



# SHAREHOLDERS RANK EQUALLY WITH CREDITORS

## LENDERS BEWARE - THE NEW SHIFT IN INSOLVENCY LAW

### In This Issue

#### SHAREHOLDERS RANK EQUALLY WITH CREDITORS

LENDERS BEWARE - THE NEW  
SHIFT IN INSOLVENCY LAW

Page 1

**A recent decision by the High Court of Australia ("Sons of Gwalia") has confirmed that where shareholders have made a loss on their shares because the company has engaged in misleading and deceptive conduct, those claims may rank equally with claims of unsecured creditors. This decision appears to reverse the once commonly accepted principle that members can only assert claims in insolvent administrations, that are postponed to the rights of creditors.**

### BACKGROUND

Mr Margaretic (*M*) lost over \$25,000 of his retirement savings after investing in a West Australian mining company, Sons of Gwalia, eleven days before it went into voluntary administration. The company had failed to disclose to the Australian Stock Exchange that it was no longer able to meet sale contracts and was effectively insolvent. *M* claimed damages against the company for its failure to disclose the relevant information to the market as required by the ASX Listing Rules.

His claim had two foundations, misleading and deceptive conduct under the Trade Practices Act 1974 and a breach of the Australian Securities and Investments Commission Act 2001 arising from failure to follow listing rules.

### COURT RULING

The High Court gave *Corporations Act 2001* section 563A its plain meaning and swept aside previous legal views that the common law prevented members claiming damages in relation to losses on their shares in competition with unsecured creditors. It ruled that *M*'s claim for damages did not arise from *M*'s capacity as a member of the company, but because of the company's breach of the statutes. This meant that *M*'s claim had the same ranking in the winding up as an unsecured creditor's claim, in effect diluting claims of Sons of Gwalia's unsecured creditors.

### S.563A of the Corporations Act states:

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

Continued on page 2...

Level 2, 200 Adelaide Street Brisbane Qld 4000  
Phone 07 3221 4550 Facsimile 07 3221 8500

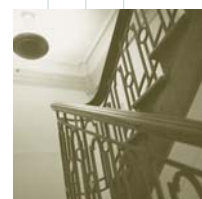
Level 7, 4 O'Connell Street Sydney NSW 2000  
Phone 02 9239 9400 Facsimile 02 9239 9499

Level 9, 190 Queen Street Melbourne VIC 3000  
Phone 03 8622 2700 Facsimile 03 8622 2722

Level 5, 50 Cavill Avenue Surfers Paradise Qld 4217  
Phone 07 5630 9500 Facsimile 07 5630 9599

1 Ocean Street Maroochydore Qld 4558  
Phone 07 5451 1455 Facsimile 07 5451 0744

E-mail us at [macgill@macgillivrays.com.au](mailto:macgill@macgillivrays.com.au)  
Phone us on 1300 369 581



# SHAREHOLDERS RANK EQUALLY WITH CREDITORS

Continued from page 1...

## LENDERS BEWARE -THE NEW SHIFT IN INSOLVENCY LAW

Previous common law decisions created the perception that despite this language members in M's position could not claim damages from an insolvent company unless they rescinded their membership contract before the insolvency administration commenced.

The High Court's decision opens the door for all types of members (whether a long-time share subscriber, or a recent share buyer) to prove their claims in competition with unsecured creditors during insolvency proceedings.

### PRACTICAL EFFECTS

The decision does not affect creditors who are fully secured.

It means unsecured creditors (including unsecured lenders) may have to share the remaining assets of the company with any shareholders who can prove a loss on their shares arising from their rights, *other than as members*, because of a statutory breach by the company. This would reduce the dividend to this class of creditor in the winding up.

It is important to note that the existing Sons of Gwalia shareholders would have been very unlikely to have had a claim as the with-held information would have reduced the value of their shares to nil as soon as it became known. The vast majority of members would have been unlikely to have had the opportunity to sell their shares before the market price of those shares adjusted to the information, had the information been disclosed by Sons of Gwalia when it should have been.

The most likely shareholders to have a valid claim are those buying shares between when the information should have been released and when it became known. This is what happened to M.

The decision potentially increases the cost of insolvency administration as shareholder claims will need to be litigated before it is known if they are valid. This will delay insolvency proceedings and impact upon the amount unsecured creditors will eventually receive from the winding up.

### RECOMMENDATIONS TO LENDERS

The Sons of Gwalia Case highlights the need for all lenders to do the following.

- Wherever possible take security - regardless of whether the company is listed or unlisted.
- When lending to corporate groups of companies, give financial accommodation to, and take security from, the subsidiary with the operating assets and/or income, rather than the holding company. This ensures members of a holding company are subordinated to the claims of lenders to its subsidiaries.



### THE FUTURE

It appears that Parliament did not fully consider the impact of the additional remedies for misleading and deceptive conduct added to the laws governing corporations on the priority of creditors in insolvency administrations. As a consequence Australian law has deviated in this respect from that of the UK and US.

If Parliament determines that losses relating to shareholder investment decisions should not rank equally with unsecured creditors (which we believe is likely), Parliament will need to amend the *Corporations Act 2001* to again give unsecured creditors priority over claims relating to shareholder investment decisions.

Until that time lenders and other creditors must readjust their risk, pricing and security policies to reflect the new world of competing shareholder claims.

**For further information or to discuss the ruling please contact either Nicholas Diacos, Partner, MacGillivrays Solicitors (07) 3228 5206 or Gordon Perkins, Solicitor, MacGillivrays Solicitors (07) 3228 5267.**



PLEASE NOTE: This newsletter is not legal advice and our comments are of a general nature only. This document is not to be relied on as substitution for proper detailed advice. If you would like to be removed from, or added to our mailing or emailing list, contact Meredith Clarke on (07) 3221 4550 or [meredithc@macgillivrays.com.au](mailto:meredithc@macgillivrays.com.au)