

Sons of Gwalia judgment — aftermath and implications

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A fundamental idea in corporate finance is the ranking of stakeholders in a company in terms of claims over the cash flows generated by company assets and over those assets if the company is wound up. This ranking has important consequences for the expected return demanded by investors in the various securities (such as debt and equity) issued by the firm. The notion that shareholders have the residual claim on earnings, and importantly the residual claim on a return of capital in the event of the company being wound up, has been central to our understanding of the role of equity capital in the modern limited liability company.

In the case of a failed company, shareholders stand to lose their entire investment in the company because distributions from the company assets are paid to higher priority claimants first. This paper investigates the consequences of the January 2007 High Court decision to uphold the decision reached earlier by the Federal Court in the case of *Sons of Gwalia v Margaretic* [2007] HCA 1, which upsets this conventional arrangement in the case of a failed company. Sons of Gwalia was an Australian gold mining company (with a stock market capitalisation of approximately \$600 million six months prior to insolvency) that was placed in voluntary administration in August 2004. The case involved a shareholder, Luka Margaretic, who purchased 20,000 fully paid ordinary shares on the ASX 11 days prior to the company going into voluntary administration, and who (successfully) claimed to be entitled to be ranked equally with all other unsecured creditors of the company.

Subsequent to the High Court decision a request was made by the then Parliamentary Secretary to the Treasurer, the Hon Chris Pearce MP, for the Corporations and Markets Advisory Committee (CAMAC)¹ to consider the implications of the decision. This was in recognition of the potential disadvantages caused by the decision to unsecured lenders, trade and other creditors, the added complexities and delays to external administration of failed companies and the possible consequences to the market for corporate

- *Two class actions involving shareholders seeking to claim as creditors of companies in administration*
- *Credit spread on unsecured debt may increase, particularly for companies with volatile share prices, high share turnover or reliance on unsecured debt*
- *Shareholder class action claims likely if potential rewards sufficient*

financing, including the cost of debt. Our discussion focuses on the cost of debt and considers some of the perspectives contained in the report released by CAMAC.²

The case

Mr Margaretic's claim for damages was based on two principles in law. The first basis for his claim was the continuous disclosure regime encapsulated in s 674 of the *Corporations Act 2001*. This section of the Act imposes obligations on listed companies to disclose information that is not generally available and that a reasonable person would expect, were that information to be generally available, to have a material effect on the price or value of the listed securities.

The second basis for the claim lay in the allegation that as a result of non-disclosure Sons of Gwalia had engaged in misleading and deceptive conduct in breach of s 52 of the *Trade Practices Act 1974*, s 1041H of the *Corporations Act* and s 12DA of the *Australian Securities and Investments Commission Act 2001*, which are aimed at providing some measure of consumer and investor protection. Because those Acts provide for payment of damages, he would, it was argued, be eligible for compensation for loss suffered from purchase of shares. This would not be in his capacity as a member of the company³, and he should thus be eligible to rank equally with other (unsecured) creditors under s 563A of the *Corporations Act*.

After it was put into voluntary administration, the company executed a deed of company arrangement (DOCA) that effectively meant that distributions from the assets of the company would occur in the same order of priority as would occur if the company were being wound up. The deed administrators then applied to the Federal Court that Mr Margaretic's claim was either not provable in the deed, or should be postponed until all other claims made by creditors were met. The essence of the argument was that shareholders claims as members of the company should rank last.

Emmett J of the Federal Court released his decision on 15 September 2005. He held that Mr Margaretic was a creditor of Sons of Gwalia and was entitled to all the rights of a creditor under Pt 5.3A of the Corporations Act and also declared that his claim not be postponed until debts to ordinary creditors were satisfied. This decision was unsuccessfully appealed to the Full Bench of the Federal Court, with special leave granted to appeal to the High Court. The appeal to the High Court was also unsuccessful. The High Court's decision confirms that shareholders' (identified as 'aggrieved investors' in the CAMAC report) claims to recover losses due to wrongdoing by a company rank equally with the claims of other unsecured creditors. In this regard, there is to be no distinction between claimants who acquired their shares by subscription or those who acquired them on the open market.

The consequences

One potential consequence is that, because claims by aggrieved shareholders will reduce the amount creditors will receive in failed companies, the cost of unsecured borrowing will increase for Australian companies. Where there is any risk of a company failing, lenders will demand a higher interest rate to offset the lower payout which would occur should the company fail. Most aggrieved shareholder claims will arise from situations where the company has failed to keep current and, more importantly, potential investors informed of material price-sensitive information that is known to the company in the weeks leading up to the point where trading in the company's shares is suspended. This was the case with Mr Margaretic,

who bought around \$26,000 worth of shares 11 days before the company was suspended, and claimed misleading and deceptive conduct by Sons of Gwalia.

To assess the likely impact on the cost of unsecured debt, some idea of turnover of shares in the period prior to suspension is needed. Using historical data on the turnover of shares prior to suspension of failed companies we have estimated that unsecured creditors could have their recovery diluted by as much as 40 per cent.⁴ Such dilution would lead to higher expected losses on the debt and consequently a higher credit risk premium. The CAMAC Report suggests that when assessing the impact of likely claims two points should be

noted. The first is that entities that are required to disclose under the Corporations Act are a small proportion of incorporated entities (albeit they are the larger ones). Second, less than five per cent of companies that lodged an insolvency report with ASIC in 2005–2006 paid a return of ten cents or more in the dollar to unsecured creditors, thereby reducing incentives for shareholders to litigate against the company.

The first point is somewhat irrelevant when assessing the impact of the judgment on the credit spread of publicly issued unsecured debt. Generally, only large listed companies that are rated by external rating agencies can issue debt into the capital markets. It is precisely these companies that are required to continuously disclose material information, and which are therefore affected by the *Sons of Gwalia* judgment. In previous work we have estimated the impact on credit spreads for Australian companies using modern credit risk modelling techniques based on option pricing theory. The predicted credit spread increase depends on assumptions about dilution of unsecured creditor claims, leverage ratios and ratios of unsecured to secured debt. Based on reasonable assumptions, the increase

in spread ranges from around four basis points for low overall leverage to 160 basis points for highly levered firms with predominantly unsecured debt. These estimates will be lower to the extent that the second point raised in the CAMAC report is valid. That is, if low expected payoffs deter litigation, lower dilution of unsecured credit claims and lower increases in credit spreads are expected. Whether this turns out to be a significant deterrent remains to be seen.

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Two cases as warnings

The added complexities and delays to external administration of failed companies are illustrated in the following two examples. To date, Sons of Gwalia Limited and Ion Limited are the two failed companies where there is a class action that involves shareholders seeking to claim as creditors of the companies in administration.⁵ In June 2007 the administrators of Sons of Gwalia estimated a return of 12 cents in the dollar for all creditors, including shareholder claims of \$250 million. Based on this estimate, shareholders reclassified to the status of unsecured creditors can expect to receive around \$30 million in aggregate, ignoring legal costs of the class action. If legal actions against auditors, Ernst & Young, and former directors are successful the administrators propose splitting shareholders into junior and senior claims with one-off payments for junior claimants with no ongoing rights and a more vigorous claim process for senior claimants with ongoing rights. The termination date for the deeds of company Arrangement has been extended several times from the original date of August 2005 to the most recent terminal date of 31 December 2007.

Consider now the example of Ion Limited, which was suspended from trading in December 2004, with unsecured debts in the order of \$369 million as reported in the balance sheet for June 2004. At November 2005, the administrators advised that 'some 2,500 proofs [from shareholders] have been received totaling approximately \$113m'⁶. By September 2007 the administrators under the DOCA had received more than 3,200 proofs of debt from shareholders, coming to approximately \$122 million. The administrators have stated that 'they may need to approach the Court in due course for guidance on the matters of disclosure obligations, causation and the quantification of shareholders losses.'

Clearly the process of collecting shareholder claims is a complex and time consuming task which results in delayed distributions to creditors. Both the Sons of Gwalia and Ion class actions have been funded by IMF Australia, with no up-front fee payable by shareholders participating in the class action. The class action vehicle makes the pursuit of numerous small claims viable because they can be rolled into a single lawsuit. It also allows institutional investors to anonymously pursue losses. Class action promoters essentially have a call option on a portion of the liquidation proceeds. The easier it is to prove misleading and deceptive conduct by the failed company⁸, the greater the size of potential shareholder claims (this depends on turnover in the period prior to suspension) and the greater the liquidation spoils, the more likely a litigation funder will be to pursue that option. This

suggests that low expected payoffs (in terms of proportional returns on the dollar) for unsecured creditors may not be sufficient to deter class actions on behalf of shareholders, provided the payoff is large enough to generate an adequate fee for the litigation funder.

Conclusion

Our message is that the credit spread on unsecured debt, which includes trade credit terms, for Australian companies could increase substantially. This would be particularly so for companies heavily reliant on unsecured debt, those with volatile share prices, and those with a relatively high share turnover.

Although the CAMAC report suggests that the relatively small historical liquidation spoils might act as a deterrent to shareholder litigation, class actions will be likely provided the liquidation rewards and potential aggrieved shareholder claims are large enough. Litigation funders have a call option on a portion of the potential proceeds to shareholders and their profit motive will make pursuit of claims more likely when company non-compliance with the disclosure regime can be shown to have caused shareholder losses.

As illustrated in the cases of Sons of Gwalia and Ion, pursuit of shareholder claims has the potential to seriously complicate the administration process and result in long delays in distributions to trade and other unsecured creditors.

Notes

- 1 CAMAC is a statutory advisory committee of business people and academics who advise the federal government on corporations and financial markets law and practice
- 2 See <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/\\$file/Sons_of_Gwalia_D_P_Sep07.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/Sons_of_Gwalia_D_P_Sep07.pdf)> [14 January 2008]
- 3 Registered shareholders are 'members' of the company under s 231 of the Corporations Act
- 4 C Brown and K Davis 2006, 'Shareholders or Unsecured Creditors? Credit Markets and the Sons of Gwalia Judgement', *Agenda*, Vol 13 No 3, pp 239-252
- 5 See <<http://www.delisted.com.au/legal.aspx>> [14 January 2008]
- 6 McGrathNicol+Partners (2005), 'Deed Administrators' Update 28 November 2005', <<http://www.ionlimited.com.au/images/articles/051202.pdf>> [14 January 2008]
- 7 See <<http://www.delisted.com.au/Company/4378>> [14 January 2008]
- 8 Class action promoters and shareholders have also been aided by the recent decision in *Riley v Jubilee Mines NL* [2006] WASC 199, where the Supreme Court of Western Australia held that information could be said to have a material effect on the price or value of a company's shares when the eventual release of the information does in fact affect the share price ●