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SUBMISSION

CORPORATIONS AMENDMENT (SONS OF GWALIA) BILL 2010

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1. Executive Summary

1.1 The Corporations Amendment (Sons of Gwalia) Bill 2010 (the "**Bill**") proposes to change the status quo in respect of the interaction between debt and equity markets in Australia. This is purportedly in response to the decision of the High Court of Australia in Sons of Gwalia[1] which clearly enunciated the existing law that Australian's who suffer loss as a result of a breach of our Market Protection Regime[2] are treated equally with all other unsecured creditors.

1.2 The first two remarkable facts about the Government's decision to subordinate claims for compensation by shareholders in reliance upon the Market Protection Regime ("Shareholder Compensation Claims") behind other unsecured debts is that is has been made:

(a) contrary to the advice of CAMAC[3] and ASIC[4]; and

(b) only after three years of lobbying by banks and service providers who rarely act otherwise than in the banks' interests.[5]

1.3 The Government has taken this path "primarily due to the negative affect that non-subordination of Shareholder Compensation Claims would have on the cost and access to debt financing for companies, particularly companies in distress."[6]

1.4 The third remarkable fact is that the Senate Select Committee is being asked to report to Parliament on the Bill without any evidence of the cost or availability of debt being affected by the Sons of Gwalia decision having been made public. The experience in the UK, which also doesn't discriminate between Shareholder Compensation Claims and other unsecured creditors' suggests the effect is negligible, if existent at all.

1.5 Accordingly, IMF implores the Senate Select Committee to compile the relevant evidence in respect of this "primary" factor and make it public in its report to Parliament.[7]

1.6 The principle concern raised by the Bill is its detrimental effect upon the Market Protection Regime addressed in section 6 below.

1.7 Unless the law can actually protect, and ultimately provide compensation to victims of illegal conduct, the Market Protection Regime risks becoming an irrelevancy.

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1 *Sons of Gwalia (Subject to Deed of Company Arrangement) v Luka Margaretic* [2007] HCA 1 (31 January 2007).

2 The Market Protection Regime refers to the continuous disclosure obligation and the misleading and deceptive conduct provisions of the Corporations Act at sections 674 and 1041H, respectively, and the related provisions in the ASIC Act and Trade Practices Act, 1974.

3 CAMAC's Report (Shareholder Claims against Insolvent Companies: Implications of the Sons of Gwalia Decision; presented to the Minister on 22 December 2008 at [3.4]. A summary of its finding are at paragraphs 7.1 and 7.2 below.

4 The detail of ASIC's submissions to CAMAC have not been made public.

5 Justice Finkelstein in *Commonwealth of Australia v Fernandez* on 11 October 2010 said "*I have had for some years a growing sense of unease about the power and influence that large creditors have over insolvency administrations".* The Australian Financial Review on 29 October 2010 extrapolated at page 44 as follows: "At the heart of his caution is deeply rooted mutual back-scratching and fee referral network in the insolvency profession. Nepotism reigns. While the recent Senate report on the insolvency industry was dismissed by many in the profession as lacking analysis, it highlighted a number of truths that cannot be ignored – and it seems that the Fink is willing to tackle them head on. Administrators and liquidators wield wide, quasi-judicial powers but many creditors, especially smaller ones, report lack of communication because insolvency practitioners are too keen to focus on appeasing banks and lawyers that provide them with work. The Fink's orders reflect a recognition that accountants should be subjected to the same winds of efficiency, transparency and competition that have blown through major law firms and law firms should refresh their focus on independent, fearless advice even if this might upset a big client."

6 Paragraph 2.48 of the Explanatory Memorandum to the Bill.

7 There is also other areas of inquiry that the Senate Select Committee ought to address which are listed in section 9 below.

1.8 If the laws are not enforceable, then one of the main tools for preventing market misbehaviour is severely undermined.

1.9 IMF submits that the Bill ought not be presented to Parliament until a full inquiry into the factors listed in section 9 is conducted.

1.10 When the issue of subordination of shareholder creditor rights first arose, IMF polled members of class actions it had funded to prosecute claims to enforce Corporation Act rights. These members manage about eighty percent of all funds invested through the Australian Securities Exchange. Two thousand five hundred and seven responses (95% of all responses) agreed with the proposition that there are insufficient policy considerations for the Parliament to overturn the Sons of Gwalia decision. A list of each petitioner's name has been provided to the Government.

1.11 IMF acknowledges, in making this submission it has an interest in ensuring that the strength of the Market Protection Regime is not undermined by the passage of the Bill. Nevertheless, IMF submits that that interest is an interest of the community at large.

2. The Existing Insolvency Priorities' Law and Practise

2.1. Section 563A of the Corporations Act has been part of the law of Australia for a long period of time without causing any problems for the external administration of companies in this country or the funding of listed Australian corporations.

2.2. The introduction of the continuous disclosure regime into the Corporations Act and then the advent of litigation funding have recently combined to focus attention on this section.

2.3. The content and meaning of the section are clear and unambiguous. Shareholders with compensation debts rank equally with all other creditors.

2.4. Had the Sons of Gwalia matter involved a single investor making a claim in fraud against the company, it is doubtful that it would have gone before a single judge let alone have gone all the way to the High Court. The Sons of Gwalia case went to the High Court because it involved a relatively new provision of the law (continuous disclosure), a large number of claimants, a new system for funding such large numbers (litigation funding) and a relatively large claim.

2.5. Nevertheless the three Courts which dealt with the action had no hesitation in confirming the law as it appeared in the statute. It is clear from the decision of the High Court that no earlier rulings were overturned during the course of that decision.

2.6. In addition, the High Court essentially agreed with the decision of the single Federal Court Judge and the Full Court of the Federal Court in coming to its decision.

2.7. In other words the interpretation of section 563A was and is straightforward and unremarkable.

3. The Potential to Undermine the Market Protection Regime

3.1. The timely disclosure of material information to the market is critical to ensuring the confidence of capital market participants in the efficiency and fairness of the market. This, in turn, is essential to ensure the market can maximise the capital available to it and that the capital in the debt and equity markets is allocated effectively. As the then Minister noted when introducing the continuous disclosure regime:

> *"In essence, a well informed market leads to greater investor confidence and in turn a greater willingness to invest in Australian business."*[8]

3.2. The then Minister also noted in that speech that the continuous disclosure regime would have an important regulatory function by acting as a check on corporate misconduct:

> *"An effective disclosure system will often be a significant inhibition on questionable corporate conduct. Knowledge that such conduct will be quickly exposed to the glare of publicity, as well as criticism by shareholders and the financial press, makes it less likely to occur in the first place."*[9]

3.3. The Government has recognised this benefit by increasing penalties and widening the scope of the continuous disclosure regime since its introduction in 1994.[10] As noted by French J, as he then was:

> *"The importance attached to the continuous disclosure provisions of the Act by the legislature is emphasised by the penalties for their contravention which have recently been significantly increased and their widened scope since 2002 which is now not limited to intentional reckless or negligent non-disclosure."*[11]

3.4. Importantly, market protections have not only been put in place to protect shareholders. In deciding whether to lend or provide credit, including trade credit, and if so at what price and under what terms, lenders and trade creditors also rely on the Market Protection Regime. The principal cause of the Sons of Gwalia creditors' loss was the same as the cause of the shareholders' loss; namely a misinformed market.

3.5. To subordinate defrauded shareholders from claiming damages against a company would be to eschew the purpose for which the Market Protection Regime was designed.

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8 Second Reading Speech of the Minister for Administrative Services introducing the Corporate Law Reform Bill (No 2) into the Senate, Parliamentary Debates, 26 November 1992 at p 3561.

9 Ibid.

10 Before 1994, the regime was contained in the ASX Listing Rules and thereby remained a contractual issue between the listed entity and the ASX.

11 *Australian Securities and Investments Commission, in the matter of Chemeq Limited v Chemeq Limited* [2006] FCA 936. The *Financial Services Reform Act* of 2001 removed the requirement to prove "intentional, reckless or negligent" non-disclosure.

4. The Illusory Market Protection if the Bill is Passed

4.1. The then Chief Justice, Gleeson CJ noted in the Sons of Gwalia decision at paragraph 18:

"Corporate regulation has become more intensive, and legislatures have imposed on companies and their officers obligations, breach of which may sound in damages, for the protection of members of the public who deal in shares and other securities. This raises issues of legislative policy. 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."* (emphasis added)

4.2. Unfairness would result to innocent victims of breaches of the Market Protection Regime perpetrated by a company or its representatives if no remedy were available.[12]

4.3. The Market Protection Regime provisions should be construed and applied broadly and the rights to damages should not be limited in relation to companies in liquidation.[13]

4.4. As noted by the then Chief Justice of the High Court of Australia in the Sons of Gwalia decision:

> *"What determines the present case is that the claim made by the respondent is not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of [Sons of Gwalia]…The obligations he sought to enforce arose, by virtue of [Sons of Gwalia's] conduct, under one or more of [the Corporations Act*, *ASIC Act* and *Trade Practices Act.]"*[14]

4.5. The Government wants the Australian Parliament to follow the Federal Bankruptcy Code of the United States[15] which subordinates Shareholder Compensation debts to other creditors' debts.

4.6. On the other hand, the Companies Act 1985 (UK)[16] reflects a contrary policy and which expressly denies any such subordination of Shareholder Compensation Claims.

4.7. Accordingly, Australian law is currently consistent with the relevant UK law and inconsistent with the relevant law in the United States. Australian law must be examined contextually and that context includes broad reaching consumer protection provisions enacted in Australia.

4.8. The then Chief Justice in the Sons of Gwalia decision pondered if the Australian Parliament were to introduce a provision similar to the United States provision:

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12 *Re Pyramid* (1992) 10 ACLC 110 at 114 per Vincent J.

13 *Webb Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR per McHugh J.

14 Per Gleeson CJ at 31.

15 11USC§510(b).

16 s111A.

"…it would need to consider what would be the practical effect upon the rights conferred upon people who deal in shares and securities by legislation of the kind relied upon by the respondent. One thing is clear. Section 563A [of the Corporations Act] 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 that in such a capacity, it rejects such a general policy."[17]

4.9. The Bill proposes to impose this general policy in place of the status quo.

5. The Assumption of Risk Argument

5.1. It is implicit in the argument of those seeking legislative change that there are good policy reasons why a shareholder attending an AGM who slips on a wet floor as a result of the negligence of the company and suffers damage should have a claim that ranks above a shareholder (or potential shareholder) who is lied to by the company at the AGM and thereby suffers loss.

5.2. The policy consideration justifying the distinction, so the argument goes, is that the slip victim does not assume the risk of negligence whereas shareholders must, as a matter of policy, assume the risk that they will be lied to when making their investment decision as part of the trade off for gaining a share of any potential profit or capital gain.

5.3. This argument is cynical and debases our Market Protection Regime. Shareholders, as with all other beneficiaries of the regime, should be able to expect the companies with whom they deal to comply with their statutory obligations and invest freely in and allocate capital within, the market on that basis. The whole foundation of the Market Protection Regime rests on companies being able to be held accountable for breaches.

5.4. No policy can assume less, with any breach entitling compensation to rank equally with the claims of the slip victim. Any policy reasons to differentiate, and create priorities, between beneficiaries of the Market Protection Regime and other unsecured creditors must be soundly based and clearly articulated and evidenced to justify legislative change.

5.5. What are these policy considerations which require Shareholder Compensation to be subordinated while investors other than those who become shareholders (for example, those that purchase options or convertible notes) are creditors whose claims will not be subordinated? What is the imperative other than placating the bank lobby and insolvency practitioners whose major clients are the banks, which cause this demarcation in policy consideration and consequent discrimination?

5.6. Before listing all these arguments in section 7 below, section 6 deals with a consequence of the Bill that is not articulated in the Explanatory Memorandum.

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[17] at [19].

6. An Unintended Consequence of the Bill

6.1. The Government's proposal to overturn the effect of the Sons of Gwalia decision is surprising in the face of the conflicting opinions of the Corporations and Markets Advisory Committee ("CAMAC") and ASIC.

6.2. The decision has been lobbied for and justified on the basis, among other grounds, that it will not affect shareholder rights against companies that are not under external control. This is simply incorrect.

6.3. Shareholder class actions in the Federal Court of Australia relying upon the Market Protection Regime cost up to $10 million each to prosecute.[18]

6.4. In order to justify a decision to file, applicants need litigation funding which, in turn, requires reasonably clear evidence of the company's capacity to pay any judgment debt.

6.5. Under the current law Shareholder Compensation Creditors can look to their fair share of the value of the unsecured assets of the company if it enters into external control in order to obtain satisfaction of a judgment **debt**.

6.6. Under the Bill, this right will be taken away.

6.7. A direct consequence of the passage of the Bill will be to make unviable the enforcement of the Market Protection Regime will become commercially unviable to enforce against companies with net unsecured assets of less than about $50 million[19] (that is "Small to Medium Cap Companies") unless it is known to the victims of the contravention at the commencement of proceedings that the company has insurance that will materially respond.[20] The reason for this is that the risk will be too great of the claims success resulting in the company becoming insolvent and (if the Bill is passed) Shareholder Compensation Creditors receiving nothing.

6.8. The proportion of companies listed on the Australian Securities Exchange that fall within this population is material as a result both of their lack of net unsecured assets and there not currently being an obligation on our companies to disclose their relevant insurance policies either before or at the commencement of court proceedings.[21]

6.9. Shareholders will be unable, in a practical sense, to enforce the Market Protection Regime in respect of Small To Medium Cap Companies thereby reducing the Regime's effectiveness as a deterrent to contravening conduct and its ability to facilitate compensation where contravening conduct can be proved.

6.10. This unintended consequence needs to be addressed if this effective change to the Market Protection Regime innate in the Bill is to proceed.

6.11. The effect of non enforcement of the Market Protection Regime against Small to Medium Cap companies needs to be examined and, in particular, the effect on:

(a) compliance; and

(b) the availability and cost of equity capital to Australian businesses.

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[18] Refer, for example, to the applicant's costs in Aristocrat and AWB class actions.

[19] IMF introduced this investment guideline as a result of the proposed overturning of the Sons of Gwalia decision.

[20] Under current Australian law, companies and their insurers are generally not obliged to disclose the existence or indemnity limits of insurance that indemnifies the defendant in respect of the plaintiff's claim. Although ASIC will still have a role to play in these circumstances, it does not have unlimited resources.

[21] A contrary position is taken in the United States.

6.12. If the Bill is passed contrary to this submission, thought should be given to exempting in the Bill claims based on a court judgment from the class of subordinated claims.

7. Arguments for Changing the Status Quo

7.1. CAMAC's Report, in concluding that the legislative intervention to change the legal position as stated by the High Court was not appropriate, (an opinion supported by ASIC), noted a significant shift in Australian corporate regulation towards giving shareholders direct rights under the Market Protection Regime:

> "*Any move to curtail the rights of recourse of aggrieved shareholders where a company is financially distressed could be seen as undermining the apparent legislative intent to empower investors.*"[22]

7.2. Ford's Principles of Corporations Law summarised CAMAC's findings as follows:[23]

> "*The Committee accepted neither the argument that shareholding includes as one of its elements acceptance of the risk of being misled as a result of corporate misconduct; nor the argument that shareholders, unlike ordinary creditors, have it within their means to avert corporate misconduct.*
>
> *The Committee acknowledged that the Sons of Gwalia decision may have had an impact on the availability and cost of funds for Australian companies in the unsecured debt market, but it said it was likely that the market had already adjusted to the decision. Prospective investors in the rehabilitation of financially distressed companies could protect their financial interests through creditors' schemes of arrangement, whereby aggrieved shareholders would agree to restrictions on their claims in return for the injection of capital.*
>
> *The Committee also acknowledged the possibility of complexity and delay in the conduct of external administrations, especially given the possible growth of class actions by aggrieved shareholders. But it suggested (in Ch 4 of the Report) some ways to facilitate the efficient conduct of external administration proceedings involving claims by aggrieved shareholders.*"

7.3. After listing the "Arguments for non-subordination"[24] (**Attachment 1**), the Explanatory Memorandum to the Bill then listed the "Arguments against the status quo"[25] and concluded,[26] after weighing the pros and cons, that claims for compensation by shareholders against externally controlled companies should be subordinated below the claims of other creditors.

7.4. The Government's stated reasons for preferring to change the status quo are set out in the Explanatory Memorandum and quoted in the boxes below:

> 2.48 "*This option is preferred primarily due to the negative effect that non-subordination of shareholder compensation claims would have on the cost and access to debt financing for companies, particularly companies in distress*" (the "**Debt Financing Arguments**").

22 CAMAC Report presented to the Minister on 22 December 2008 [3.4].
23 [24.510] Member's claim for damages – policy and reform.
24 At [2.16]
25 At [2.17] to [2.39]
26 At [2.46]

> 2.49 "*The additional costs, complexity and delays to insolvency administration arising from the decision also argue strongly for subordination, in particular in relation to its expected impact on attempts at business rescue*" (the "**Insolvency Administration Arguments**").

> 2.50 "*Investor protection arguments against subordination are significantly weakened by the fact that the status quo does not result in a shift of the losses from shareholders onto those responsible for the conduct that caused their loss; instead losses are transferred onto unsecured creditors. Any investor protection benefits are likely to result from redistributions of losses amongst those suffering from a corporate collapse, rather than through deterring misconduct and reducing the risk of loss*" (the "**Marginalise Deterrent Argument**").

7.5. Each of the arguments underlying each of these primary arguments for a change to the status quo identified in the Explanatory Memorandum are recited *verbatim* below and then addressed in turn.

A. The Debt Financing Arguments

> 2.17 "*The effect of* Sons of Gwalia v Margaretic *is to shift losses suffered by shareholders, due to misleading conduct or non-disclosure, from shareholders to unsecured creditors.*"

7.6. The decision of the High Court merely stated the law. It did not change the law. The effect of the proposed legislation will be to terminate, in practical terms where the company enters external control, the statutory rights of victims of breaches of the Market Protection Regime to compensation and thereby increase the distributions to other unsecured creditors. There is no loss shifting that occurs other than that inherent in the fundamental principle referred to above, namely that unsecured creditors rank equally.

> 2.18 "*By reducing the likely return to unsecured **lenders** in the event of insolvency, the decision is likely to increase credit spreads for unsecured debt and to adversely affect the availability of credit, particularly in respect of distressed companies and companies where there have been concerns regarding corporate disclosure.*"

> 2.19 "*The decision increases the complexity and cost to **lenders** of assessing risk; monitoring those risks to ensure that their positions are not eroded by corporate conduct that misleads investors; and putting in place legal arrangements to mitigate those risks. Borrowers are subject to additional costs in complying with lender's requirements in respect of these matters.*"

> 2.20 "*In addition to charging increased risk premiums,* ***lenders*** *are expected to respond by imposing more burdensome restrictions or requirements on the provision of funds to companies, such as seeking or requiring security or guarantees. This is expected to lead to greater costs and restrictions on the supply of credit.*"

> 2.21 "*There are particular concerns regarding the effect of the decision on the corporate bond markets as bonds are typically unsecured (and sometimes subordinated).*"

7.7. These arguments by **lenders** are the primary basis for the Government seeking to change the status quo.[27] Given the Government has not made public the relevant data it has in support of these arguments, stakeholders, other than perhaps the banks, currently remain in the dark in respect of whether there is any basis for or evidence (both in Australia and in the UK) to support, these arguments.

7.8. IMF strongly urges the Senate Standing Committee to identify and make public the relevant data, including the submissions from the Banking and Finance industry, before Parliament is asked to change the status quo.

7.9. Prior to public disclosure of the relevant data, IMF notes the following:

(a) At a seminar hosted by the Investment & Financial Services Association on 8 March 2007, Stuart Gray, a senior credit analyst at Deutsche Asset Management, said that he and his colleagues had expected that Australian credit spreads (the difference between the yield on a government bond and a company's bond, reflecting the risk of the company bond) would widen after the Sons of Gwalia decision, but "this isn't happening".

(b) Mr Gray cited the "benign credit environment" in support of this observation and said that "investors directly affected by [the] Sons of Gwalia [decision] were limited" since there were only 30 to 50 US investors in the private placement market in which Sons of Gwalia issued its debt, and there were only seven investors in the Sons of Gwalia debt itself. Mr Gray said the US private placement market was dwarfed by the size of the investment grade market, which would not be affected by the Sons of Gwalia decision. The Sons of Gwalia decision only has the capacity to affect a small component of the debt market.

(c) The overwhelming majority of debt providers will not be affected by the Sons of Gwalia decision. In reality only a few reorganisations each year will be affected. This is because in order for Shareholder Compensation to be viable, all five of the following factors need to exist at the same time:

(i) a listed company needs to have become insolvent;

(ii) there must be sufficient assets to make distributions to unsecured creditors worthwhile;

[27] Explanatory Memorandum [2.48]

(iii) there must not be unpaid secured debt ranking in priority;

(iv) there must have been a reasonably clear breach of the Market Protection Regime; and

(v) a shareholder claim must have been identified and litigation funding obtained.

(d) The day after the Sons of Gwalia decision, Standard & Poor's director Anthony Flintoff, said: "*In Standard & Poor's view, the case does not realign the debt-equity balance; rather it recognises that the market-protection laws are powerful and that absolute transparency in information flows is a key protection for companies and investors alike*."[28]

(e) In Australia, there has been no evidence that the Sons of Gwalia decision resulted in any increase in credit margins or difficulty for Australian companies to raise debt finance. It would be improper for the Parliament to consider changing the law until the persons raising concerns about the cost of debt can present, and make public, tangible evidence to support their assertions.

(f) In any event, one cannot generalise about the cost of debt and need to assess the provision of debt to a particular company on a case-by-case basis. Lenders will always assess the probability of default before estimating what losses will be if default does in fact occur. The High Court decision is not likely to influence lenders' assessments of the probability of default.

(g) This point was clearly noted by Standard & Poor's which said after the High Court decision: "For debt investors, it is Standard & Poor's view that this decision should have no impact on the probability of a default in debt payments in the ordinary course, so we do not anticipate credit ratings being affected."[29]

(h) Logically, why should the cost of lending increase? Lenders will always put in place measurers to protect themselves from corporate misconduct. A failure by a company to disclose material information (which by its nature goes to the value of the company) can impact just as much on a lender as on a share purchaser.

(i) The spectre of funding difficulties has been put up in order to demonstrate that one should do something about the problem without first determining that the problem does in fact exist.

(j) No studies have been carried out and no commentators seem to be interested in the fact that the UK experience shows that the same law in that country has had no apparent effect on the funding of UK companies.

(k) Without some empirical study demonstrating that the Sons of Gwalia decision has had an impact on funding, this argument should not be relied upon by Parliament as a reason for taking away the current legal rights of Australian investors.

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[28] "Gwalia Court Decision Is Credit Neutral For Australian Ratings, But Recovery Risks May Rise, Says S&P", Standard & Poor's Ratings Services, Press Release dated 1 Feb 2007.

[29] Ibid. Another ratings agency, Fitch, said the decision "is not expected to have any immediate major impact on Australian debt markets". (See "Fitch: Gwalia Shareholder Case Decision Unwelcome for Debt Markets; But No Major Impact Likely", Fitch Ratings, Press Release dated 1 February 2007.)

2.22	"*The decision has resulted in Australian law differing from that in place in the United States (where case law to similar effect was reversed in 1978 by the introduction of section 510(b) of the US Bankruptcy Code)*."

2.23	"*Concerns are held regarding how the decision may be perceived by potential American credit providers who are accustomed to such claims being deferred; and who, due to their exposure to the American litigation landscape, may be highly sensitive to the threat posed by shareholder class action damages claim*."

2.24	"*Inconsistencies in business laws between Australia and the United States may be expected to increase business costs for enterprises operating in both jurisdictions, due to the need to maintain knowledge and processes to meet the needs of both laws*."

7.10. These arguments focus on the position in the United States. Their statement, without reference to the relevant law in the United Kingdom, suggests the Explanatory Memorandum is argumentative rather than explanatory. The United Kingdom legislature has taken a different approach to the United States as a matter of policy as noted in Ford's Principles of Corporation Law[30] where it states:

> "*A person is not debarred from obtaining damages from the company by reason of holding shares (Companies Act 2006 s 655 (following s 111A of the 1985 Act)). But if the company is in liquidation, the shareholder's claim is postponed to the claims of external creditors if it is made in the character of a member (Insolvency Act 1986 (UK) s 74(1)(f)). Whenever the shareholder's claim is not made in the character of member, and is therefore not postponed, the claim ranks equally with external unsecured creditors and so, to that extent, the outcome is to the contrary of the US position (cf Sons of Gwalia at [41], per Gummow J).*
>
> *In light of the Sons of Gwalia case, the position in Australia is very close to the position in the United Kingdom. The only significant difference appears to be that in Australia, the Houldsworth rule applies where the claim is by a subscriber for damages not under a statutory regime, and the company is not in liquidation or otherwise subject to the statutory liquidation provisions, whereas in the United Kingdom the rule is excluded by s 655 in all cases. Now that Australia has come so far, there is probably a case for simplifying the law by adopting a provision similar to the UK s 655.* ***A harder and broader question of policy is whether we should move away from the UK model towards a "shareholders come last" approach, which would satisfy the expectations of US bondholders and other US creditors of Australian companies***." (emphasis added)

7.11. Does the Government have any data on the cost and availability of equity capital to Australian businesses which will arise if the Bill is passed due to shareholder creditors 'coming last'?

30 At [24.510]

7.12. Where is the evidence from the UK that liquidity in the UK debt markets, or the cost of debt finance, has been affected by “shareholders not coming last”?

B. The Insolvency Administration Arguments

> 2.30 “*The decision has had a negative effect on costs and delays in the conduct of some external administrations, and consequently a diminution of returns to creditors*.”

7.13. Costs and delays in insolvency administrations are a concern whether or not proofs are lodged claiming losses arising from breaches by the company of the Market Protection Regime.

7.14. The real question is how often these claims are made and the extent of any legitimate costs and delays arising as a result of the claims being made.

7.15. In reality, only a few insolvency administrations each year will be affected. This is because in order for Shareholder Compensation Claims to be viable, all of the factors noted on paragraph 7.9 (c) of these submissions need to exist at the same time.

> 2.31 “*Costs and delays arise due to the complexities introduced into external administration in respect of identifying which parties are creditors and the quantification of their claims for the purpose of providing access to information, determining voting rights and making distributions of funds*.”

> 2.32 “*Although there can be significant complexities in determining certain creditor’s claims, ordinarily this process will involve the insolvency practitioner making an assessment of written agreements and records setting out the quantum of credit provided by them to the company*.”

> 2.33 “Sons of Gwalia v Margaretic *creates a new class of creditors the claims of which are inherently difficult to determine. Claims are unliquidated and involve the resolution of complex factual and legal issues of alleged conduct, causation, reliance and quantification of damage. Where misleading conduct has occurred there may be expected to be large numbers of claims to be processed and, depending on the circumstances, case by case assessments may be required*.”

7.16. There have only been two cases of any import where the Market Protection Regime has been relied upon against insolvent listed companies, being Sons of Gwalia and ION.

7.17. The administrators of Sons of Gwalia have stated publicly[31] (as have the solicitors for Sons of Gwalia) that change is not required to section 563A of the Corporations Act so as to enable them to effectively carry out their administrative duties. They dealt with 8,000 Shareholder Compensation Claims within about a year. (The five years it will take the ION administrators to address the ION Shareholder Compensation Claims ought to be the subject of an inquiry rather than used as an argument in favour of the Bill by some of the Bill's proponents).

7.18. The salient point is that, until a journalist asked the Sons of Gwalia administrator for his opinion, no one else seemed interested in finding out what impact the Sons of Gwalia decision and section 563A had had upon his administration of Sons of Gwalia Ltd.

7.19. Not many cases will be as complicated as the Sons of Gwalia administration. The position adopted by the administrators of that company, from personal experience, is such that administrative complexity can no longer be used as an argument in favour of the Bill.

7.20. The fact that the administrator of the company and his solicitors were prepared to be quoted publicly on this matter is at the same time a strong argument against the need for the Bill and an indictment of those who have used this argument to support the Bill without reference to the opinion of these gentlemen.

7.21. In any event, it would be wrong for the legislature to react to the cost and delay argument by effectively abolishing the rights of shareholders arising from the Market Protection Regime by subordinating these rights so as to make them illusory. If we abolished legal rights that were costly and time consuming to enforce, we would be left with very few rights.

7.22. Some insolvency practitioners have been calling on the legislature and courts to clarify principles and methodologies to enable claims to be determined quickly. For example, after the decision of Justice Emmett in the first Sons of Gwalia case[32], Tony McGrath told the AFR:

> "*I would hope there's a fairly straight-forward decision tree we can all follow so the creditors at large don't have to wait too long for their dividends.*[33]

7.23. Once it is recognised that the misled or uninformed shareholder is a creditor (and there is no question that this is the case), there is no logical reason why that creditor should be treated in a different way to other creditors. Simply changing the priorities (by subordinating the shareholder creditor's claims) does not relieve the external controller of duties towards those subordinated creditors.

2.34	"*The decision also has the potential to affect attempts at business rescue which depend upon debt funding to rehabilitate the business or company; due to its effect on credit costs and availability. This applies to attempts both prior to external administration and pursuant to rescue attempts via entry into voluntary administration*."

[31] Australian Financial Review article headed "The Sins of Gwalia" at page 77 on 13 May 2010 (**Attachment 2**).
[32] *Sons of Gwalia Ltd v Margaretic* (2005) 55 ACSR 365, 24 ACLC 244 (Emmett J).
[33] The Australian Financial Review; 21 September 2005.

7.24. One needs to ask the rhetorical questions:

- When is there a business rescue that doesn't require an equity risk being taken?

- Won't the passage of the proposed Bill into legislation diminish the availability, and increase the cost, of equity capital for insolvent companies?

7.25. IMF invites the Senate Select Committee to seek any data available from the Government or other sources on these issues.

> 2.35 "*The primary method of reorganising and rehabilitating insolvent companies is the voluntary administration process. Voluntary administration takes place in a relatively short timeframe, although the deadlines imposed by legislation can be extended by the Court. Delays in the business rescue process may adversely affect efforts to rehabilitate and reorganise the company. Sons of Gwalia v Margaretic, by adding complexity and delays, may interfere with the operation of this regime in respect of companies against which there are investor claims*."

7.26. This argument, as with the next, lacks sufficient focus to be the basis for any decision by Parliament. It seems to suggest that Shareholder Compensation Claims may delay or interfere with the business rescue process. This is not the case. Any vote that is needed in respect of a speedy rescue process will, under current insolvency practise, be on the basis that each shareholder creditor will only be admitted for voting purposes at a nominal value of $1.00[34] until such time as their claims may be adjudicated. The adjudication process can and does follow any rescue process.

> 2.36 "*Insolvency administration is not purely directed at maximising the amount of any distribution to creditors and investors. One objective of an insolvency regime is to contribute to the efficiency of the economy by enabling assets to be reallocated to productive uses in an expeditious and cost-effective manner. Another objective is the promotion and preservation of employment. Factors that delay the conduct of insolvency administrations and interfere with business rehabilitation processes obstruct the achievement of these objectives*."

7.27. As stated in response to the argument in paragraph 2.35 of the Explanatory Memorandum, the adjudication process in respect of shareholder proofs will not delay assets being reallocated in an expeditious and cost-effective manner or adversely affect employment. In any case, these are not relevant to considering whether to deprive people of their fundamental rights. The question might be asked, rehabilitation at what cost? By allowing misconduct to go uncompensated?

[34] See *Re Oriel Homes Pty Ltd* (1997) 15 ACLC 564 at 566.

7.28. No reliance ought to be placed on the arguments in paragraphs 2.35 or 2.36 by the Senate Select Committee.

C. **Marginalise Deterrent Arguments**

> 2.25 "*If shareholder claims are not subordinated, the burden of meeting compensation claims does not fall upon those who are responsible for or benefited from the misconduct of the company. Instead they are met by another class of stakeholders (unsecured creditors), who may also have suffered loss as a result of the breaches of disclosure obligations or misleading conduct giving rise to shareholders' claims*."

7.29. This argument, intentionally or otherwise, misstates the truth. The truth is that shareholder creditors are unsecured creditors. They may logically be distinguished from other unsecured creditors by reference to their claim arising from the purchase of shares, but that in no way by itself means they are not unsecured creditors who ought to rank equally with all other unsecured creditors. An argument for treating them differently must be justified if subordination itself is to be justified. No such argument is made in paragraph 2.25. The real argument is in paragraph 2.26 below.

> 2.26 "*As a mechanism that may operate to deter negative corporate conduct, it is noted that Sons of Gwalia v Margaretic does not transfer losses arising from misconduct to those responsible for misconduct (or who take advantage of that misconduct). It does not, therefore, create any incentive for those who are responsible for misconduct (or who take advantage of misconduct) to adopt alternative behaviour*."

7.30. This argument reframes the then Minister Chris Bowen's address on 4 May 2010 when he said:

> "*Another problem with the Sons of Gwalia decision which relates to my earlier point about coming down hard on wrongdoers- was that it did not transfer losses arising from misconduct to those responsible for that misconduct. Or to put it another way, it did not create an incentive for those who have misled their shareholders to change their behaviour.*"

7.31. This argument in turn falsely assumes that directors of listed companies contemplating breaching the Market Protection Regime are only deterred from doing so because their company or themselves may have to pay compensation if they breach the legislation and are caught. IMF submits that the primary deterrent effect of the Market Protection Regime is the negative effect on the directors' reputations that would arise on being publicity identified as the cause of the companies' legislative breach. The compensation is usually covered by insurance, but the directors' reputations would be permanently harmed.

7.32. Contrary to the argument above undermining the effectiveness of the Market Protection Provisions by introducing subordination of shareholder creditor claims does run the real risk of creating an environment where there is no incentive to change behaviour at all.

7.33. Furthermore, the perverse outcome which may occur if the Bill is passed, is that defaulting directors may be better off if they allow the companies they direct to go into external control as the likelihood of any class action would greatly diminish due to the subordination of the claims. In this respect IMF repeats that an unintended consequence of the Bill is that breaches of the Market Protection Regime by Small to Medium Cap Companies will go unanswered, unless ASIC takes up the gauntlet. IMF urges the Senate Select Committee to review the Government's data on the detrimental effect the Bill may have on diminishing deterrence from potential breaches of the Market Protection Regime.

D. Other Arguments in Favour of Changing the Status Quo

> 2.27 "*It may be argued that the negative effects on financing referred to above may result in investors generally being worse off, for example, due to increases in financing costs and lost investment opportunities by companies due to restrictions on access to finance*."

7.34. This may be argued, but not seriously. The Bill waters down the value of the Market Protection Regime, both in terms of deterrence and compensation. The weighing up of these factors against the current law's effect on the cost and availability of debt finance requires clear data in respect of both sides of the equation. Parliament doesn't have sufficient data (at least as far as the public is aware) on either side to justify an amendment to the status quo.

> 2.28 "*Any positive investor protection effects apply only to equity investors who have compensation claims against a company; investors in debt are adversely affected in a similar way to other creditors*."

7.35. It is false to suggest that only equity markets receive the benefit of the Market Protection Regime. The continuous disclosure and trade practices obligations resulting from the Corporations Act benefit all investors, debt and equity, in their allocation of resources. No one suggests that continuous disclosure obligations do not assist the trading banks in their allocation and pricing of debt finance. As a result of the deterrence effect, markets are better informed, benefiting everyone.

7.36. The status quo is that everyone is treated equally. The Bill seeks to prejudice equity investors for the benefit of debt investors.

> 2.29 "*Some stakeholders have asserted that, from a corporate governance perspective, as the stakeholder group that is best able to manage the risk of management misconduct, shareholders as a group should bear the cost of failing to mange this risk. The inappropriate allocation of credit risk away from those who are best able to manage that risk may have the potential to contribute to suboptimal economic outcomes*."

7.37. For most shareholders who are still holding their shares at the time a company which has breached the market protection laws enters external administration, the first indication that the company is in trouble is typically an announcement to the Australian Securities Exchange that external administrators have been appointed.

7.38. This is because in the modern equity market, shareholders typically remain outside the company and have little influence on the company's operation, or insight into its performance, other than through the information which is publicly disclosed to the Australia Securities Exchange.

7.39. As one commentator noted after the Sons of Gwalia decision, "*in large listed companies, ordinary shareholders, even institutional shareholders, have only notional ownership rights in most circumstances. They have no real ability to direct the company, are rarely able to influence the composition of the board or strategies of their management and are in reality more like financiers receiving equity returns and accepting equity risk*."[35]

7.40. This is in contrast to trade creditors and unsecured finance creditors, who are typically much closer to the company. Many trade creditors would receive an indication that a company is in financial difficulty when accounts are overdue or not being paid. To continue to advance goods or services in this situation is to assume the risk that ultimately you will not be paid for those goods or services.

7.41. Similarly, Banks are always in close contact with company management and some seek and receive access to the company's book and records to allow them to assess the risk of their loans. If anyone is best able to manage the risk of misinformation, it is the companies' bankers. Their loan conditions often give them significant rights to access information.

7.42. Hence it is arguable that it is even more important that the investor protections are made available in the context of insolvency to protect shareholders who can prove their right to compensation, as it is the shareholders who practically have less opportunity to assess the company's performance when compared to the company's traditional creditors.

7.43. Of all the possible creditors of an insolvent company, only investors in the shares of that company are unable to take steps to secure their position at the time they enter into their transaction with the company.

7.44. Trade creditors can include romalpa clauses in their contracts, banks can obtain fixed and floating charges and debenture holders can obtain security to ensure the repayment of their debentures.

[35] Bartholomeusz S, 'Shareholders win at cost to creditors", The Sydney Morning Herald, 1 February 2007 at page 24.

7.45. An investor, purchasing shares in the company in question, cannot secure his or her position i.e. he or she cannot ensure the amount he or she expends is given priority to other creditors of the company. All other creditors can ensure this priority against the investors in one way or another. The investor is totally reliant on the Market Protection Provisions to protect him or her.

7.46. It is therefore counterintuitive to take away the right of the shareholder creditor to share in the assets of the company.

> 2.37 "*There is significant potential for the effect of Sons of Gwalia v Margaretic to be avoided, at least by some creditors in some circumstances. For example, by lending to subsidiaries of listed entities rather than those entities themselves any compensation claims by shareholders of the listed company would (in the absence of cross guarantees or similar arrangements) remain subordinated. Such avoidance arrangements have the potential to create additional costs and distort financing arrangements from what may be economically optimal*."

7.47. Creditors may, as has always been the case, take priority through obtaining a charge.

7.48. Investment and trading banks are, however, only too aware that they will receive a higher return if they provide unsecured funds to listed Australian companies. They have enormous resources at their disposal to protect them from loss. As a matter of choice, such banks often give up the priority which arises from security and elect to advance funds on an unsecured basis.

7.49. It is illogical to prefer such banks over persons damaged by breaches of the Market Protection Regime.

7.50. When a bank lends on an unsecured basis to a company it takes the chance that either before the lending or after it the company will do something which causes enormous damage to other persons (for example, by selling defective products). The bank takes the chance that such a claim for damages will be made and will rank equally with its unsecured debt.

7.51. The Bill will not of course interfere with this priority but it will interfere with the priority of other damages claims made against the company.

7.52. There is no apparent rhyme or reason why the banks should be protected in this way.

7.53. The argument that the status quo requires the banks to avoid the risks of Shareholder Compensation Claims, with an admission that it can be done, ought be given little weight.

> 2.38 "*In practice, some creditor groups, such as trade creditors, may have little scope for protecting themselves by such arrangements and may therefore be more exposed than other categories of creditors to the consequences of aggrieved shareholder claims*."

7.54. It goes without saying that trade creditors are the second most vulnerable creditors of a company after investors who have purchased shares in the company.

7.55. It is difficult for trade creditors to obtain security (although some do) but other mechanisms are available to protect their position. The romalpa clause, for example, ensures that ownership of the creditor's property does not pass until the creditor has been paid.

7.56. As always, however, the question is one of degree. What percentage of a company's creditors consists of its trade creditors? If this figure is low (say 10%) then this Bill is being introduced to protect a small sector of creditors but, at the same time, provides equal protection for major banking institutions and hedge funds which don't need (and certainly do not deserve) such protection.

7.57. In any event, a priority which puts investors behind trade creditors would be sufficient to achieve this policy objective.

> 2.39 "*The impact of Sons of Gwalia v Margaretic is mainly upon business (debtors, creditors and employees) and investors. There is minimal impact on Government. Through its effect on business activity and employment, it may have a minor impact upon the community. To the extent that it adversely affects business rescue procedures it may also have minor impact upon consumers*."

7.58. The Government has not made any data available on the impact of Sons of Gwalia on business (debtors, creditors and employees), investors or the community. Shareholder Compensation Claims do not have the capacity to delay or interfere with the business rescue process as identified in IMF's response to paragraph 2.35 above.

8. Some of the Anomalies Arising from the Bill

8.1. Listed below are some of the other anomalies thrown up by the Bill.

A. Convertible Note Holders

8.2. Investor A may spend his or her money buying shares in a company. Investor B may invest the same amount of money but in convertible notes issued by that company.

8.3. The second investor receives an interest rate and, at his or her option, can convert his or her investment into shares in the company.

8.4. If that company goes into administration or liquidation then one of these investors loses priority and the other doesn't.

8.5. Investor A loses his priority because the Bill applies to persons who deal in shares while investor B does not lose his priority because the Bill does not affect those who invest in securities other than shares.

8.6. There is no sensible basis to differentiate between these investors. It is confusing and arbitrary to terminate the rights of one group of investors but not the rights of the others.

B. Options

8.7. In the same way, those investors who put their money into options over unissued shares in the company, will be protected as to their priority by the provisions of the Bill.

8.8. Priority will be interfered with depending upon whether an investor invests in shares or in options to purchase shares.

C. Summary

8.9. Investors who purchase shares, who take up options or who invest in convertible notes, are all beneficiaries of the Market Protection Regime. All of them are protected by that Regime where the company they invest in remains solvent but only some of them will lose their priority under the provisions of this Bill if the company becomes insolvent.

8.10. It is difficult to discern a policy basis upon which this could properly occur. All three are providing capital to the company on a unsecured basis. The Bill discriminates against one of them, but not the other two.

D. The Reach of the Bill

8.11. The Bill, of course, travels well past the Market Protection Regime. It provides that any claim by a person arising out of any dealing in shares will lose its priority.

8.12. This will capture more than just claims based upon the Market Protection Regime. At one extreme it will cover claims based upon outright fraud.

8.13. Claims based upon fraud are the best basis to test the utility (if any) arising from the provisions of the Bill.

8.14. Why for instance should the interests of hedge funds, investment banks and trading banks be put in front of the interests of defrauded investors in any circumstances whatsoever let alone circumstances where, out of these four types of creditors, only the investors cannot protect themselves by way of security?

9. Further Necessary Inquiries By The Senate Select Committee

9.1. In order to make a reasoned decision on the Bill, and before taking a decision that fundamentally affects existing rights, Parliament will need evidence in respect of the following:

(a) the effect the Bill will have on the enforceability of the statutory rights arising from the Market Protection Regime against companies not under external control;[36]

(b) the resulting effect upon compliance with the Market Protection Regime and the consequent availability of equity capital and its cost to Australian businesses[37];

(c) the nature and extent of any increased costs of, and access to, debt financing caused by the Sons of Gwalia decision;[38]

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36 Refer to paragraph 6.7.

37 Refer to paragraph 6.11.

38 Refer to paragraphs 7.7 to 7.9.

(d) the nature and extent of any increased costs of, and access to, equity finance to Australian businesses caused by shareholder creditors 'coming last' if the Bill is passed;[39]

(e) the cost and availability of debt finance in the UK due to shareholder creditors not coming last;[40]

(f) the cost and delays to insolvency administrations caused by shareholder creditor claims; [41]

(g) the cost and availability of turnaround equity finance for insolvent companies if the Bill is passed;[42]

(h) the diminution of the deterrent effect of the Market Protection Regime if the Bill is passed;[43] and

(i) the impact of the Sons of Gwalia decision upon business (debtors, creditors and employees) and investors.[44]

9.2. IMF strongly urges the Senate Select Committee to source, and make public, evidence in respect of each matter listed above to enable Parliament to make an informed decision as to whether or not to change the status quo.

29 October 2010
John Walker
Executive Director
IMF (Australia) Ltd

[39] Refer to paragraph 7.11.
[40] Refer to paragraph 7.12.
[41] Refer to paragraph 7.14.
[42] Refer to paragraph 7.24.
[43] Refer to paragraph 7.33.
[44] Refer to paragraph 7.58.

Arguments for non-subordination:

'Limited impact of the decision

While aggrieved shareholder claims could potentially be made against any company, in practice they are most likely to arise in the external administration of disclosing entities. Shareholders in these publicly listed companies typically rely on the company for accurate information affecting the value of the investment.

Argument based on acceptance of risks invalid

The risk that equity investors take is that the venture in which they are investing will not succeed (including because the managers were incompetent). However, shareholders (and creditors) do not take on the risk that a company may have concealed information or provided false or misleading information affecting the investment decision.

Investor protection and market confidence

The High Court decision is consistent with the direction of investor protection law, including its extension to the financial services sector. Since the need for shareholder protection may be most marked in the event of insolvency, such protection may be illusory if relevant claims are subordinated to the claims of ordinary creditors.

One of the aims of the continuous disclosure provisions is to compensate shareholders and potential shareholders for the losses that might be suffered from undisclosed facts and to reduce the incidence of such losses. It may not encourage reliance on financial markets if, in the very situation (a voluntary administration or liquidation) in which investors may need to resort to relevant statutory remedies, their rights are postponed behind those of conventional unsecured creditors.

Another aim of the continuous disclosure, and other corporate disclosure, requirements is to promote a properly informed market, thereby enhancing the integrity and reputation of that market and encouraging investment. All things being equal, prospective shareholders will be more likely to invest in the share market if they feel confident that they will have a meaningful remedy should the companies in which they invest fail to make adequate disclosure. Promoting investor confidence in the equity market may generate greater liquidity in that market and offset, in whole or part, increased costs for companies in the smaller debt market.

Promote market neutrality

Both the debt and equity markets rely on the investor protection provisions and should receive the same protections in the event of corporate misconduct.

Corporate control

In some companies, such as large listed companies, ordinary shareholders, even institutional shareholders, have limited practical ability to direct the company and in reality may have no greater power than creditors. They therefore need a comparable level of protection in an insolvency.

Corporate culture

The *Sons of Gwalia v Margaretic* decision reminds boards of the importance of a culture of corporate compliance with disclosure obligations and the increased possibility of shareholder claims if these obligations are disregarded.

Private enforcement

Aggrieved shareholder claims can act as a form of private enforcement and help promote the integrity of corporate conduct, in particular the reliability of public disclosures, to the benefit of lenders and the market generally, not just shareholders.

Implications for debt markets

Lenders in the debt finance market can protect their interests in various ways, such as by adjusting the terms on which they provide finance to companies. In the United Kingdom, the House of Lords decision in Soden a decade ago (see Section A1.2 of Appendix 1 of CAMAC's report), which is similar in effect to that of the High Court in *Sons of Gwalia v Margaretic*, does not appear to have affected the market for corporate debt. There is some indication in American investor restitution legislation of a move away from blanket subordination of aggrieved shareholder claims.

Fairness and workability in an external administration

Aggrieved shareholders should be in no worse a position in an external administration than holders of options or convertible notes who have been similarly deceived into acquiring their securities at the same time by means of the same faulty disclosure or non-disclosure (option and note holders have never been considered to be postponed to other creditors under section 563A). Although aggrieved shareholder claims may add a layer of complexity to external administrations, administrators already have to deal with complex situations, including determining certain claims by conventional unsecured creditors (for instance, product liability claims). Making external administrations simpler, quicker or more expedient does not justify postponing a category of shareholder creditors. Any procedural difficulties may be ameliorated by appropriate administrative reforms.

The sins of Gwalia

Aggrieved investors fighting for compensation against a failed goldminer have unwittingly contributed to a dilution of shareholder rights in compensation cases, writes James Eyers.

It is ironic that the claims by aggrieved shareholders of Sons of Gwalia became the lightning rod for legislation that will strip away the rights of shareholders to claim compensation against failed companies before all other unsecured creditors. The process for determining shareholder claims need not be too complicated and time-consuming, says the leading law firm partner and the administrator who oversaw the resolution of the claims by shareholders of the failed goldminer.

This is despite one of the government's key justifications for restricting shareholder rights against insolvent companies – that such claims prevent failed companies from being wound up in a timely and cost-efficient manner, as set out in an explanatory memorandum to draft legislation released last month.

The government also says the laws will help insolvency practitioners work stressed companies out of trouble, reduce the price of debt financing for companies and protect the claims of traditional creditors from being diluted by shareholders – motives that are also the subject of some conjecture.

In January 2007 the High Court found that shareholders with a legitimate claim for damages arising from rights provided to them by the Corporations Act – such as a company's breach of the continuous disclosure laws – could receive distributions from the failed company's assets, with other unsecured creditors. The government's corporate law adviser, the Corporations and Markets Advisory Committee, and the Australian Securities and Investments Commission, backed the decision.

Konrad de Kerloy, a partner at Freehills who, with Gwalia's administrators Ferrier Hodgson, oversaw the adjudication of more than 8000 claims from Sons of Gwalia shareholders (5500 were accepted), said shareholder claims could be determined efficiently. This required broad principles to be agreed to, and an appropriate adjudication process designed and approved by the creditors or the court.

"It will take extra time, but the problems are not insurmountable if people want to take a view that you can solve the problem," de Kerloy says. "We were told, 'This will be huge, you will never be able to get on top of it'. We didn't approach it with that attitude – we wanted to get on top of it and get the administration completed within a reasonable time frame and at a reasonable cost."

Darren Weaver, one of Gwalia's administrators from Ferrier Hodgson, said that once the process for determining the shareholder claims against Gwalia was approved by the company's creditors in December 2007 (less than a year after the High Court decision), every claim had been adjudicated on by July 2008.

Weaver says that of the nearly 3000 claims the administrator rejected, only three claimants appealed against the way those claims were assessed. (The appeals are under way.) "I think that speaks a lot for the process," he says.

As with most large-scale administrations, Ferriers conducted a thorough investigation into Gwalia's affairs after being appointed in August 2004. They found huge potential hedging losses had not been disclosed in the accounts.

During this period, the administrator "formed our own view on whether certain claims of misleading and deceptive conduct were correct and what time periods they apply to", Weaver says.

This allowed the administrator to construct a process whereby shareholders were given a clear indication of the information they must provide before their claims were admitted.

One of Western Australia's leading silks, Chris Zelestis, QC, provided advice about the process, including how claimants should illustrate a sufficient causal connection between their loss and the misconduct of the company (a necessary step to prove their claims) and about how their losses should be quantified.

The legal, accounting and expert fees for the seven-month adjudication process resulted in costs of less than half a cent in the dollar of dividends forgone by creditors, Weaver says. (All creditors, including shareholder-creditors, have been paid dividends of 21¢ in the dollar.)

Hugh McLernon, managing director of litigation funder IMF (Australia), which funded the Gwalia shareholder claims and the High Court test case, said: "Sons of Gwalia is the paradigm case for how an administrator should deal with multitudinous claims against the company."

IMF is also funding shareholders of the failed car parts maker ION to make similar claims in its administration. But unlike the Gwalia administrators, the administrators of ION, McGrath Nicol, have not determined any claims. They decided to wait for the High Court decision in Sons of Gwalia (a delay of 26 months) and have since embarked on an "extremely wide-ranging and detailed forensic investigation into all underlying causes of the company's collapse", says Ben Phi, the lawyer at Slater & Gordon representing ION shareholders.

"We believe much of the cost and delay in this exercise could have been avoided if either the administrator had engaged meaningfully with us from the outset, or if appropriate directions had been obtained from the court.

"Administrators are given a wide discretion in how to perform their very important functions. Just because the administrators in ION have regarded their role as requiring a wide-ranging factual investigation and legal inquiry, this does not mean this was the only way for the administration to be conducted."

Stuart Wilson, chief of the Australian Shareholders' Association, says even if shareholder claims were costly and timely to determine, this does not provide sufficient justification for the government's decision to strip shareholders of their statutory rights.

"It is largely irrelevant what the costs are if there is a valid claim," he says. "You could run the same argument that all unsecured creditors should be left out of the group as well, simply because they are expensive to maintain."

Illustration: DAVID ROWE

Why would the minister want to favour the banks and hedge funds over defrauded investors?

Hugh McLernon, IMF (Australia)

The government also justified the decision to overturn the High Court ruling on the basis that it adversely affected the ability to work stressed companies out of trouble, and on the availability and pricing of debt financing for companies.

The explanatory memorandum to the bill said the High Court decision "is likely to increase credit spreads for unsecured debt and to adversely affect the availability of credit".

But Wilson says: "There is absolutely no evidence over the time that the decision was in place that any increases in margins or costs were as a result of the Gwalia decision."

This view is also supported by experts in the debt markets.

Anthony Flintoff, an analyst at Standard & Poor's, says it is "difficult to discern what impact [the Sons of Gwalia decision] had spread-wise.

"The cost of borrowing increased dramatically during 2007, 2008 and 2009. It is absolutely impossible to work out in that increasing spread how much is due to liquidity, to economic fears or to Sons of Gwalia."

Although some US noteholders were unnerved by the decision, no evidence has been put forward that the decision killed off the prospect of any corporate workouts. Some say the government's logic in citing workouts as a justification for the laws is counter-intuitive, because if a workout is successful, shareholders' causes of action against the company will survive.

In other words, Gwalia-style claims will be possible only if the workout is ultimately unsuccessful – not the result a provider of capital to a workout would seek.

Furthermore, funding for workouts has normally been provided on a secured basis – which also makes the impact of Gwalia a moot point, as shareholder claims can be made only on unsecured assets.

"In circumstances where an investor contemplates providing capital to a distressed company, that investment will still be at risk of potential claims by shareholders in the event the company is successfully turned around outside formal administration procedures," Blake Dawson partner James Marshall said in a recent note to clients.

Federal Corporate Law Minister Chris Bowen suggested last week the other key motivator for the decision to overturn Gwalia was to protect other unsecured creditors, presumably trade creditors, from dilution from shareholder claims.

The Sons of Gwalia shareholder claims increased the total pool of creditor claims by $450 million – from $800 million to $1.25 billion.

"Investors make a conscious decision to invest money in a company in the hope of sharing in the company's profits," Bowen told a conference hosted by IMF. "In doing so, they are entitled to expect proper disclosure from the company. But they must accept that they are taking a risk in making that investment.

"In contrast, creditors are not hoping to increase their wealth by gambling on the future profitability of a company. They are often small businesses or trade creditors who are simply owed money for work they have already done, or for materials they have supplied.

"So while investors who have been misled into making that investment should rightly be able to claim redress, they should not be able to do so to the detriment of creditors in terms of receiving distributions when a company is insolvent."

But McLernon says the Corporations Act places the responsibility and liability for breaches of the continuous disclosure requirements squarely on the company. (Liability on officers for continuous disclosure breaches is secondary and was introduced only in 2004.)

"So it is the case that a claim by a defrauded investor against the company is a claim against the person responsible for the misconduct," McLernon says.

In Gwalia, the "creditors" to whom the minister refers consisted not only of trade creditors, but banks, which had lent unsecured; hedge funds, which had bought debt at distressed prices; and defrauded investors, many of whom were not shareholders at the time of the misconduct, but were misled into buying shares as a result of it.

"Why would the minister want to favour the banks and hedge funds over defrauded investors?" McLernon says.

"If he truly wants only to protect the trade creditors, then he need only postpone defrauded investors behind such creditors."

Last week, IMF presented Bowen with a petition on behalf of 2637 shareholders that had participated in IMF-funded class actions, a group that represented about 70 per cent of all funds invested through the Australian Securities Exchange, IMF said.

IMF also said that 2507 of the respondents, or 95 per cent, said there had been insufficient policy considerations for the government's decision to overturn the High Court decision.

The government will receive comments about the "final wording" of the legislation until May 18.