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Shareholder Damages Claims Against Insolvent Companies: Subordinated or *Pari Passu* with Unsecured Creditors?

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In Sons of Gwalia v Margaretic[1] *the Federal Court of Australia recently held that claims by shareholders against an insolvent company for damages, arising from misleading and deceptive conduct inducing the purchase of shares on market, are to be treated equally with the claims of unsecured creditors. This is in contrast to the position of damages claims from shareholders who acquired their shares via subscription from the company – such shareholder claims will be subordinated to the claims of unsecured creditors. This article considers the* Gwalia *decision and this distinction in the context of the principle that 'members come last in insolvency.'*

The subordination of shareholder claims

An insolvent company has a deficiency of assets to pay its creditors, and insolvency principle dictates that those assets are to be distributed *pari passu* to admitted unsecured creditors. Shareholders (or members) are not entitled to receive any distribution from the assets of the insolvent company in their capacity as members unless creditors' claims are first discharged in full. In other words, the rights and interests of members of an insolvent company come last and are not to compete with the rights of creditors.

It is uncontroversial that members' claims which arise from their *entitlements* as members should be subordinated to the claims of creditors – for example, claims of members for dividends or for profits.

However, where a shareholder has a claim for damages against the insolvent company for being misled into acquiring or holding on to those shares ('shareholder damages claims'), the issue arises whether that claim is entitled to treated as an ordinary unsecured claim (as with any other damages claim) or whether that claim, being a claim of a member, should be precluded or subordinated to the claims of the general body of unsecured creditors.

For a number of reasons described below, the common law historically in England and Australia treated such shareholder damages claims as either subordinated to the general body of unsecured creditors or incapable of being pursued at all against an insolvent company.

However, there is now a line of authority, stated most recently in the *Gwalia* decision, which provides that shareholders who have purchased their shares on market ('transferee shareholders') fall outside this principle (i.e. the subordination or preclusion of shareholder damages claims), and that the principle only applies to claims by shareholders who have been allotted their shares from the company via subscription ('subscribing shareholders'). In other words, subscribing shareholder damages claims are subordinated or precluded, whereas transferee shareholder damages claims are not subject to subordination and rank equally with the claims of the body of unsecured creditors.

Before considering the *Gwalia* decision and the basis for this distinction, it is important to first consider generally the rationale for the subordination of shareholder damages claims and then the legislative regime which embodies this principle.

The rationale for the principle that shareholder damages claims come last in insolvency

There have been a number of different expressions for the rationale and legal basis for subordinating or prohibiting damages claims by shareholders against an insolvent company. Central to each of these is ensuring that shareholders, in their capacity as shareholders, do not compete with the rights of the general body of creditors. The justifications which are discernable from the case law include the following (noting that there is some overlap between them).

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1 *Sons of Gwalia Ltd (Admin Appted) v Margaretic & Anor* [2005] FCA 1305 (15 September 2005).

(i) *Maintenance of Share Capital*. The primary justification is that allowing shareholder damages claims to compete with the claims of the general body of creditors would undermine the fundamental tenet of corporate law that a company's share capital is to be available to meet the claims of creditors. Any claim by a member against the company seeking damages for the purchase price of the shares would amount to a claim to return the capital which that member had previously subscribed to the company, and which was effectively to provide a guarantee fund for creditors. Such a claim is said to be inconsistent with a member's position and a member's obligations under the statutory contract. Further, persons who provide credit to a company rely upon the fact that the company is trading with a certain amount of capital already paid, as well as the responsibility of its members for the capital remaining at call.[2]

(ii) *The price of limited liability*. In respect of a limited liability company, it has also been said that in exchange for members being entitled to rely upon the limitation of their liability to the value of the shares held by them, they are bound to be liable to the creditors up to that amount. Tadgell J in *Victoria v Hodgson*[3] highlighted what he regarded as the inconsistency of a shareholder seeking compensation for their investment in the capital of the company:

> In my opinion the principle of limited liability leads inevitably to the conclusion that a member at the commencement of the winding up of a company limited by shares cannot prove in the winding up for damages designed to indemnify him for loss sustained in subscribing share capital to the company. The member's only title to such damages would depend on his having sustained loss through a subscription of share capital. If he were to obtain indemnity from the company in respect of that loss he could not logically be regarded as having subscribed the share capital for the subscription of which the company had indemnified him.

(iii) *The statutory contract*. A related justification to (i) and (ii) arises from the statutory contract which exists between all the members of a company and the company.[4] The statutory contract applies equally to both subscribing shareholders and transferee shareholders. The principle established by the decision of the House of Lords in *Houldsworth v City of Glasgow*[5] is that a shareholder contracts under the statutory contract to contribute a certain amount to the company, and it is inconsistent with that contract (or an implied term of that contract) to claim any of those monies back, unless that member first rescinds the contract.[6] Accordingly, a shareholder could not sue for damages for misrepresentation inducing his or her acquisition for shares unless he or she first rescinded the contract. Rescission, however, is impossible once the company becomes insolvent, as to rescind would defeat the interests of innocent third parties, and in particular creditors whose rights have intervened because of the winding up.[7] Accordingly a member of an insolvent company, in his or her capacity as a member, is incapable of suing or claiming against an insolvent company.

(iv) *Shareholders' and creditors' rights and interests*. A more general policy justification for the subordination of shareholders claims is that shareholders, as the owners of the company, have an interest in the potential capital gain and profits of the company as well as other rights and privileges which attach to membership which of course do not enure to creditors. It has been suggested that it would be unfair to allow a shareholder who has had these benefits and the potential greater return to then acquire the characteristics of a creditor on an insolvency, even where the shareholder has a claim for being misled by the company. The assumption of risk by a shareholder in their investment is fundamentally different from the risks assumed by a provider of credit to the company. While both creditors and shareholders bear some risk in relation to a company's insolvency, the shareholders bear the primary risk given that a shareholder's interest is ultimately in the 'value' of the company. Where the company is insolvent, the company has no 'value', and its assets must be available solely to meet the claims of creditors without competition from the company's members.

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2 *Trevor v Whitworth* (13) (1887) App Cas at 423–424 and see also *Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR 15 at para 18–20.

3 (1992) 2 VR 613 at 627. Note that this is the decision of Victorian Court of Appeal which was considered on appeal by the High Court in the *Webb* decision.

4 Section 140 of the *Corporations Act* provides that the Company's constitution and any 'replaceable rules' that apply to the company have effect as a contract: between the company and each member and between a member and each other member.

5 (1880) 5 App Cas 317.

6 A recent case considering the application of the *Houldsworth* principle in Australia outside of the insolvency context is *Cadence Asset Management Pty Ltd v Concept Sports* [2005] FCA 1280 (14 September 2005) (Finkelstein J).

7 *Oakes v Turquand* (1867) LR 2 HL 325 and *Tennet v The City of Glasgow Bank* (1879) 4 App Cas 615.

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The legislative provision and the Webb decision

Section 563A of the *Corporations Act* 2001 (Cth) (Corporations Act) applies to companies being wound up. It provides:

> 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.

The effect of the section is to subordinate members' claims to the claims of the ordinary unsecured creditors. Of course the section makes clear that it only applies to claims pursued 'in their capacity as a member' and accordingly it does not affect any claims members might have in a separate capacity (for example if they were also a lender). There has to be a sufficiently close connection between the claim of the member and his or her membership.

The *Houldsworth* principle (described above) has been widely regarded as the genesis of both this provision and also related provisions such as s515 and s516 of the *Corporations Act* (which requires members of limited liability companies to contribute in a winding up in an amount not exceeding the amount unpaid on the shares).[8] It should be recognized however that s563A actually represents a modification of the *Houldsworth* principle given an application of the *Houldsworth* principle would have precluded an action being pursued at all, whereas s563A does not so preclude, but rather postpones such a claim to the unsecured creditors.[9]

The leading Australian High Court authority on the application of this statutory provision to shareholders damages claims is *Webb Distributors v The State of Victoria*.[10] In *Webb*, shareholders of insolvent building societies were seeking to prove in the liquidation for damages which amounted to the purchase price of their shares. The damages were claimed on the basis that the shares, which they still retained, were not what they were represented to be. The High Court held this was a sum directly related to their shareholding, and accordingly, fell within the ambit of the legislative provision, being the predecessor to s563A.[11] In other words, the High Court regarded such a claim as being, in the terms of s563A, in the 'capacity as a member of company, whether by way of dividends, profits or otherwise'.

The meaning of 'dividends, profits or otherwise' and its application to shareholders damages claims was first considered by the English High Court in *Re Addlestone Linoleum Co*, where Kay J observed:[12]

> Now, unquestionably the applicants – retaining these shares and claiming damages because the shares are not exactly what they were represented to be – are making such claims in the character of members of the company, and the only question is whether such claims are for sums due 'by way of dividends, profits, or otherwise.' ... Practically, what these applicants are seeking to recover by their proof is a dividend in respect of the £2 10s per share which they have been compelled to pay in the winding up. But as shareholders they have contracted that they will pay this money, and that it shall be first applied in payment of the creditors whose debts are not due to them as members of the company - that is, they are practically admitting their liability to pay the £2 10s per share to such other creditors and yet seeking to get part of it back out of the pockets of those very creditors themselves. I confess it seems to me that the money so claimed is not only claimed in the character of members but that the claim is just as unreasonable as if it were a claim of dividends or profits, and that, accordingly, it comes within the words 'or otherwise'.

Accordingly, on this reasoning, s563A applies to subordinate shareholder damages claims against an insolvent company.

The *Gwalia* decision

Sons of Gwalia v Margaretic concerned a damages claim by a shareholder (Margaretic) against a company in voluntary administration.[13] The shareholder, who was put forward on a representative basis, alleged that the company had engaged in misleading and deceptive conduct in relation to the failure to provide disclosure to the market (in accordance with the continuous disclosure requirements of the Australian

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8 *Webb*, para 32.

9 Accordingly, such claims can be made and will be taken into account in relation to the final adjustment of the rights of members amongst themselves, but they will not be able to be proved in the liquidation in competition with the unsecured creditors.

10 (1993) 179 CLR 15. Note that *Webb* actually dealt with the statutory predecessor to s563A, being s360 of the Victorian Code.

11 *Webb* para 37.

12 (1887) 37 ChD 191 at 197–198 and cited with approval in *Webb* at para 35.

13 At the time of the hearing, a deed of company arrangement had been put forward by the administrators which was to be voted on by creditors. One of the provisions of the proposed deed of company arrangement incorporated s563A.

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Stock Exchange (ASX)) of a number of material matters in relation to the company's financial position. He alleged that this was in breach of a number of statutory provisions, that he was entitled to compensation from the company, and that this claim was provable and entitled him to be treated as a creditor in the company's voluntary administration and any subsequent deed of company arrangement. Importantly, Margaretic was a transferee shareholder and not a subscribing shareholder as he had purchased his shares on market through the ASX.

Justice Emmett distinguished the *Webb* decision on the basis that his Honour considered that *Webb* did not deal with or apply to the position of a transferee shareholder. Justice Emmett held:[14]

> I do not regard *Webb's Case* as authority for the principle that a claim by a person who, in reliance upon conduct of a company in a contravention of a prohibition on misleading or deceptive conduct, acts to the person's detriment, albeit by buying shares in the company from a third party in a transaction that has no connection whatsoever in the company, is a claim by that person in his capacity as a member of the company.

Accordingly, his Honour held that the claim of Margaretic, being a transferee shareholder, was not a claim or debt owed 'in his capacity as a member of the company', and accordingly, would not be subordinated by operation of s563A (or by any deed of company arrangement incorporating this provision).

While his Honour observed that the precise *ratio decendi* of *Webb* is 'by no means clear and certain',[15] his Honour concluded that the observations of the High Court in Webb 'quite clearly indicate that the majority was dealing with the question on the assumption that there was an agreement between the member and the building society.'[16]

Although not referred to in the *Gwalia* decision, the House of Lords decision in *Soden v British and Commonwealth Holdings Plc & Anor*[17] is consistent with Justice Emmett's approach in *Gwalia*. In *Soden*, Lord Browne-Wilkinson held that both the decision and reasoning of the High Court in *Webb* were focussed upon the protection of creditors from indirect reductions in share capital. His Lordship observed that in his view those are factors relevant to cases of subscription for shares issued by the company but wholly irrelevant to purchases from third parties of already issued shares. His Lordship held:[18]

> to allow proof for a damages claim by a transferee shareholder in competition with the general body of creditors does not either directly or indirectly produce a reduction of capital. The general body of creditors are in exactly the same position as they would have been in had the claim been wholly unrelated to shares in the company.

Accordingly, the House of Lords also concluded that the equivalent section to s563A in the UK[19] did not apply to damages claims of transferee shareholders, but only subscribing shareholders.

An Australian decision which was not referred to by Justice Emmett but which is also consistent with his Honour's conclusion is the Federal Court decision in *Media World Communications Ltd (Administrator Appointed)*[20]. In that decision, Justice Finkelstein agreed in *obiter dicta* with the *Soden* decision and regarded *Soden* as applicable in Australia.

Consideration of the distinction between transferee shareholders and subscription shareholders

A considerable focus of judgment in *Gwalia* (and also in *Soden*) was considering whether or not the previous case law dealing with this issue considered, or was otherwise relevant to, the position of transferee shareholders as opposed to subscribing shareholders. Although it is beyond the scope of this article to embark on further analysis of the scope of the previous authorities, it can be observed that there nothing expressly in the *Webb* decision which indicates that the High Court was limiting its considerations to the position of subscribing shareholders – there is simply no distinction drawn between transferee and subscribing shareholders.[21]

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14 *Sons of Gwalia Ltd (Admin Appted) v Margaretic & Anor* [2005] FCA 1305, para 43.

15 Iibid, para 27.

16 Ibid, para 42. It may however be possible that the agreement between the member and the building society referred to in Webb was the statutory contract, which, as discussed below, is equally applicable to a transferee shareholder and a subscribing shareholder.

17 [1997] 4 All ER 353.

18 Ibid, at 359–360.

19 s74(2)(f) of the *Insolvency Act* 1986 (UK).

20 *Re Crosbie; Re Media World Communications Ltd* (2005) 216 ALR 105.

21 Indeed it was submitted in argument in the *Gwalia* hearing that the shareholder claimants in *Webb* actually included transferee shareholders.

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Leaving aside the issue of scope of the past authorities, there are a number of matters which bring into question the distinction drawn in the *Gwalia* decision.

First, the Corporations Act draws no distinction between subscribing shareholders and transferee shareholders. Indeed, the term 'member' is specifically defined to include both types of shareholders.[22] Accordingly, the reference in s563A to the postponement of members' debts, must be taken to apply equally to subscribing shareholders and transferee shareholders.[23]

Second, significant emphasis is placed in drawing the distinction upon the transferee shareholder not having entered into the subscription contract with the company and the fact that a transferee shareholder acquires the shares not from the company, but from an existing shareholder. However, regardless of from whom the shareholder acquired the shares, the effect of the *Corporations Act* is to make a member (including a transferee shareholder) a party to the statutory contract between the company and its other members.[24] A transferee shareholder assumes all the rights and obligations of the subscribing shareholder and effectively steps into the shoes of the original shareholder. The transferee shareholder is a party to the statutory contract on exactly the same basis as the assigning subscribing shareholder. Accordingly, the *Houldsworth* principle, being based upon the inability of a member to sue a company whilst remaining a party to the statutory contract (and being recognized as the foundation for s563A), should apply to both subscribing and transferee shareholders.

Third, if the vice which s563A is aimed at preventing is impermissible reductions of capital, it is difficult to see how the effect on the company of a damages claim between a transferee shareholder and subscribing shareholder is actually materially different. Even where the shares are fully paid, then whether or not an action for damages against the company (to claim back from the company the subscribed capital) is pursued by a subscribing shareholder, or an assignee of that subscribing shareholder's position, the effect should be broadly the same.[25] While a claim by a purchaser of shares may not be so closely related to the capital subscribed by the original subscriber, it can nevertheless be regarded as a claim seeking a return of the capital earlier contributed to the company by the subscriber.

Fourth, even if a claim by a transferee shareholder is not properly regarded as directly attacking the company's capital, but rather as an attack on the assets of the company, the effect is in substance the same for a creditor (the protection of whose interests is the foundation for s563A). A shareholder damages claim, regardless of whether the claimant is a subscribing or transferee shareholder, will compete with the unsecured claims and deplete the resources available to meet the claims of ordinary unsecured creditors. The avoidance of such competition is a distinct rationale for the subordination of shareholders damages claims.

Finally, and perhaps most importantly, is the practical consequence of the distinction. The disparity between the rights of subscribing shareholders and transferee shareholders to claim damages would appear to have no commercial justification or relevance. In practice, transferee shareholders and subscribing shareholders are regarded as being in exactly the same position, and their differential treatment flies in the face of commercial reality and common sense. In addition, the distinction can produce anomalous results. For example, a subscription shareholder and a transferee shareholder may have relied upon the same misleading information provided by the company, may have purchased their shares almost at exactly the same time (assuming for example the transferee shareholder purchased immediately from a person who had just acquired a shareholding in an IPO), and indeed may have purchased at the same price; however, as a result of this distinction, only one type of shareholder is caught by the legislative provisions requiring subordination.

The position in the US and the UK

In the United States, section 510(b) of the Bankruptcy Code has the effect that shareholder damages claims are subordinated to creditors. There is no distinction drawn between transferee and subscribing shareholders.

In the United Kingdom, s111A of the *Companies Act 1985* (UK) provides:

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22 s231 *Corporations Act.*

23 It should be noted however that the basis for the distinction drawn in *Gwalia* is not that s563A does not of itself apply to transferee shareholders, but rather that a shareholder damages claim from a transferee shareholder is not properly regarded as a claim in the shareholder's capacity as a shareholder.

24 s140 *Corporations Act.*

25 One difference may be that the price paid by the transferee shareholder, and accordingly the amount of damage suffered as a result of being misled into acquiring the shares, will likely be different from the subscription amount originally paid to the company by the subscribing shareholder.

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> A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares.[26]

The operation of this section has been held to override, at least in part, the *Houldsworth* principle in the UK.[27] Nevertheless, s74(2)(f) of the *Insolvency Act 1986* (UK) (being the equivalent to s563A) appears to remain applicable, and on the basis of the House of Lords decision in *Soden*, does not subordinate transferee shareholder damages claims.

Concluding remarks

The *Gwalia* decision has a significant practical effect upon the administration of a number insolvencies in Australia. It has arguably changed the orthodox view that a shareholder's damages claim, regardless of whether possessed by a transferee shareholder or a subscribing shareholder, is subordinated.

It has been suggested that the effect of the decision is to increase risk to unsecured creditors, and that this could make it more expensive for Australian companies to raise funds, particularly where funds are to be raised through the issue of bonds in the US. There is no doubt that in some insolvencies of publicly listed companies, the ability of transferee shareholders to pursue such damages claims could have a significant detrimental effect upon creditor returns. In addition, there will be practical consequences for the conduct of the insolvency administration given the *Gwalia* decision found that such a shareholder is entitled to receive notices of creditor meetings and reports, and to attend and vote at creditor meetings like any other creditor might.

To put the decision in context however, it must be borne in mind that most companies (and even those that end up in insolvency proceedings) will not have engaged in misleading of deceptive conduct that would found an action by a shareholder for compensation. Also, even where there has been such conduct, each shareholder will need to establish reliance on the relevant misleading conduct in order to establish their claim. Of course, the process of adjudication of proofs of debt from a potentially large pool of shareholders, will likely be an expensive and time consuming exercise.

Finally, as noted above, it is difficult to identify any commercial justification for treating transferee shareholders and subscribing shareholders differently. This differential treatment has the potential to produce anomalous results and appears to be at odds with the principle, and the rationale behind the principle, that 'members come last in insolvency.'

The Gwalia decision is presently on appeal to the Full Federal Court.

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26 Inserted by the *Companies Act 1989* (UK).

27 *Soden*, at 360.

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