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Can Shareholders Now Rank With Creditors In An Administration? 01

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Sons of Gwalia Limited (Administrator Appointed) v Margaretic

The decision of Justice Emmett in *Sons of Gwalia Limited (Administrator Appointed) v Margaretic* (2005) FCA 1305 (*Sons of Gwalia*) rattles the comfortable consensus that equity, by definition always ranks behind debt in any insolvency administration. It confirms a shareholder can rank with creditors, if the shareholder's claim does not relate to his contract, as a shareholder, with the company.

The Dispute

The shareholder made a claim against the company for loss of the purchase price of his shares. The shares were acquired at a time when the company had failed to disclose that its gold reserves were insufficient to satisfy its gold delivery commitments to the extent that it adversely affected the company's solvency. The non-disclosure was in breach of the company's obligations under the *Companies Act 2001* and ASX Listing Rules and was misleading and deceptive conduct in contravention of the *Trade Practices Act 1974*, the *Companies Act 2001* and the *Australian Securities & Investments Commission Act 2001* (Cth).

The fundamental contention by the shareholder was that its claim, being the loss of the value of the shares purchased, was not owed in its capacity as a member of the company and therefore should not be postponed to other creditors.

The Issues

Webb Distributors (Aust.) Pty Ltd v State of Victoria (1993) 179 CLR 15 (*Webb's Case*), a decision of the High Court, was the central authority considered by the Federal Court.

In Webb's Case a member of a building society claimed he was entitled to be a creditor in its liquidation because he had purchased his shares relying on misleading and deceptive conduct by the building society. He understood the shares would be redeemable 'like deposits'. In fact, the shares were not redeemable. If a member wanted to redeem the shares a sum would be paid to the member for the shares, which would be transferred to another building society. The member argued s.360(1) of the *Companies (Victoria) Code*, which postponed shareholders to other creditors in a winding up, did not affect his claim.

The High Court relied on two streams of authority based on 19th century English decisions:

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» company legislation prohibiting a company purchasing its own shares or reducing the amount of its capital without Court sanction. This had the effect of prohibiting transactions between the company and shareholders by which money paid for shares could be reimbursed to a shareholder without court sanction

» once the winding up of a company has begun, a shareholder cannot, on the grounds of fraud, rescind a contract for the purchase of shares from the company. The rationale was that innocent third parties such as creditors (that had acquired rights) would be defeated by a rescission, in that they would lose their priority to shareholders.

The Federal Court observed that all of the cases cited by the High Court in *Webb's Case* were concerned with attempts by members of companies in liquidation either to avoid liability in respect of partly paid shares or to set off against that liability a claim for damages for deceit or misrepresentation that induced the application for the shares.

In *Webb's Case*, the members sought to prove damages which amounted to the purchase price of their shares in the liquidation of the building society. The High Court held that the damages directly related to their shareholding. Accordingly, it rejected the shareholder's claim.

However, the majority in *Webb's Case* confirmed that:

> *"… s.360(1) would not prevent claims by members for damages flowing from a breach of contract separate from the contract to subscribe for the shares …"*

In other words, the court was stating that members would rank with creditors for claims that are not a direct consequence of the terms of their purchase of shares.

The Federal Court, in finding for the shareholder, distinguished *Webb's Case* on the basis that it applies only to members of the company who are suing on their contract with the company. In this case, the shares were purchased from a third party on the stock exchange. The dispute did not involve an agreement between the company and the shareholder regarding the conditions of the shareholding.

Conclusion

Sons of Gwalia puts unsecured creditors, including lenders, on notice of the possibility that in a winding up or voluntary administration, shareholders can rank as unsecured creditors if they relied on false and misleading conduct by the company when acquiring their shares.

The case is on appeal. In the meantime lenders to public companies should consider imposing covenants on borrower companies in respect of continuous disclosure, carefully monitor the company's disclosure regime, and be aware of the impact non disclosure may have on their position as an unsecured creditor.

Nicholas Diacos | *Partner*

Further information

Sydney
Nicholas Diacos
Partner
T: +61 2 9513 2365
nicholas.diacos@middletons.com.au

Dina Glass
Partner
T: +61 2 9513 2360
dina.glass@middletons.com.au

Jeff Goss
Partner
T: +61 2 9513 2317
jeff.goss@middletons.com.au

Melbourne
Armando Scenna
Partner
T: +61 3 9205 2092
armando.scenna@middletons.com.au

Paul Sroka
Partner
T: +61 3 9640 4347
paul.sroka@middletons.com.au

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