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There's Gold in Them Thar Liquidations: Securities Class Actions in Australia

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1. Introduction

Although not restricted to the mining sector, securities class actions in Australia have been particularly prominent in that sector, presumably because of the speculative nature of the investment.

The mining industry currently contributes around 4-5 percent to Australia's gross domestic product. It is Australia's second largest export earner (after manufacturing), and accounted for a third of the total value of the country's exports in 2004–05.[1] The world's largest mining company, BHP Billiton, is headquartered in Australia. Almost a third of the companies listed on the Australian Securities Exchange are resources companies.

That favourable position does not provide investors in Australian mining companies with any protection from the risks inherent in mining. Traditionally, the collapse of a mining company or the announcement of a profit downgrade was regarded as evidence of the high risk nature of investment in that class of stocks.

In the last couple of years, however, investors have started to bite back - not through a flight of capital, but through closer investigation of the circumstances surrounding their company's economic misfortunes. This is increasingly manifesting itself in the form of securities class actions, against both solvent and insolvent companies. At this stage of the process, this category of class actions is still working through a number of procedural and conceptual issues. The signs, however, are that they are here to stay and will become a major factor for many insolvency practitioners to deal with in the future.

This paper sketches out the substantive legal elements underlying securities class actions and their relevance to insolvency practitioners.

After this paper was completed, the High Court of Australia handed down its decision in *Sons of Gwalia Ltd v Margaretic; ING Investment Management LLC v Margaretic* [2007] HCA 1. That decision is discussed in Section 6 of this paper. Although it clearly states an answer to one issue discussed in this paper (if an on-market purchaser of shares claims to have been misled into buying the shares, is that purchaser's claim postponed to the claims of other creditors?)[2], the High Court's decision simply highlights for insolvency practitioners the problems we have highlighted in Section 4.5 of the paper.[3]

2. Legal elements - securities law

2.1 Introduction

Because this is a paper about insolvency, it is not proposed to discuss in great depth the substantive legal provisions under which shareholder claims arise. Rather, we will describe the broad legal framework which supports those claims.

2.2 The Australian Securities Exchange

The Australian Securities Exchange (ASX) operates a system of "continuous disclosure". This takes the form of a listing rule (LR 3.1) which requires listed companies to make immediate disclosure to the market of any information that is price-sensitive in relation to its share price.[4]

Because ASX is a private corporation, LR 3.1 is a private contractual provision between ASX and each listed company. However, the *Corporations Act* 2001 (Cth) also imposes a statutory obligation on all listed companies to comply with this particular rule: section 674. Breach of this requirement can give rise to a liability in damages to anyone who suffered a consequent loss: section 1317H. It may also ground a claim for loss arising out of misleading or deceptive conduct: see below.

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[1] 2006 Year Book Australia, Australian Bureau of Statistics, p 453.
[2] The answer, incidentally, is No.
[3] Indeed, as will perhaps be apparent, Section 4.5 was written in anticipation of what turned out to be, in fact, the High Court's ultimate decision.
[4] There is a limited number of exceptions for information that is confidential or incomplete business proposals, but the ambit of these exceptions in practice is getting narrower.

2.3 Misleading or deceptive conduct and statements

Australia's major consumer protection statute, the *Trade Practices Act* 1974 (Cth) has a provision which prohibits companies from engaging "in conduct that is misleading or deceptive or is likely to mislead or deceive". Since its enactment, section 52 has come to occupy a central place in the Australian legal system; in fact, there are probably more court cases involving "misleading or deceptive" claims between companies that between consumers and companies: contractual disputes between companies regularly include a claim that one side or the other engaged in misleading or deceptive conduct.

A major reason for this is that, as a statutory test, it is not subject to the limitations of any of the analogous common law causes of action such as deceit, fraudulent misrepresentation or negligent misstatement. As a result, Australian courts have adopted a fairly wide reading of "misleading or deceptive". Although there is no definitive judicial statement of what the term means, it is generally accepted that its central target is conduct that leads (or is likely to lead) a person to arrive at an erroneous conclusion.

The Corporations Act 2001 incorporates a number of provisions which are based on section 52. These provisions have three main areas of impact:

- misleading or deceptive statements in fundraising documents (section 728) - this can give rise to a claim by someone who invested in the company on the basis of the fundraising documents (section 729);
- misleading or deceptive statements in takeover documents (section 670A) - this can give rise to a claim by a person who accepted (or rejected) a takeover offer on the basis of the takeover documents (section 670B);
- misleading or deceptive conduct "in relation to" securities (section 1041H) - this is a "catch-all" provision, which encompasses misleading or deceptive conduct outside the other two provisions (for example, misleading statements in ASX announcements or shareholder communications, or the deliberate withholding of information).

2.4 Maintenance of capital

From the establishment of British colonies in Australia until very recently, Australian company law was largely a copy of English company law.

One longstanding principle of the two systems was the doctrine of maintenance of capital - the proposition that companies had to maintain a level of capital that would be available for payment of its creditors in the event of its insolvency.

In Australia in the 1980s and 1990s, two key manifestations of the doctrine of maintenance of capital were abolished: the prohibition on companies' buying back their own shares (1989) and the concept of par value (1998). Despite this, there was not a wholesale abandonment of the doctrine, which continued to manifest itself in:

- the rule in *Houldsworth's case* (*Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317), which is that a subscribing shareholder cannot recover damages from the company for fraudulent misrepresentation in connection with the subscription for the shares - the shareholder's only remedy is to seek rescission of the contract of allotment of shares (which would remove his name from the shareholders' register of members) and thereby to receive restitution of his application money; *Houldsworth's case* was followed by the High Court of Australia as recently as 1993;[5]
- section 563A of the Corporations Act, which postpones payment of the claims of shareholders until all other creditors have been paid out in full - see below.

3. Legal elements - insolvency law

In order to understand the current and future picture for insolvency practitioners in this area, it is necessary also to have regard to a number of Australian corporate insolvency law concepts. Overall, it is important to

[5] *Webb Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR 15.

remember that, generally speaking, class actions by shareholders are an issue for insolvency practitioners and unsecured creditors: secured creditors have the security of assets that, except in relatively unusual circumstances, cannot be attacked by liquidators or unsecured creditors

3.1 Pari passu

With a few exceptions (the costs of winding up or the payment of employee entitlements, for example), all unsecured creditors rank equally in a liquidation. Where there are insufficient funds to pay all creditors the full amount of the debt of to them, the creditors are paid "pari passu" (ie. in the same proportion (cents in the dollar)). However, as mentioned above, this general proposition is altered by section 563A:

> "563A Member's debts to be postponed until other debts and claims satisfied
>
> 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."

Until very recently, section 563A was regarded by liquidators (and everyone else) as being a rule that "members come last". Now that view is being challenged, as the cases discussed below illustrate.

3.2 Rescission of share subscription contract

As noted above, the rule in *Houldsworth's case* is that a subscribing shareholder can only claim a return of his subscription money (on the grounds of misrepresentation, for example) if he rescinds his subscription contract. This neat solution falls over once the company becomes insolvent, in another manifestation of the doctrine of maintenance of capital.

In *Oakes v Turquand* (1867) LR 2 HL 325 the House of Lords held that, once the winding up of a company has begun, a shareholder cannot rescind the contract under which he acquired his shares. The reason for this, of course, is that the return of the purchase price at that point would constitute a return of capital to the shareholder and a consequent reduction of capital for the company (which would, in theory reduce the amount of money available to pay its creditors).

4. Legal elements: the issues

4.1 Background

The legal rules outlined above survived the abolition of par value and the legalisation of share buybacks in Australia - largely, it would seem, because no-one turned their minds to them.

In economic terms, it is easy to see why this should have been the case. The abolition of par value and the legalisation of share buybacks were driven by the need for viable companies to have flexible capital management techniques, especially as capital markets became global phenomena through the 1980s and 1990s.

Who, in contrast, would be interested in examining the position of shareholders in a collapsed company?

"Everyone knew" that, thanks to section 563A, shareholders came last, and, given that a collapsed company is *ipso facto* one that is chronically short of funds, what individual shareholder would have the economic incentive to obtain a legal opinion about whether it might have some grounds of redress: why pay for legal advice that you might possibly have a cause of action if the proposed defendant was insolvent?

4.2 An interesting series of events

Then two things happened which changed that picture dramatically.

The first was the introduction into the Australian legal system of class actions in 1992.

The second was a novel legal argument put to the court on behalf of a liquidator in 1995. For a long time, Australia had followed the English doctrine on maintenance and champerty (which, in effect, prevented a person's paying a litigant's legal costs if that person was not a party to the litigation). There were some moves in some of the States to abolish the torts of maintenance and champerty, but there was still a strong body of opinion that a court could overrule a litigation funding agreement on the same public policy grounds that underlay maintenance and champerty (ie. the discouragement of litigation as a purely commercial activity).

In 1995, the liquidator of Movitor Pty Ltd entered into an agreement to obtain funding to pursue a civil action against a former director of the company. The person supplying the funding would, in return, receive, a share of any sum that the liquidator recovered in the action. The liquidator successfully argued to the court that it was not in breach of the principles of maintenance and champerty, because one of the statutory powers conferred on liquidators is the power to sell or dispose of company property (which includes choses in action). The court held that that power clearly constituted a statutory exception to the rules of maintenance and champerty: *Re Movitor Pty Ltd* (1996) 14 ACLC 587.

It would be no exaggeration to say that this opened the floodgates to litigation funding. Very quickly, the original narrow base of the decision was washed away as an entire litigation funding industry sprang up - and not one that was restricted to providing funding to liquidators.

Notwithstanding the rapid growth of the litigation funding industry, there were still doubts about its legal credentials. These were largely removed in August 2006, when the High Court held that litigation funding is neither an abuse of process nor contrary to public policy: *Campbells Cash and Carry Pty Limited v Fostif Pty Limited* [2006] HCA 41.

Together, the rise of class actions and litigation funding changed the economic factors which had discouraged any sustained testing of section 563A and the rule in *Houldsworth's case*.

As a result, there have been a number of recent cases which threaten to give shareholders a say in the administration of insolvent companies and a right to share equally in distributions to an insolvent company's unsecured creditors.

4.3 Relevant insolvency administrations

Part of the significance of shareholders' claims against insolvent companies arises from the mechanics of insolvency in Australia. In that respect, there are two significant forms of external administration: voluntary administration and winding up.

Voluntary administration

Voluntary administration is a statutory regime for companies which are experiencing significant financial difficulties: *Corporations Act* Pt 5.3A. The object is to provide a short moratorium for companies that are insolvent or nearly insolvent. The affairs of a company in voluntary administration are to be administered in a way that:

- maximises the chances of the company, or its business, continuing in existence; or
- if the company or its business cannot continue in existence, results in a better return to its creditors and shareholders than would result from an immediate winding up.

Voluntary administration is designed to be implemented quickly, and to be uncomplicated, inexpensive and flexible. In essence, it provides for a short period of external administration of the company, during which options for its continued survival can be explored.

The voluntary administration of a company may be initiated by its directors if they think that the company is insolvent or likely to become insolvent. An administrator may also be appointed by a creditor with security over the whole, or substantially the whole, of the company's property, or by a liquidator or provisional liquidator (with the leave of the court).

The administrator takes control of the company's business, property and affairs. This imposes an immediate moratorium on the enforcement of claims against the company (except with the leave of the court).

The administrator investigates the business and financial circumstances of the company, and forms an opinion about whether it would be in the interests of the company's creditors for:

- the company to execute a deed of company arrangement (which is a formal work-out plan, usually involving the injection of cash and some postponement of creditors' rights)
- the administration to end; or
- the company to be wound up (through a creditors' voluntary winding up - see below)).

The administrator must hold a meeting of the company's creditors, usually with four weeks of his appointment (although this can be extended by a court and the meeting itself may adjourn for up to 60 days). At that meeting, the administrator reports to the creditors on his view of the three options, and they vote on which option to adopt.

Crucially, the statute provides special rules for counting the votes at this meeting:

- a motion is only carried if it is supported by a majority of creditors by number *and* by value of debts
- where a motion is supported by only one of the required majorities, the administrator has a casting vote: *Corporations Regulations* 2001 (Cth), reg 5.6.21.

Winding up

Winding up (also called liquidation) is a procedure used to bring a company's existence to an end where it has insufficient assets to satisfy all of its liabilities.

There are two main forms of insolvent winding up:

- winding up by a court-appointed liquidator; and
- winding up by a liquidator appointed by a meeting of the company's creditors (creditors' voluntary winding up).

Most court applications to wind up a company in insolvency are based upon a failure to comply with a statutory demand for payment of a debt of more than $2,000. That failure gives rise to a prima facie presumption that the company is insolvent. If the company does not disprove the presumption, it will be wound up by the court. An application to a court to wind up a company in insolvency is most commonly made by a creditor relying on an unsatisfied statutory demand. An application, however, can also be brought by the company itself, a secured, contingent or prospective creditor, a shareholder, a director, a liquidator, a provisional liquidator or ASIC.

Creditors' voluntary winding can be initiated in one of two ways.

The members of the company can vote to wind up the company and appoint a liquidator. If the liquidator finds that the company is insolvent, he will usually convene a meeting of creditors. That meeting has the power to replace the liquidator but the more significant effect is that the creditors are effectively given oversight over the liquidator during the course of the liquidation.

The other method of entering a creditors' voluntary winding up is through a voluntary administration. As noted above, the creditors in a voluntary administration may vote to place the company in a creditors' voluntary winding up, rather than adopting a deed of company arrangement.

4.4 The issues

There are two main ways in which a person becomes a shareholder in a company:

- taking up an issue of shares from the company (IPO)
- buying shares from an existing shareholder (on-market or by private treaty).

In either case, the person taking the shares would normally do some preliminary research on the company, its business and its commercial prospects. In the case of a listed company, the relevant information sources would include prospectuses, stock market announcements, investor briefings and media releases.

If, after the shares have been acquired, the company goes into insolvency, the shareholder may re-check those information sources. The object of that exercise is to ascertain whether, in the light of its subsequent insolvency, those sources contained misleading or deceptive statements; alternatively, was there information suggesting the possibility of insolvency that the company withheld from the market (misleading or deceptive conduct)? Either possibility would give rise to a claim against the company under the *Corporations Act*, for the difference between the price at which the shares were acquired and their current value.

Of course, if the company is in insolvency, the claim would be delivered to the company's external administrator. That person may be a liquidator or a voluntary administrator.

A claim has a dual significance:

- it provides an indication to the liquidator or voluntary administrator of the extent of the debts of the company, and therefore the likely return to creditors

- because of the voting rules for creditors' meetings, it is relevant to the individual creditor's voting power at such meetings (the larger the debt, the bigger the creditor's vote).

A voluntary administrator or liquidator is under no obligation to admit a creditor's claim in full. Nevertheless, the imminence of a creditors' meeting (especially in the short timeframes of voluntary administration) will usually require some kind of response short of complete rejection. In that situation, a disputed claim will normally be admitted, but only for a nominal amount. This preserves the creditor's right to vote pro tem, without binding the voluntary administrator or liquidator to treat the whole claim as admitted when there is a pari passu distribution to the creditors.

The issue currently facing Australian courts is how this traditional modus operandi is affected by section 563A and the old case law. When it was generally believed that shareholders come last, no shareholders ever submitted claims for the lost value of their shares.

As things currently stand (February 2007), the position that the courts have arrived at is this:

- where the shareholder acquired his shares directly from the company (through an IPO, for example), any claim is postponed by section 563A: *Sons of Gwalia* (infra), *Concept Sports* (infra)

- where the shareholder acquired his shares from another shareholder, the shareholder is a creditor and his claim is not postponed by section 563A: *Sons of Gwalia*, *Concept Sports* (cf *Johnston v McGrath* (infra).

4.5 The big questions

Until the High Court hands down its decision in *Sons of Gwalia*, voluntary administrators and liquidators will be understandably nervous if they receive a shareholders' claim.[6]

One significant problem for voluntary administrators is that the receipt of a claim (or, as would be more likely, a number of claims) may create a voting bloc that could prevent the passage of a motion in favour of a deed of company arrangement. As noted above, such a motion requires the support of a majority of creditors by both headcount and value of claim. Even if shareholders' claims are admitted for a nominal sum, they may be numerous enough to prevent the motion's achieving the support of a headcount majority. If the proposed deed of company arrangement does not recognise their claims or attempts to postpone them to those of other unsecured creditors, the shareholders may have a significant incentive to impose such a veto.

Of course, the deed may contain some provision for paying the claims of shareholders, but that may invoke a veto from other unsecured creditors, angry at having their entitlements diluted by the shareholders' claims. Indeed, where the deed of company arrangement aims to revive the company, unsecured creditors may not be willing to compromise their claims in the long term interests of the company if they see that shareholders are only interested in exiting the company as quickly as possible with the largest cash payout possible. Similarly, there may be a shortage of third parties willing to inject cash into the deed if that cash is simply being used to pay off shareholders, rather than support the company as an ongoing business.

All this is just the tactical skirmishing before the real substantive issue: does the voluntary administrator or liquidator contest the shareholders' claim in court, or does he compromise it? In either case, the cost of legal advice on which course to pursue will be a further drain on the already-limited funds available for the payment of creditors. Those costs would be multiplied if the matter proceeds to litigation. Because the action would be purely defensive one, the administrator or liquidator would not be able to obtain litigation funding - which, since modern litigation funding was in Australia was largely invented by liquidators, would be the ultimate irony.

[6] See now Section 6.

5. The cases

5.1 Media World Communications

Re Media World Communications Ltd (2005) 52 ACSR 346

Media World Communications ("MWC") was formerly Werrie Gold Ltd. It became a technology company in 2001.

MWC raised money under a prospectus in 2004 to develop video compression technology. A few months later, doubts were raised about the technology. The share price slumped and the company subsequently went into voluntary administration.

A group of shareholders who had acquired shares off the prospectus claimed to have done so on the basis of misleading conduct or misleading material in the prospectus. They indicated to the administrator that they intended to prove as creditors in the administration for the loss in the value of their shares.

The administrator applied for directions as to whether those shareholders were entitled to be treated as creditors. If the answer were affirmative, he intended to admit their claims. This would them allow them to vote on a Deed of Company Arrangement ("DOCA") and, if the DOCA so provided, to have their claims dealt with under the DOCA.

It had previously been held that "creditor" in relation to voluntary administration has the same meaning as in relation to winding up - a person who has a debt or claim against the company which is present or future, certain or contingent, ascertained or sounding only in damages as provided by section 553(1) of the *Corporations Act.*

Justice Finkelstein noted that, in a winding up, section 563A of the *Corporations Act* postpones the claims of shareholders to the claims of other unsecured creditors, but he did not believe that section 563A was imported into voluntary administration.

In any event, the question of whether the shareholder in this case was a creditor was, in effect, "short-circuited" in *Houldsworth's case*: a person who has subscribed for shares in a company cannot recover damages on a claim that he subscribed on the basis of misrepresentation.[7] Instead, his remedy is to rescind his subscription and obtain restitution of his subscription money.[8]

If a company is being wound up or in voluntary administration, a shareholder cannot renounce his shares (although, in the case of voluntary administration, the court can allow rescission of the share subscription contract: section 437F). It followed, therefore, that the claimant shareholders in this case were barred by the rule in *Houldsworth's case*.

5.2 Concept Sports

Cadence Asset Management Pty Ltd v Concept Sports (2005) 147 FCR 434.

Concept Sports listed on 10 June 2004 after an IPO with an issue price of 50c. On 18 August 2004, the company announced that it would not meet the revenue or profit figures in its prospectus. In September, Cadence disposed of its Concepts Sports shareholding for a price of 11.5c per share.

Cadence then began a class action against Concept Sports, alleging that the prospectus had breached section 728 of the *Corporations Act*. Cadence claimed damages under section 729, which allows a person who has suffered loss from a defective prospectus to recover damages from a number of persons, including the company that issued the prospectus.

At first instance, Justice Finkelstein held that the rule in *Houldsworth's case* applied to actions under section 729. Accordingly, he held that, because Cadence had on-sold its shares, it could not now rescind the subscription contract and so was barred from proceeding with its section 729 claim.[9]

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[7] *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 at [325] per Earl Cairns LC
[8] ibid at [329] per Selbourne LJ
[9] See *Cadence Asset Management Pty Ltd v Concept Sports* (2006) 56 ACSR 309.

This decision was reversed on appeal[10]. The Full Court noted that the High Court had followed *Houldsworth's case* in *Webb Distributors v Victoria* (1993) 179 CLR 15. That case had concerned a claim for damages allegedly arising from misleading or deceptive conduct in a prospectus. The company itself was in liquidation at the time of the claim.

However, the Full Court also looked at the wider policy issues behind *Houldsworth's case*. In essence, that policy is based on the doctrine of maintenance of capital. To allow a shareholder to rescind his share contract and claim against the company for the purchase price after the company is in liquidation would give the shareholder two bites of the cherry. While the company was a going concern, the shareholder would be entitled to participate in its profits. In return for that right, the shareholder had to pledge a certain amount of capital to the company in the event of its liquidation. If the shareholder could renounce his shareholding after the company had gone into liquidation, the shareholder would be defeating the expectations of creditors for whose benefit the shareholder had originally agreed to subscribe his capital.

The Full Court said that the rule had subsequently been given statutory recognition and modification in section 563A of the *Corporations Act*. That provision says that payment of a debt by a company in liquidation "to a person in the person's capacity as a member of the company" is postponed to all debts owed to persons "otherwise than as members". The Full Court said that this modified *Houldsworth's case* by entitling a subscribing shareholder to an indirect return of capital by way of a claim against the company in respect of the initial subscription. However, it also "enshrined" *Houldsworth's case* by preventing members' claims from derogating from the interests of unsecured creditors.[11]

The Full Court concluded, contra Justice Finkelstein, that section 729 of the *Corporations Act* was not subject to *Houldsworth's case*:

- there was no textual or other evidence that the legislature had intended subscribing shareholders' rights under s 729 to be subject to the rule in *Houldsworth's case*; and
- in any event, the mischief to which *Houldsworth's case* was directed had been addressed by section 563A of the *Corporations Act*, so that there was no need for the legislature to have intended that section 729 was qualified by *Houldsworth's case*.[12]

In obiter, the Full Court said that:

> However, by reason of section 563A of the Act, if the company is in liquidation the subscriber’s right to be paid the loss is postponed until the claims of persons made otherwise than as members have been satisfied.[13]

On 3 October 2006, it was announced on ASX that this litigation had been settled.

5.3 Johnston v McGrath

Johnston v McGrath (2005) 195 FLR 101

Mr Johnston claimed that he had been induced to buy shares in HIH (on market) after reading press reports of HIH's optimistic public statements in 2000. When the HIH share price collapsed, he allegedly incurred a loss. When HIH subsequently went into liquidation, he lodged a proof of debt for his loss, claiming damages under section 52 of the *Trade Practices Act*. The liquidator rejected his proof and he appealed.

The Court examined the evidence and concluded that Mr Johnston had not relied upon the media reports before buying his shares. It held that he therefore had no claim under the *Trade Practices Act*.

Notwithstanding this conclusion, the Court then went on to consider, in obiter, what the effect would have been if Mr Johnston had made out his claim under s 52. It reached a number of interesting conclusions.

It noted the decision of the House of Lords, in *Soden v British & Commonwealth Holdings plc* [1998] AC 298. The Law Lords held that the English equivalent of section 563A of the *Corporations Act* did not require the

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[10] *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 147 FCR 434.
[11] ibid at [43].
[12] ibid at [46].
[13] ibid at [49].

postponement of a misrepresentation claim by a shareholder who had acquired his shares from another shareholder. The NSW Court said that, if it had had a free hand, it would have followed *Soden*. However, the NSW Court was bound to follow *Webb Distributors.*

The next question examined by the NSW Court was the difference (if any) between the position of a shareholder who bought on market and a shareholder who subscribed on a prospectus. A few months earlier, a single judge of the Federal Court had held that, in *Webb Distributors*, the High Court had only ruled on the application of section 563A to a shareholder who had subscribed on a prospectus.[14]

The NSW Court did not agree with this interpretation of *Webb Distributors*. On both a reading of *Webb Distributors* and the underlying policy objectives, it could see no reason for reading the High Court's decision as limited to a subscriber shareholder.[15]

5.4 Sons of Gwalia

Sons of Gwalia Ltd v Margaretic (2005) 149 FCR 227

Mr Margaretic bought shares in Sons of Gwalia (SoG)on market in August 2000. A day after his name was entered on the register of members, voluntary administrators were appointed to SoG. SoG reportedly had $862 million-worth of unsecured creditors, including US noteholders allegedly owed $284 million.[16]

Mr Margaretic claimed that SoG had failed to disclose its financial problems to ASX, as required by the continuous disclosure rules. He asserted an entitlement to damages.

When the administrators proposed a DOCA to SoG's creditors, Mr Margaretic asserted an entitlement to be treated as a creditor. The more crucial issue, however, was the terms of the DOCA itself. It proposed to embody the terms of section 563A of the *Corporations Act*. If the deed were approved, the result would be that Mr Margaretic's claim for damages would be postponed to the claims of other unsecured creditors.

Mr Margaretic and the administrators went to the Federal Court. The central issue for the Court was whether an on-market purchaser of shares was postponed by section 563A.

At both first instance and on appeal, the Federal Court distinguished *Webb Distributors*. It held that section 563A only applies to the claims of a shareholder who subscribes on a prospectus.[17] A shareholder who claims damages for an on-market purchase can rank equally with other creditors in respect of that claim.

The administrators then successfully applied for special leave to appeal to the High Court. That appeal was heard on an expedited basis on 7 August 2006.[18]

5.5 Jubilee Mines

Riley v Jubilee Mines NL [2006] WASC 199

Jubilee was a small West Australian gold explorer. In 1994 it received a letter from WMC, informing it that WMC had accidentally done some drilling on one of Jubilee's tenements. The letter included the results of the drilling, which showed the presence of nickel. Jubilee effectively filed the letter away and went on looking for gold.

In 1996, WMC began talks with Jubilee about a possible joint venture in relation to the nickel in the tenement. Jubilee then announced the 1994 drilling results to the market. Jubilee's share price subsequently rose.

A shareholder sued Jubilee for damages. The shareholder had sold a large number of Jubilee shares between 1994 and 1996. His argument was that he would have held back and sold at a later time if the nickel drilling results had been announced to the market on 1994.

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[14] *Sons of Gwalia Limited (Subject to Deed of Company Arrangement) v Margaretic* (2005) FCA 1305 per Justice Emmett.
[15] *Johnston v McGrath* (2005) 195 FLR 101 at [77]
[16] Elizabeth Sexton, "*Riff-raff slip into the creditors' queue*", Sydney Morning Herald, 20 March 2006.
[17] *Sons of Gwalia Ltd v Margaretic* (2005) 149 FCR 227 at [51], [61] and [131].
[18] *Sons of Gwalia v Margaretic & Anor; ING Investment Management LLC v Margaretic & Anor* [2006] HCATrans 430.

The Supreme Court of Western Australia held that the nickel results from WMC's drilling had been materially price-sensitive information back in 1994. In accordance with the continuous disclosure requirements of ASX and the *Corporations Act*, therefore, the results should have been disclosed to the market at that time. The Court awarded the shareholder damages of $1.856 million.

When determining whether the nickel results had been materially price-sensitive, the Court had regard to the type of company involved and the type of people who usually trade in the shares of that type of company:

> "[I]t is not relevant to ask what a member of the general public might make of the information. Nor is it relevant to consider the information from the point of view of a stockbroker or a geologist or a mining entrepreneur. What is to be considered is the perspective of the person who `commonly', as opposed to occasionally or rarely, invests in securities. There are, of course, persons who commonly invest in securities but would not dream of investing in speculative mining stocks. Presumably such persons would never be in a position of deciding whether to buy or sell such shares. They simply do not trade in that area. So the notional person to be considered in this case is a person who commonly invests in small speculative miners."[19]

Applying that test, the Court held in small speculative miners (like Jubilee) would have made investment decisions on the basis of the nickel results. In arriving at that conclusion, the Court dismissed two arguments by Jubilee:

- Jubilee argued that the nickel results would not have affected its share price in 1994 because it was then just a gold miner. The Court's response, in essence, was that a junior explorer is a junior explorer first, and a gold or nickel miner second: "there is no reason why, if, in the course of exploration activities it comes across an interesting result for nickel when it is looking for gold, it cannot then go off and look for nickel."[20]
- Jubilee also argued that, if it had announced the results in 1994, it would have included a statement that it didn't intend to follow up on the nickel results. The Court rejected the fundamental premise of this argument:

> "[I]t is simply not the practice of junior explorers to include negative sentiments when announcing positive results. ... That is just not the way that junior explorers operate."[21]

Immediately after this decision was handed down (on 6 September) Jubilee said that it was examining the possibility of an appeal. However, there was no subsequent statement on this issue from the company.

6. Postscript: High Court ruling on Sons of Gwalia

6.1 High Court holds for shareholders

Since this paper was written, the High Court of Australia has held that shareholders of failed companies can, in certain circumstances, rank equally with unsecured creditors in the winding up of a company: *Sons of Gwalia Ltd v Margaretic; ING Investment Management LLC v Margaretic* [2007] HCA 1.

For the background to this case, see para 5.4.

By a majority of 6-1, the High Court held that Mr Margaretic's claim was not postponed by section 563A.

Each Justice gave reasons for his or her decision, but the overall thrust was that there is no overriding principle that "shareholders come last", and that any common law rule tending to that conclusion (eg. *Houldsworth's case*) could not stand in the way of the words of the statute.

In a decision with which the majority of the Court indicated assent, Justice Hayne discussed what was meant by "a debt owed … to a person in the person's capacity as a member of the company":

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[19] *Riley v Jubilee Mines NL* [2006] WASC 199 at [63].
[20] ibid at [174].
[21] ibid at [294].

> "[T]he obligation which Mr Margaretic seeks to enforce is not an obligation which the … Act creates in favour of a company's members. The obligation Mr Margaretic seeks to enforce, in so far as it is based in statutory causes of action, is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct and the company's liability to suffer an order for damages or other relief at the suit of any person who has suffered, or is likely to suffer, loss and damage as a result of the contravention. In so far as the claim is put forward in the tort of deceit, it is a claim that stands altogether apart from any obligation created by the ... Act and owed by the company to its members. Those claims are not claims 'owed by a company to a person in the person's capacity as a member of the company'. For these reasons, section 563A does not apply to the claim made by Mr Margaretic."[22]

This decision leaves unanswered the question of the position of shareholders who subscribe for shares (as opposed to buying them on market). In the oral arguments during the High Court hearing, the meaning and relevance of *Webb Distributors* was debated. However, in the decision, the majority of Justices distinguished *Webb Distributors*, without making any conclusive comment on how section 563A would apply to a shareholder who subscribed for shares. When discussing the meaning of a claim in the "capacity as a member of the company" in section 563A, Justice Hayne appeared to say that the claim must be one which arises out of an antecedent relationship of member and company. In other words, a claim for repayment of subscription money would not be made in the "capacity as a member of the company" if the person was not a member before paying the subscription:

> "[I]f money is paid to the company to create the relationship of member (as will be the case when a person subscribes for shares) the company's obligation to pay damages for fraudulent misrepresentation inducing that subscription, or to pay damages because loss was occasioned by the company's misleading or deceptive conduct, will not, in the absence of specific legislative provision to the contrary, be an obligation whose foundation can be found in the legislative prescription of the rights and duties of members. In this respect, absent specific legislation giving subscribing members particular remedies as members, no distinction is to be drawn between shareholders who complain that a company's deceit or misleading or deceptive conduct induced them to acquire shares in the company according to whether that acquisition was by subscription or transfer."[23]

That would not seem to address the *Webb Distributors* issue of whether such a subscriber would be able to lodge a claim in the first place (because he might not be able to rescind the purchase contract).

6.2 Government's reaction

The Australian Government reacted to the High Court decision by referring it to the Corporations and Markets Advisory Committee (CAMAC), the statutory corporate law reform body.[24]

The Government's reference requires CAMAC to examine three issues:

> "Should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct?
>
> If so, are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims?
>
> If not, are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information?"

---

[22] *Sons of Gwalia* Ltd v Margaretic; ING Investment Management LLC v Margaretic [2007] HCA 1 at [206]

[23] ibid at [205]

[24] "Pearce asks CAMAC to examine the *Sons of Gwalia* ruling", Parliamentary Secretary to the Treasurer, Chris Pearce, 8 February 2007.

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