

Shareholder Damage Claims: Diverse Treatment in Australian and U.S. Insolvency Cases

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The recent *Sons of Gwalia Ltd.* decision by the Australian High Court clarifies the extent to which, under Australian law, shareholder claims rank with the claims of other creditors in an Australian winding up. Shareholders possessing a damage claim against a company, arising out of the purchase of their shares, now rank *pari passu* with unsecured creditors in an Australian bankruptcy law at odds with U.S. bankruptcy law and has potential implications for U.S. creditors participating in the debt markets in Australian companies.



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Under the U.S. Bankruptcy Code, shareholders have a lower distribution priority than unsecured creditors both for stock holdings and rescission or damage claims. Unsecured creditors must be paid in full before shareholders receive any distribution, absent a consent by the requisite creditors to the contrary in a chapter 11 case. See 11 U.S.C. §§1129(b) and 726. Moreover, §510(b) of the Code provides that a claim arising from the purchase or sale of a debtor's security is subordinated to all claims or interests that are senior or equal to the claim or interest represented by such security, except that if the security is common stock, such claim has the same priority as common stock. 11 U.S.C. §510(b). The underlying theory is that, while general creditors and equityholders both share the risk that a company may become a debtor in a bankruptcy case, only equity shares the risk of an unlawful issuance of equity securities. See *Collier on Bankruptcy*, 15th ed. rev. 2005, ¶510.04[2]. As a result, unlike in Australia, §510(b) prevents a shifting of the risk to general creditors. *Id.*

About the Authors

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Background

On Aug. 18, 2004, Luka Margaretic purchased 20,000 fully paid, ordinary shares in the publicly listed gold mining company Sons of Gwalia Ltd. (SOG) for \$26,200. Eleven days later, the directors of SOG appointed administrators, and the company went into voluntary administration in Australia.



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Margaretic commenced court proceedings against SOG on the grounds that SOG had breached Australian Stock Exchange (ASX) Listing Rules, engaged in misleading and deceptive conduct, and was in contravention of s52 of the Trade Practices Act 1974 (Cth), s1041H of the Corporations Act 2001 (Cth) and s12DA of the Australian Securities and Investments Commission Act 2001 (Cth). Margaretic sought damages for the cost of his worthless shares at the time he acquired them.

Margaretic's claim relied upon the continuous disclosure obligations under the ASX Listing Rules to which SOG was subject. He asserted that by failing to notify the ASX that its gold reserves were insufficient to meet its sale contracts, and that it could not continue trading as a going concern, SOG was in breach of these disclosure obligations. In response to Margaretic's contentions, the SOG administrators applied to the Australian Federal Court for a declaration that the

claim was not provable or, alternatively, a declaration that payment of that claim should be postponed. Resolution of the claim involved interpretation of s563A of the Corporations Act 2001 (Cth) (Act), which provides:

Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.

Margaretic argued that his claim was not a product of his shareholding or membership in SOG, and that s563A of the Act did not apply. The Federal Court agreed and declared Margaretic to be a general creditor of SOG, entitled to all

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associated rights. The SOG Administrators appealed to the Australian High Court.

The High Court Ruling

By a majority of six-to-one, the High Court upheld the decision of the Federal Court that s563A of the Act did not have the effect of subordinating Margaretic's claim for misleading and deceptive conduct, ruling that the claim did not arise out of Margaretic's "capacity as a member" of SOG. The Court noted the policy reasons for a postponement of shareholders' claims: that investments of shareholders carry an inherent risk and degree of speculation that is understood to be undertaken by shareholders themselves, and that is not shared with general creditors. The court considered the wording of s563A of the Act and found that "section 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 other than in such capacity, the Act rejects such a general policy.

The court reasoned that the Australian Parliament had considered the precedent of the U.S. Bankruptcy Code (under which shareholders have a lower priority in distributions) when it drafted s563A of the Act. It concluded that Parliament explicitly delineated the debts of members in their capacity as shareholders from other shareholder claims, but that Australia does not have a statutory subordination provision like §510(b) of the U.S. Bankruptcy Code. Ultimately, as Margaretic's claims were not derived from any obligations owed by him or to him as a member of SOG, but were drawn from statutory causes of action, s563A of the Act did not prevent his claim from ranking equally with those of creditors of the company in the administration process.

Key Implications

In Australian insolvency cases, general unsecured creditors may be adversely affected by the potential increase in claimants and relating dilution of the return to that creditor class. In any future public company insolvency, if there is a reasonable basis for a claim for misleading and deceptive conduct, it is quite possible that securities class actions will be brought to salvage value for

shareholders who acquired shares leading up to the insolvency filing. Company administrations can already be lengthy, costly and complex. Each claim by a shareholder may need to be assessed on its merits to determine whether a valid claim may be proved in the administration. This could be cumbersome, time-consuming and expensive. The effective "broadening" of the pool of claimants in an insolvency may also reduce the potential for restructurings. With a greater range and number of interests to balance, there could be a reduced chance of a company being able to continue in existence.

Impact on Access to U.S. Bond Market

The *Sons of Gwalia* judgment appears to put Australia out of step with the United States, whose investors represent a substantial source of debt capital for Australian companies. Australian companies regularly tap the U.S. debt markets, which offer competitive pricing and long maturity (typically 10 years or more). Many bond issues by Australian companies into the U.S. capital markets are unsecured, and accordingly, the decision may adversely

affect access of Australian companies to the U.S. bond market. Some U.S. bondholders expressed concern when the first lower-court judgment in *Sons of Gwalia* was handed down in 2005, as the decision appeared to change at least some parties' understanding of applicable Australian law.

Despite this, subsequently there have been several successful unsecured bond offerings into the U.S. debt market by Australian companies. Based on this, and the low risk of bankruptcy associated with Australian investment grade companies, there is reason to believe that U.S. investors may not overreact to the SOG decision. In addition, the High Court's construction of s563A of the Act seems broadly consistent with U.K. legislation, which does not appear to have adversely impeded U.K. companies' access to the U.S. bond markets, although that section was introduced to address a specific prior case in England and has not been seen as an impediment to the subordination of shareholder claims. However, it is plausible that non-investment-grade Australian companies may be less attractive in light of the

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SOG decision, and that this may adversely affect pricing and result in higher demand for secured bonds. If credit markets tighten in the future, investors may prefer to invest in bonds of companies in markets other than Australia, where shareholder claims are subordinated to claims of unsecured creditors.

Legislative Reform

The Parliamentary Secretary to the Australian Treasurer has referred the SOG decision to the Corporations and Markets Advisory Committee (CAMAC) for review. CAMAC is a statutory advisory committee that reports to the government and gives recommendations for law reform. The law may be changed

to address any potential adverse implications of the *Sons of Gwalia* decision. Legislative intervention would be likely if there is a chance that Australia's position in the international capital markets could be adversely affected, but any such legislation is unlikely to commence until CAMAC has reviewed and reported on the issue. ■