debts already deemed provable by s 553(1). Unlike hitherto developing Australian lower court precedent on this issue, this section made no distinction between what kinds of members might claim. Gleeson CJ noted that the existence of a liability was the hypothesis upon which s 563A proceeded, and left the relevant question as whether the debt was owed to the person in their capacity as a member of the company. The ancestral form of s 563A in s 38(7) of the 1862 Act (as also seen in s 360(1)(k), the operative provision in *Webb*) stated that no sum due to a member in their capacity as a member would be deemed to be a debt of the company payable in case of competition with non-member creditors. Gleeson CJ stated that the 'effect of subordination rather than denial is clearer' in s 563A than its predecessors, with the wording in both s 38(7) and s 360(1)(k) possibly accounting for 'some elision of the issue whether a debt is provable and the issue of its ranking in terms of priorities'.

Although the erosion of creditors' recoverable assets could have been dealt with by express legislative intervention as for example in the US, for Gleeson CJ the relevant statute in s 563A did not declare that in insolvency proceedings "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'. Indeed, unlike the more refined state of the law that existed in other jurisdictions such as the US where all shareholder claims are subordinated, and the UK where by virtue of s 111A shareholder claims are allowed to rank with creditor claims, Gummow J remarked that the legislation in s 563A 'has not been marked by any close legislative consideration of the ends sought to be achieved by a provision in the terms of s 563A'.

For Kirby J the adoption of a 'less absolute, and more nuanced criterion' in s 563A did not embody a general legislative policy concerning the subordination of shareholder claims: 'This more limited ambit of postponement is clearly deliberate…The identity of the claimant is not the chosen criterion for postponement. Instead, the criterion is addressed to the character and incidents of the 'debt', that is, the claim'. The fact that the claimant was a member was not to be determinative of the character of the claim, rather, it was the character of the debt that mattered. Kirby J further noted that it would be easy with a 'presumed general policy of the act' to come up with an interpretation which would subordinate claims by shareholders to those of creditors. Indeed, his Honour stated that there exist significant policy arguments for postponing Margaretic's recovery from the company to debts owed to creditors 'whose involvement with the company is typically not, as such, risky or speculative in character'. Kirby J nevertheless remained sympathetic to the arguments of the Appellants, despite coming to the conclusion that 'a correct analysis of the statutory provisions in issue in these appeals does not sustain the arguments of the general creditors'.

His Honour stated that the fact the alleged misconduct related to disclosure requirements was not enough of itself to characterise the debt owed as one due to the member in their capacity as a member, as the duty of disclosure was designed not only to inform and protect shareholders but also other market participants not yet members of the company: '[A]t the time of the alleged non-disclosures, the respondent was not a member of the company at all. In this sense, the disclosures were not then received in that capacity but as a consumer of corporate information and as an investor'.

In his textual analysis of s 563A, Kirby J noted that although the words "or otherwise" could be thought to refer to a "debt", owed to a shareholder for damages due to misleading and deceptive conduct that when it is apprehended in context, that is, next to the terms "dividends" and "profits", it 'suggests that what is involved in the postponement are sums constituting the ordinary revenue (and possibly the capital) of the company and not claims of an extraordinary and exceptional kind for false and misleading conduct'. Kirby J concluded that it was only debts due under the statutory contract which were to be postponed. After commenting that the option for legislative change in line with the US was open to the legislature and that this opportunity was

not availed of, leading to the adoption of the more limited criterion of postponement based on the character of the debt, his Honour called for legislative intervention in the case that the High Court struck the wrong balance in its determination.

Callinan J argued against the majority's interpretation of s 563A, stating '[i]t cannot be seriously argued here that... s 563A is unambiguous, or, to use the language of Kirby J, not "contestable"', arguing that postponement is just as natural a reading of s 563A as equal ranking is, especially when the words "capacity" an "otherwise" are taken into account. In the context of the statutory provisions his Honour considered, Callinan J chose to read s 563A in view of the 'superior opportunities, rights and advantages' shareholders hold above creditors. As such, his Honour stated that 'it seems intuitively, as Kirby J points out, to be a more likely construction of s 563A that it means what SoG, rather than Mr Margaretic contends it to mean'.

It was the character of the debt and the grounds upon which it was owed which made a consideration as to whether the shareholder is a subscribing or transferee shareholder 'unhelpful' for Kirby J in construing s 563A, as the simple fact that one is a member and makes a claim is not the point on which the legislation turns, rather, it is the character of the debt owed itself that mattered. As such, '[i]n light of the present legislation, specifically s 563A, there would appear to be no foundation for the operation of the distinction drawn in that case (*Webb*)'.

Transferee shareholders would thus be allowed to claim on par with creditors on Gleeson CJ's reading of s 563A and his tests above. Gleeson CJ's framing of his judgment, seeing the situation as being one where the claim arose 'out of harm suffered by reason of conduct of the company that was in contravention of certain statutory norms of behaviour' could be seen to mean that any shareholder could bring a claim on these grounds, as confirmed by the lack of a distinction between subscribing and transferee shareholders argued for by other members of the majority including Kirby and Hayne JJ, meaning subscribing shareholders would not be caught on the idea of reclamation of capital. Other comments regarding the capital maintenance doctrine, as well as the argument that it would not be sufficient to describe the effect of a claim on creditors, and that it would be unjust and capricious to allow a transferee and not a subscribing shareholder to claim when their claims arose out of the same illegal conduct of the company as per the last line of Gleeson CJ's concluding statement above, indicate that a claim by a subscribing shareholder would be allowed by Gleeson CJ together with the other members of the majority. In this way, the High Court was able to steer clear of ancient decisions and principles which were indentured to a partnership conception of the corporation, focussing instead on the statutory responsibilities of corporations and the accurate interpretation of legislative provisions.

Conclusion

In view of the awkward influence of relatively ancient principles on damages claims by aggrieved shareholders in insolvency situations, it appears necessary that the status of shareholders on the insolvency of their company in cases of fraudulent and misleading behaviour be set clearly, one way or the other. This is especially the case in view of the fact that the rule in *Houldsworth's case* may still prove good law in certain circumstances, such as when a claim is made by a subscribing shareholder when statutory liquidation provisions do not apply. Indeed, as stated by Justice Austin, 'the effect of the *Sons of Gwalia* case is to compound the technicality of what was already an extremely technical and unsatisfactory part of the law'. While the Government correctly decided to abrogate the rule in *Houldsworth's case*, in deciding to reverse the decision of the High Court in *Sons of Gwalia* and subordinate shareholder claims it ignored the potential result that shareholders may be held accountable for illegal, fraudulent or misleading activities engaged in by management. In doing so it has not accorded sufficient weight the broader frame of market controls already in place designed to ensure the continued existence of a sustainable market and shareholder participation in it.

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