CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

17 December 2007

Mr John Kluver
Executive Director
CAMAC
Level 16
60 Margaret Street
SYDNEY NSW 2000

By mail
and by email: john.kluver@camac.gov.au

Dear John

Shareholder claims against insolvent companies: Implications of the *Sons of Gwalia* decision

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the discussion paper, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, which deals with the reference to the Corporations and Markets Advisory Committee (CAMAC) by the Parliamentary Secretary to the Treasurer on the implications of the High Court decision in *Sons of Gwalia* which reinterpreted a longstanding provision of the law.

CSA is the peak professional body delivering accredited education and the most practical and authoritative training and information on governance, as well as thought leadership in the field. We are an independent, widely-respected influencer of governance thinking and behaviour in Australia. We represent over 8,000 governance professionals working in public and private companies, all of whom deal with shareholders, shareholder claims, corporate administration and compliance with the *Corporations Act*. We have drawn on their experience in the formulation of this submission.

General comments

CSA notes that the Terms of Reference request CAMAC to advise on whether shareholders who acquire shares as a result of misleading conduct by a company prior to its insolvency should be able to participate in the distribution of funds in an insolvency proceeding equally with other unsecured creditors who are not shareholders in relation to any debts that may arise from that misleading conduct. CSA further notes that CAMAC has put forward three options for consideration and comment as follows:

- Option 1: retain the current law, as determined in light of the High Court decision
- Option 2: amend the Corporations Act to reverse the effect of the law as determined in the High Court decision
- Option 3: as per Option 2, with an internal ranking of shareholder claims.

CSA is of the firm belief that it is in the best interests of providing an orderly market that Option 2 be implemented, that is, that the Corporations Act be amended to reverse the High Court decision in *Sons of Gwalia*.

Our reasons for this recommendation relate to the potential that the current law as determined in light of the High Court decision has to:

- diminish existing creditors' rights
- create uncertainty for external administrators in adjudicating the claims of aggrieved investors and risk substantial delay in distributions while those claims are adjudicated
- split the rights of shareholders, favouring some to the disadvantage of others
- create a climate conducive to speculative claims, which in turn could encourage class actions based on mere possibilities rather than substantiated claims
- create uncertainty for insurers, with a commensurate negative impact on insurance premiums
- create increased cost or reduced availability of finance for companies
- overturn the debt/equity distinction.

In short, CSA supports the rationale for the 'absolute priority rule' in the US Bankruptcy Code (as set out on page 53 of the discussion paper), which is based on the recommendations of a Commission on the Bankruptcy Laws which supported the postponement of claims arising from the purchase or sale of securities behind those of unsecured creditors in a liquidation on the argument that:

> allowing equity-holders to become effectively creditors by treating these two classes as though they were one gives investors the best of both worlds: a claim to the upside in the event the company prospers and participation with creditors if it fails. It also dilutes the capital reserves available to repay general creditors, who rely on investment equity for satisfaction of their claims.

CSA believes that shareholders should absorb the risk of insolvency as part of the risks they take in acquiring shares, which includes the risk of corporate fraud, misconduct and the non-disclosure of price-sensitive information as well as company failure. That is, shareholders should be liable for their equity investment if a company fails for whatever reason. CSA notes that shareholders have existing rights to raise claims against the directors in relation to their actions in the event of default.

We set out our reasons for our recommendation that Option 2 be implemented in more detail below.

The potential to diminish existing creditors' rights

CSA notes that, until the High Court decision in *Sons of Gwalia*, creditors expected to have priority over shareholders in having access to the company's equity base. By ranking aggrieved investors equally with general creditors, this priority is no longer assured, which diminishes creditors' expectations and rights as they have long been supported by both statute and the common law. CSA is opposed to such a diminishing of creditors' rights.

Moreover, creditors have the choice to vote on whether a company should end the administration and resume trading (with the intent of trading out of difficulties), enter into a deed of company arrangement (DOCA) or be wound up; that is, they have the right to vote on any proposed reorganisation of the company. As the discussion paper notes on page 39:

> Voting by creditors in a voluntary administration on this, and other, matters is by number and value (though administrators have a casting vote where the voting outcomes by number and value differ).

If aggrieved investors, as defined by the discussion paper, have the right to vote at a creditors' meeting, the weight of their numbers rather than the value of their (unsubstantiated) claims could decisively influence the voting, and in turn the administration outcomes. This provides aggrieved investors with an unwarranted influence in decisions affecting conventional unsecured creditors, which further diminishes creditors' rights.

CSA is opposed to the potential for investors with claims that have yet to be determined having the same rights as creditors in insolvency proceedings, particularly as their claims may never be substantiated.

The potential to create uncertainty for external administrators in adjudicating the claims of aggrieved investors and risk substantial delay in distributions while those claims are adjudicated

CSA supports the generally accepted principles of contemporary insolvency law, as identified in the Harmer Report (General Insolvency Inquiry ALRC 45, 1988, at para 5). These include provision for:

- a fair and orderly process for dealing with the financial affairs of insolvents
- the least possible delay and expense
- an impartial, efficient and expeditious insolvency administration
- the principle of equal sharing between creditors.

If aggrieved investors are given equal billing with creditors, CSA believes that there is a strong potential to disturb the application of these principles. In particular, CSA believes that the need for certainty of the resolution of claims, their efficient and prompt assessment and the payment of dividend returns to creditors will suffer.

CSA disagrees with the argument raised on page 64 of the discussion paper that 'making external administration simpler, quicker or more expedient does not justify postponing a category of shareholder creditors'. CSA believes that this argument undermines the principles of insolvency law as identified above.

CSA believes that each claim by an aggrieved investor may require separate adjudication, which would create undue delay and costs in an external administration. This in turn would reduce the return to general creditors.

CSA also believes that the uncertainty created for external administrators in adjudicating the claims of aggrieved investors would add further to the delays.

CSA recommends that certainty should be granted to creditors and shareholders that they need not wait many years for payment in the winding up of a company.

CSA also notes that the discussion paper puts forward the argument that '[a]ny procedural difficulties may be able to be ameliorated by appropriate administrative reforms' (page 64). However, CSA points out that any such administrative reforms may themselves take many years to develop and implement. CSA therefore doubts that any such hypothetical reform of procedural difficulties would compensate for the disadvantage to creditors and the whole body of shareholders that substantial delay in proceedings would give rise to.

The potential to split the rights of shareholders, favouring some to the disadvantage of others

CSA is concerned that privileging the claims of aggrieved investors over those of other shareholders would lead to ongoing uncertainty concerning shareholders' rights. The decision in *Sons of Gwalia* may afford recent purchasers of shares with a claim because of inadequate disclosure, when longer-term shareholders, who may have sold if such information was disclosed, may have no such claim.

CSA opposes the differentiating of shareholders and their rights based on how or when they purchased shares.

The potential to create a climate conducive to speculative claims

CSA is concerned that, if the law stands following the High Court decision in *Sons of Gwalia*, a shareholder can stake a claim to have equal billing with general creditors without having to prove their claim. It is left to the external administrator or liquidator to adjudicate the claim.

CSA believes that this will lead to speculative claims being lodged. Given that the potential in Australia for class actions and funded litigation is more closely aligned with practices in the United States than in the United Kingdom (as noted in the discussion paper), CSA believes that the UK precedent is not appropriate under Australian law.

The potential to create uncertainty for insurers

CSA is aware of concerns expressed by our members working in the insurance industry that there could be a detrimental effect on the recoveries that insurers would normally expect to receive via unsecured trade creditors' dividends if the present law is retained.

The potential to create increased cost or reduced availability of finance for companies

Should the law stand following the High Court decision in *Sons of Gwalia*, CSA believes that the resulting ambiguity with regard to the traditionally accepted investor hierarchy of claims in the event of corporate collapse has the potential to adversely affect the market for corporate debt in Australia. Banks as lenders, trade creditors and institutional investors as buyers of corporate bonds are all potentially affected, and CSA believes that the ability of Australian companies to issue debt into international markets (in competition for funds with overseas companies where creditor rights are not subject to such dilution effects) will be adversely affected if the legal position in Australia is different from that in the United States.

Potential lenders to any Australian company will be confronted with higher risk on unsecured debts (a lower recovery rate in the case of company failure) than before. Consequently, CSA is of the opinion that interest rates charged on unsecured debt will increase to compensate for the increased risk.

CSA also believes that debt investors, both in Australia and overseas, may be unlikely to acquire some corporate bonds in Australia, as such an investment would heighten their exposure to risk. In particular, US debt investors will note that

- shareholder claims can no longer be guaranteed to be postponed behind their claims as occurs in the United States, where all claims by shareholders relating to their shares, including as aggrieved investors, are subordinated to those of conventional unsecured creditors

- there is increased potential for speculative claims by aggrieved investors to give rise to class actions.

CSA is concerned that, by affecting the opportunities for Australian companies to obtain debt finance or credit in the United States, or have the cost of doing so significantly increase, the law thereby disadvantages Australian shareholders, as increased cost or reduced availability of finance would have implications for solvent companies, not only for those subject to external administration.

CSA opposes any law that reduces the opportunity for Australian shareholders and the companies in which they invest to compete with shareholders from other jurisdictions in relation to securing finance.

The potential to overturn the debt/equity distinction

CSA supports the maintenance of the debt/equity distinction in a limited liability company. Shareholders risk losing their equity investment but can participate in the distribution of dividends and capital gains, whereas creditors can only recover from the company their principal and any interest provided for in the contract. Moreover, shareholders have remedies for obtaining damages from a company for false or misleading conduct.

CSA believes it is important to maintain the distinction between those who deal with the company on a commercial basis, that is, creditors, and those who are members, that is, owners.

CSA supports the comments of Callinan J in the High Court decision of *Sons of Gwalia* as quoted in the discussion paper on page 66 that:

> shareholders' statutory rights, their voluntary abdication of control over their investment in favour of the directors as their appointees (who have considerable statutory and constitutional discretions and obligations), their rights to proceed against the directors personally as well as the company in some circumstances, their limited liability, and their rights to participate in any successes, sit uncomfortably with the notion that they should have equal billing, on the failure of the company, with ordinary unsecured creditors.

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, that is, they should be liable for their equity investment if a company fails for whatever reason. Companies fail for multiple reasons, including fraud, corporate misconduct, currency collapses and changes in markets. CSA does not believe that non-disclosure by directors of price-sensitive information should be singled out as requiring creditors to underwrite investors' speculative risks.

Fraud on market approach

CSA is strongly opposed to the introduction of a fraud on market approach.

CSA believes that any person seeking to claim damages should be required to establish specific knowledge of and reliance on misrepresentations. CSA is also concerned that the introduction of this approach would facilitate shareholder class actions against solvent ongoing companies, which is not the policy objective of a fraud on market approach.

The policy objective would be to increase shareholder rights in rare cases where the company has become insolvent and the company was able to pay the claims of all creditors and had sufficient funds remaining to meet aggrieved investor claims. CSA is opposed to law reform that seeks to address rare cases, yet will have far greater effect on matters it was not designed to address than on those it was designed to address.

Other comments

As it is possible that CAMAC could recommend to the government that either Option 1 or 3 be implemented, we provide comments below on a number of matters that arise only in the event of either of these two options being implemented. Our comments on these matters are offered solely on the basis that Options 1 and 3 might be implemented. They are not to be read as weakening our support for Option 2.

8.2 Calling a creditors' meeting

8.2.1 Notice of meeting

CSA recommends an express statement be provided that, as set out on page 71 of the discussion paper, the administrator need not search the share register or take other steps to identify those who may have a claim against the company for possible misconduct relating to their shares, for the purpose of giving them notice of a creditors' meeting.

8.2.2 Time and place of meeting

CSA recommends that insolvency practitioners should be required to hold the meeting at the place of incorporation of the company and that notice of such meeting should only be required to be given at the place of incorporation. In this way, the meeting is held in a place convenient to the majority, and the legislation relating to aggrieved investors would align with that relating to general creditors. CSA can see no reason for privileging aggrieved investors on this matter if they rank equally with general creditors.

8.3.1 For the purpose of determining voting rights

CSA recommends that, as set out on page 74 of the discussion paper, the regulation should require that a shareholder claim relating to the acquisition of shares in the company stipulate:

- the date or dates of acquisition
- the number of securities acquired on each occasion
- the consideration supplied for the acquisition of the securities, and
- the corporate misconduct relied upon (specifying, for instance, where an alleged misrepresentation is contained in a document, the precise misrepresentation relied upon and its location in the document).

CSA further supports the suggestion that there be a requirement that the particulars of the claim be verified by statutory declaration of the shareholder or (in the case of a corporate shareholder) a director of the shareholder.

8.3.2 For the purpose of distribution to creditors

CSA recommends that, as set out on page 75 of the discussion paper, a single judicial determination for a common issue require aggrieved investors to lodge their claims by a certain cut-off date, with all appeals to the court from any decision of the external administrator on the proofs of debt being consolidated in a single action, rather than the external administrator being involved in multiple court actions on this matter.

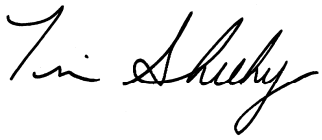
Conclusion

CSA supports taking the approach of subordinating the rights of shareholders to those of creditors in the event of company failure, which is aligned with the US approach.

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, which includes the risk of corporate fraud, misconduct and the non-disclosure of price-sensitive information as well as company failure. That is, shareholders should be liable for their equity investment if a company fails for whatever reason.

CSA strongly recommends that Option 2 be implemented, that is, that the Corporations Act be amended to reverse the High Court decision in *Sons of Gwalia.*

Yours sincerely



Tim Sheehy
CHIEF EXECUTIVE