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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

CORPORATIONS AMENDMENT (SONS OF GWALIA) BILL 2010

EXPLANATORY MEMORANDUM

(Circulated by the authority of the Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP)
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The following abbreviations and acronyms are used throughout this explanatory memorandum.

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General outline and financial impact

Outline

The Corporations Amendment (Sons of Gwalia) Bill 2010 (the Bill) amends the rights of persons bringing claims for damages in relation to shareholdings under the Corporations Act 2001 (Corporations Act). The amendments contained in the Bill give effect to a decision of the Government to reverse the effect of the High Court’s decision in Sons of Gwalia Ltd v Margaretic1 and to make other amendments to streamline external administrations. The Bill contains three key measures:

• It provides that all claims in relation to the buying, selling, holding or otherwise dealing with shares are to be ranked equally and after all other creditors’ claims.

• It removes the right of persons bringing claims regarding shareholdings to vote as creditors in a voluntary administration or a winding up unless they receive permission from the Court. They will also not be entitled to receive reports to creditors unless they make a request in writing to the external administrator.

• It eliminates any restriction on the capacity of a shareholder to recover damages against a company based on how they acquired the shares or whether they still hold the shares.

Date of effect: The Bill commences on a single day fixed by proclamation. The Bill does not have retrospective effect.

Proposal announced: The measures are based on proposals announced by the Minister for Human Services; Minister for Financial Services, Superannuation and Corporate Law in a media release dated 19 January 2010.

Financial impact: The Bill has no significant financial impact on Commonwealth expenditure or revenue.

Compliance cost impact: Low. The measures will provide minimal additional compliance costs for those bringing subordinated claims who

1 Sons of Gwalia Ltd v Margaretic (2007) 232 ALR 232
will be required to incur the cost of a written request to the external administrator for communications to creditors; and the cost of a court application should they wish to vote in an external administration. It is, however, very unlikely that such request or application will be made, as almost always, those bringing subordinated claims are very unlikely to be able to participate in any distribution to creditors due to there being insufficient assets to meet their claims. Any costs imposed on those bringing claims, in the rare circumstances where claims are brought, would be offset by the reduced costs of conducting external administrations. External administrators would have reduced costs, as unless a written request was made, they would no longer be obliged to provide communications to those bringing subordinated claims. Any reduced costs of an external administrator leads to greater returns for creditors.

Summary of regulation impact statement

Regulation impact on business

*Impact*: The amendments will have an ongoing regulatory impact on credit providers and corporations who obtain credit, shareholders and on the external administration of insolvent corporations.

*Main points:*

- The amendments will facilitate the provision of credit to companies; the reduction of the risk premiums charged; and the extent of onerous terms and conditions imposed in order to offset the effects on non-subordination.

- The amendments will reduce the costs for insolvency practitioners to carry out external administrations; both costs that they ultimately bear themselves and those that they are able to pass onto creditors claiming in the administration (through reduced distributions).

- The amendments will improve the efficacy of external administration, both in terms of the reallocation of capital to productive uses and the promotion of business rehabilitation.
Chapter 1
Subordination of claims arising from shareholdings

Outline of chapter

1.1 The Corporations Amendment (Sons of Gwalia) Bill 2010 (the Bill) amends the rights of those bringing claims for damages in relation to shareholdings under the Corporations Act.

Context of amendments

1.2 The amendments contained in the Bill give effect to a decision of the Government to reverse the effect of the High Court’s decision in Sons of Gwalia Ltd v Margaretic and to make other amendments to streamline external administrations.

Summary of new law

1.3 The Bill postpones any claim arising from a person dealing with a shareholding until all other claims against a company are satisfied.

1.4 The Bill also provides that a person bringing a subordinated claim does not have an entitlement to a copy of any notice, report or statement to creditors unless they make a written request to the external administrator, nor do they have a right to vote as a creditor of the company unless given leave by the Court.

1.5 The Bill also ensures that a person’s ability to bring a claim for damages against a company is not restricted by how they acquired shares and whether they continue to hold the shares when bringing an action.
Comparison of key features of new law and current law

<table>
<thead>
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<th>Current law</th>
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<tr>
<td>All claims against an insolvent company arising from buying, selling,</td>
<td>In accordance with Sons of Gwalia v Margareti some shareholder claims, for example, compensation claims, would not be postponed by section 563A of the Corporations Act. Instead they would rank equally with unsecured creditors in any distribution to creditors, after secured creditors and payment to priority creditors as listed in subsection 556(1) of the Corporations Act.</td>
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<td>holding or otherwise dealing with a shareholding are to rank equally</td>
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<td>and be postponed until all other claims are paid.</td>
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<tr>
<td>Persons bringing subordinated claims would not be able to receive</td>
<td>Persons bringing subordinated claims are treated as creditors and entitled to receive communications to creditors from external administrators, without making a written request, and are able to vote in the external administration.</td>
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<tr>
<td>communications to creditors from an external administrator without</td>
<td></td>
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<tr>
<td>making a written request, nor would they be able to vote in an</td>
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<tr>
<td>external administration without leave of the Court.</td>
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<tr>
<td>There is no restriction on the ability of a shareholder to recover</td>
<td>A person’s capacity to bring a claim for damages could be affected by how they acquired the shares and whether they still hold them. In Sons of Gwalia v Margareti, the High Court confirmed that the rule in Houldsworth v City of Glasgow Bank forms part of the Australian law.</td>
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<tr>
<td>damages against a company based on how they acquired the shares or</td>
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<td>whether they still hold the shares.</td>
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Detailed explanation of new law

1.6 The current section 563A of the Corporations Act subordinates any claims made by a person in their capacity as a member of the company, whether by way of dividends, profits or otherwise, below the claims of other unsecured creditors against the company. The High Court determined in Sons of Gwalia Ltd v Margareti, that a compensation claim by a shareholder against a company was not subordinated by section 563A of the Corporations Act. This went against the commonly understood meaning prior to the High Court’s decision.

1.7 The Bill changes this position so that any claim brought by a person (not just a shareholder) against a company that arose from the buying, selling, holding or otherwise dealing with a shareholding is to be postponed in an external administration until after all other claims have
been paid. Claims that are postponed include claims for payment of a judgment debt entered against a company. [Schedule 1, item 2, section 563A]

1.8 Section 9 of the Corporations Act provides that dealing in financial products, which includes shares, has the meaning provided for in Chapter 7 of the Corporations Act. Section 766C of the Corporations Act lists various activities which fall within the definition of dealing, including applying for the issue of a share in a company.

1.9 The Bill does not postpone any derivative claim for indemnity or contribution made against a company that follows a claim made by shareholders. Examples of such derivative claims that are not postponed by this Bill include auditors or officers of a company making claims against the company for indemnity or for contribution towards any liability that they may have to persons who have suffered loss from buying, holding, selling or otherwise dealing with a shareholding of the company.

1.10 The Bill also abrogates the rule in the 1880 decision of the House of Lords in Houldsworth v City of Glasgow Bank by providing that how a person acquired shares and whether they still hold them, would not restrict their ability to bring a claim for damages. [Schedule 1, item 1, section 247E]

1.11 The Bill also amends the Corporations Act so that any person bringing a claim that is postponed under section 563A of the Corporations Act, is not entitled to receive any notice, report or statement to creditors produced by an external administrator, unless they make a written request to the external administrator. The Bill would allow a person to make a single request to receive all reports, notices or statements that have been or will be provided to creditors.

1.12 Also, such persons would not be able to vote in any external administration, unless they seek leave of the Court. In determining whether to exercise its discretion, a court might be expected to have regard to whether the person might reasonably be considered to possess a real financial interest in the external administration. [Schedule 1, item 3, section 600H]

1.13 The following example illustrates the impact of the amendments.

Comparison with the current law

1.14 A company misclassified the extent of its liabilities and financial status to the market. The share price drops, and lending covenants are triggered causing the company to be placed into liquidation. The report of the liquidator appointed to examine the affairs of the company discloses
that liabilities were classified as non-current when current. Aggrieved shareholders assert a claim for compensation based on a breach of continuous disclosure obligations under the Corporations Act.

1.15 Prior to Sons of Gwalia v Margaretic, the general understanding was that any claim by a shareholder would rank after all other creditors’ claims. Post Sons of Gwalia v Margaretic, it is understood that the aggrieved shareholders compensation claims rank equally with other unsecured creditors, and above other shareholder claims subordinated by section 563A of the Corporations Act.

1.16 Post Sons of Gwalia v Margaretic, it is understood that available funds would be distributed so that any compensation claim by members would rank equally in priority with unsecured creditors. In most liquidations, unsecured creditors receive at best a small percentage of what they are owed. Most commonly, any available funds to be distributed are paid to secured creditors and priority creditors. The Bill will provide that what was generally considered to be the law prior to Sons of Gwalia v Margaretic will be in place so that all claims resulting in the buying, selling, holding or otherwise dealing with shares rank in priority of distribution after all other creditors.

1.17 In the scenario above, there could be 5,000 aggrieved shareholders, all of whom would be entitled to be provided with information by the liquidator and to attend and vote as creditors at meetings, notwithstanding that upon subordination they may have no real interests in the outcome of the liquidation. Given their numbers and the limited funds available, their votes could significantly affect the efficacy of the liquidation and reduce the returns to other creditors. The amendments provide that such shareholders would now receive reports to creditors only after making a written request, and would now not be entitled to vote as creditors unless the Court grants leave.

Application and transitional provisions

1.18 All provisions in the Bill will take effect on a date fixed by Proclamation. The Bill does not operate retrospectively.

1.19 Section 563A of the Corporations Act 2001, as amended by this Bill, applies to claims arising from the day after the date of Royal Assent.

1.20 Section 600H of the Corporations Act 2001, as inserted by this Bill, applies to claims made against a company in an external administration that commences the day after the date of Royal Assent.
1.21 Section 247E of the *Corporations Act 2001* comes into effect the day after the date of Royal Assent.

**Consequential amendments**

1.22 There are no consequential amendments resulting from the measures in the Bill.
Chapter 2

Regulation impact statement

Background

2.1 Section 563A of the Corporations Act 2001 (the Corporations Act) subordinates any claims made by a person in the person’s capacity as a member of the company, whether by way of dividends, profits or otherwise, below the claims of other unsecured creditors against the company.

2.2 However, the High Court decision of Sons of Gwalia Ltd v Margaretic (2007) 232 ALR 232 determined that a compensation claim for corporate misconduct made by a shareholder against a company was not subordinated by this section. The decision ran contrary to the meaning generally ascribed to the relevant provisions prior to the High Court’s decision.

2.3 The decision of the High Court turned upon its interpretation of when a claim is made ‘in the person’s capacity as a member of the company’. The High Court held that for the purposes of section 563A a compensation claim for corporate misconduct made by a shareholder against a company is not such a claim.

2.4 The court considered the history of the language used in the section, including case law in respect of the equivalent provisions in law going back to 1880; the original introduction of the rule in the context of the preceding rule in relation to partnerships; the lack of explicit reference to compensation claims by shareholders in the provision, in contrast to equivalent provisions in the United States of America’s Bankruptcy Code; the recent case of Soden v British Commonwealth Holdings on similar UK provisions, which held that the UK provisions did not subordinate shareholder compensation claims; the plain meaning of wording in the section; the consistency of various interpretations of the section with the rule in Houldsworth v City of Glasgow Bank; and an assessment of the presumed policy behind the section.

2.5 The effect of the decision is that shareholders with compensation claims for corporate misconduct against a company are, irrespective of whether the claims arise in respect of their shareholdings or not, entitled to share in any proceeds of an external administration with the same priority as other creditors. In particular, as was the case in Sons of Gwalia
*Ltd* v *Margaretic*, compensation claims against listed companies arising from the provision of misleading information or the failure to disclose information will gain equal ranking with creditors.

**Problem identification**

2.6 It has been asserted that the non-subordination of compensation claims for corporate misconduct by aggrieved shareholders may have significant implications for companies in respect of debt financing and the conduct of external administrations.

2.7 *Sons of Gwalia* v *Margaretic* gives rise to a number of problems in respect of debt financing for companies.

The decision may reduce 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 in respect of corporate disclosure.

The decision is also expected to increase 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 would be subject to additional costs in complying with lender’s requirements in respect of these matters.

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

2.8 *Sons of Gwalia* v *Margaretic* gives rise to a number of problems for the effective and cost efficient external administration of companies.

For example, the costs and delays arising due to the complexities introduced 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.

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.
Delays in the business rescue process may adversely affect efforts to rehabilitate and reorganize 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.

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. The non-subordination of shareholder claims interferes with the achievement of these objectives in so far as it delays and adds costs to insolvency administration generally and adversely affects reorganization attempts.

2.9 The extent and ongoing nature of the adverse reaction by those stakeholders who are subject to the effects outlined above is indicative that the effects are substantial.

2.10 The problems arising out of *Sons of Gwalia v Margaretic* will generally only arise in respect of the collapse of listed public companies. Where it occurs in other situations it is likely to have far less impact due to the small number of shareholders involved. The collapse of listed public companies is relatively uncommon, however when they do occur they tend to involve large numbers of creditors, shareholders and employees; and are likely to have a large financial impact. No statistics are collected on the number of external administrations in which shareholder compensation claims are asserted.

2.11 The decision may have some very minor negative influences on the level of deterrence existing for breaches of directors’ duties; as a result of its peripheral effect on directorial liability. Potentially, any joint liability of a director and the company for misconduct will be more likely to be partially satisfied out of company funds if the shareholders’ claim is not subordinated. Non-subordination would, in those circumstances, reduce the consequences to directors of any misconduct. However, given the large numbers of claimants, the size of the claims involved and the low distribution rates even when shareholder claims are not subordinated, it is questionable whether in practice the reduction in liability that might occur would materially alter director behaviour.
Objectives

2.12 The objectives of these reforms are to:

- facilitate the provision of credit to companies in an efficient way for the economic development of Australia.

- reduce the risk premiums charged and the extent of onerous terms and conditions in relation to credit providers;

- reduce the costs for insolvency practitioners to carry out external administrations; both costs that they ultimately bear themselves and those that they are able to pass onto creditors claiming in the administration (through reduced distributions); and

- improve the efficacy of external administration, both in terms of the reallocation of capital to productive uses and the promotion of business rehabilitation.

Options

Option A: Maintain status quo

2.13 Under this option, the non-subordinated status of shareholder compensation claims for loss due to misleading conduct or non-disclosure would have been retained.

Option B: Subordinate shareholder claims

2.14 Under this option, the law could be changed to subordinate claims for compensation by shareholders against a company for loss due to misleading conduct or non-disclosure below the claims of other creditors in the event the company is placed into insolvency administration.

Impact analysis

Option A: Maintain status quo

2.15 This option would preserve the current effects of the law regarding the relative ranking of shareholder and creditor claims in
external administration, as they are now understood to be as a result of the Sons of Gwalia v Margaretic decision.

2.16 The arguments that have been put forward by stakeholders in favour of this option (reproduced exactly as stated in the Corporations and Markets Advisory Committee (CAMAC) report Shareholder Claims against Insolvent Companies: Implications of the Sons of Gwalia decision at pages 48 to 51) are listed below. The term ‘aggrieved shareholder’ is used to refer to current or former shareholders making claims against companies for loss due to misleading conduct or non-disclosure.

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 publicy 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 expeditious does not justify postponing a category of shareholder creditors. Any procedural difficulties may be ameliorated by appropriate administrative reforms.’

Arguments against the status quo include:

Financing concerns

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.

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).

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 claims.

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.

**Investor protection**

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.

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.

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.

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.

**Corporate governance**

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 manage 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.
External administration and corporate rescue

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

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.

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.

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 reorganize 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.

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.

Other

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.

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.

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 a minor impact upon consumers.

Option B: Subordinate shareholder claims

2.40 This option (to ‘reverse’ Sons of Gwalia v Margaretic) will negate both the positive and negative effects arising out of the Sons of Gwalia v Margaretic decision, as detailed above.

Consultation

2.41 The primary stakeholders affected by the Sons of Gwalia v Margaretic decision are: equity investors in companies; unsecured non-priority creditors of companies; businesses operating under corporate structures; and corporate insolvency practitioners.

2.42 In February 2007, the previous Government referred the High Court’s decision to CAMAC for its analysis and advice. CAMAC issued a public discussion paper in September 2007.

2.43 Those making submissions to CAMAC who supported a reversal of the decision included: the Australian Financial Markets
Association (AFMA), the Australian Bankers’ Association (ABA), Chartered Secretaries Australia (CSA), the (self described) ‘vast majority’ of the Law Council of Australia’s Insolvency and Reconstruction Committee, the Law Council of Australia’s Corporations Committee, the Law Institute of Victoria, the NSW Law Society Business Law Committee (divided opinion), the Insolvency Practitioners Association (IPA); and academics from the University of Melbourne, the University of Western Sydney and Central Queensland University.

2.44 Those making submissions to CAMAC who supported retaining the decision included: Law Council of Australia Insolvency and Reconstruction Committee (minority opinion), NSW Law Society Business Law Committee (divided opinion), the litigation funding firm IMF Australia, the Australian Securities and Investments Commission (ASIC); and an academic from Monash University.

2.45 CAMAC issued its report *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision* in December 2008.

**Conclusion and recommended option**

2.46 The adopted option is that claims for compensation by shareholders against a company be subordinated below the claims of other creditors in the event the company is placed into insolvency administration.

2.47 This position arises out of an assessment of the pros and cons listed above in respect of maintaining the status quo, weighing each consideration against the significance of its likely impact on stakeholders and the economy as a whole.

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.

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.

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.
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**Schedule 1: Amendment of the Corporations Act 2001**

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<td>Item 1, section 247E</td>
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<td>Item 3, section 600H</td>
<td>1.12</td>
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