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The Sons of Gwalia judgement: implications for credit markets and corporate finance

The possibility of shareholders ranking equally with unsecured creditors as claimants on the assets of a failed company has serious implications for corporate finance markets. These include: potential complications for resolving failed companies; implications for the cost of corporate finance and corporate financing arrangements; and effects on the incentives of equity investors.

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In January 2007, the High Court released its decision in the Sons of Gwalia case[1] which upheld the Federal Court's earlier decision handed down in February 2006). The result is that shareholders, who purchase shares shortly before a company is placed into administration, may be able to claim compensation from the remaining assets of the company and, thereby, rank equally with unsecured creditors.

Because this ruling has potentially profound implications for the operation of Australian corporate finance markets, as well as for the processes involved in the winding up of failed companies, in February 2007, the Federal Government, asked its Corporations and Markets Advisory Committee (CAMAC) to review the issues arising from the judgement.[2]

We argue that there is a strong case for rewriting the relevant sections of the law to remove the possibility of some shareholders ranking equally with unsecured creditors as claimants on the assets of a failed company. Our key concerns are: the potential complications for resolving failed companies; the *ex ante* implications of the judgement for the cost of corporate finance and distortions to corporate financing arrangements; and its potential effects on the incentives of equity investors

The Sons of Gwalia judgement

Sons of Gwalia Ltd, a large Australian company, was placed under administration in August 2004. A class action followed on behalf of 600 shareholders who had purchased shares shortly before the company's failure. It was argued that, in purchasing shares, they had been misled by the company's lack of disclosure of its true financial position and were thus eligible to claim for compensation of losses under consumer protection laws, and that these claims (if proven) should rank equally with unsecured creditors. Three successive court decisions, culminating in the High Court judgement of January 2007, have now ruled in favour of this argument. That judgement also concluded that the same rights applied to subscribers to shares (such as in an IPO) as well as to on-market purchasers of shares.

Consequently, shareholders are able to participate in insolvency proceedings. Claims by shareholders that they have suffered losses due to being misled by lack of disclosure, will need to be considered under consumer protection laws. If upheld, those claims would rank equally with those of other unsecured creditors.

Credit market implications

The judgement has important widespread implications for credit markets, because lenders, in setting credit terms, take into account the possibility that the company may default and that they will not fully recover the amount owed. Because some shareholders may now be entitled to a share of the assets of failed companies, unsecured creditors will factor in lower recovery rates in setting credit terms, meaning that credit spreads (the margin charged to borrowers over the risk free interest rate) would increase. (The additional impediments to the resolution of failed companies and thus lags in receiving any recoveries would compound this effect).

In a previous article[3], we applied modern credit risk modelling techniques based on option pricing theory to derive ballpark estimates of the impact of the Sons of Gwalia judgement on credit spreads for Australian companies. The results depend on a number of company characteristics (such as leverage, the use of unsecured versus secured debt) and other assumptions made about the potential value of shareholder claims accepted as having equal ranking with unsecured creditors. For ‘reasonable assumptions’ we find an average increase in credit spreads on five-year debt in the vicinity of 50 basis points p.a., with much larger increases for companies with high leverage, particularly with a substantial unsecured debt component. The footnote provides a simplified example to assist understanding of why such results arise.[4]

The message is clear. The Sons of Gwalia judgement should lead to a noticeable increase in credit spreads on unsecured debt for high leverage, risky companies.[5] Importantly, lenders will also look to other techniques to ensure that they rank ahead of shareholder claimants in the event of company failure. Increased use of secured debt and leasing arrangements are two obvious possibilities. As unsecured creditors, trade creditors are likely to have difficulty in avoiding these deleterious effects, which is likely to increase the cost of trade credit

Failure resolution processes and investor incentives

Given that an objective of the administration procedures under the Corporations Act is to save the company where possible, the change in the law created by the High Court ruling will make the resolution of insolvency cases more lengthy, complicated and costly, a result which seems directly opposed to that objective. Administrators may find it more difficult to save the company through a deed of arrangement due to uncertainty about potential claims, and will have to negotiate with shareholder claimants in any resolution process.

Incentives and consumer protection

On the positive side, the decision does provide some limited protection to shareholders who have been misled by a lack of company disclosure in the lead up to failure. This enlargement of the group of potential claimants against the company (and its officers) may lead company Boards to be more focused on meeting disclosure requirements and to give earlier consideration to voluntary administration, if the company is approaching financial distress.

On the other hand, it can be argued that stock market investing is a profit-seeking investment activity somewhat different from those activities to which consumer protection arrangements generally apply. Protection of investors from misleading information is desirable, but needs to be done in a way which does not reduce *ex ante* incentives for self-protection (by information gathering and analysis etc.) and which does not impede *ex post* resolution processes.

The legal situation arising from the Sons of Gwalia judgement does not satisfy either of these criteria. The CAMAC inquiry provides a valuable opportunity for identification and analysis of better arrangements for incorporation into the law.

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[1] The initial judgement was made by Justice Emmett of the Federal Court on September 15, 2005 (Sons of Gwalia Ltd (Administrators Appointed) v Margaretic [2005] FCA 1305)

[2] At the time of writing (April 2007), CAMAC was preparing a discussion paper, and had not yet called for submissions.

[3] Christine Brown and Kevin Davis 2006, 'Shareholders or Unsecured Creditors? Credit Markets and the Sons of Gwalia Judgement', *Agenda*, vol. 13, no. 3, September.

[4] Consider the following (highly simplified) analysis. Using historical data on pre-suspension turnover of shares in failed companies, we calculate that shareholder claims could lead to a dilution of unsecured creditor recoveries of around 10 per cent. Consider a lender contemplating a one-year loan of $100 to a company which has a contractual interest rate of 10 per cent, and the company has a probability of failure of 0.1 in which case only $50 will be received. If the lender is 'risk neutral' (only cares about expected return), the expected payoff to this risky loan is 0.9×$110 + 0.1×$50 = $104, giving an expected rate of return of 4 per cent. If the recovery rate is reduced from $50 to $45 (due to 10 per cent dilution by shareholder claims), the expected payoff is $103.5 and the expected rate of return is 3.5 per cent. To offset that drop of 50 basis points in the expected return, the contractual interest rate will need to be increased by approximately the same amount — and market forces will lead to such an outcome.

[5] Unfortunately, there are relatively few actively traded unsecured Australian corporate debt securities available to undertake an empirical test of whether this has in fact happened.