



**SUBMISSION BY IMF (AUSTRALIA) LTD
TO
CORPORATIONS AND MARKETS ADVISORY COMMITTEE
RE
SHAREHOLDER CLAIMS AGAINST INSOLVENT COMPANIES**

Executive Summary	2
Submissions	2
Market Protections.....	3
<u>Part 1</u> SHAREHOLDER CREDITORS SHOULD RANK PARRI PASSU WITH OTHER CREDITORS	4
1.1 The Assumption of Risk Argument.....	6
1.2 Detrimental Effect on the Debt Market Argument	8
1.3 The Effect on Creditor Voting Argument.....	9
1.4 Cost and Delay Argument	10
1.5 Illusory Market Protections	11
<u>Part 2</u> REFORMS TO FACILITATE EFFICIENCY.....	11
2.1 Remove Consideration of Each Shareholder’s Circumstances.....	12
2.2 An Efficient Method of Quantifying Loss.....	14
<u>Part 3</u> REFORMS FOR BETTER SHAREHOLDER PROTECTION.....	15
3.1 Making Determination of Claims More Efficient.....	15

Executive Summary

- To subordinate defrauded shareholders in respect of their claims against a company in external administration would eschew the purpose for which the market protections were designed, namely, to enhance corporate behaviour and the efficient allocation of capital.
- Since the need for protection of investors often arises in the event of insolvency, the benefits of the market protection regime would become illusory if shareholder claims were subordinated to the claims of ordinary creditors.
- The Australian law rejects a general policy that ‘members come last’ and, after the Sons of Gwalia decision, is consistent with the law of the United Kingdom.
- There is no evidence that the cost of debt will be affected by the decision; experience from the UK would suggest such fears are unfounded.
- Policies must be considered to make rights of shareholders arising from the market protections easier to enforce.

Submissions

IMF (Australia) Ltd supports Option 1 as described in section 7.3 of the Discussion Paper – that the current law, as determined by the High Court’s decision in Sons of Gwalia, be retained.

Furthermore, IMF submits:

- (a) that the legislature clarifies that proof of reliance on misleading statements or omissions is not necessary in order to prove casually connected loss for a breach of the market protection laws; and
- (b) that the legislature stipulates a method for quantifying loss that is easily understood, enables enforcement and gives effect to the overriding principle that investors receive compensation for losses arising from breaches.

Introduction – Market Protections

1. The timely disclosure of material information is critical to the confidence of market participants to ensure the market can maximise the capital available to it and that the capital in the market is allocated effectively.¹ As the Minister noted in the Second Reading Speech of the Corporate Law Reform Bill (No 2), which introduced the continuous disclosure regime:

“In essence, a well informed market leads to greater investor confidence and in turn a greater willingness to invest in Australian business.”²

2. The Minister also noted in that speech that the continuous disclosure regime would have an important regulatory function by acting as a check on corporate misconduct:

“An effective disclosure system will often be a significant inhibition on questionable corporate conduct. Knowledge that such conduct will be quickly exposed to the glare of publicity, as well as criticism by shareholders and the financial press, makes it less likely to occur in the first place.”³

3. The Government has recognised this benefit by increasing penalties and widening the scope of the continuous disclosure regime since its introduction in 1994.⁴ As noted by French J:

“The importance attached to the continuous disclosure provisions of the Act by the legislature is emphasised by the penalties for their contravention which have recently been significantly increased and their widened scope since 2002 which is now not limited to intentional reckless or negligent non-disclosure.”⁵

4. Importantly, market protections have not only been put in place to protect shareholders. In deciding whether to lend or provide trade credit, and if so at what price and under what terms, lenders and trade creditors also rely on the market protections. The principal cause of the Sons of Gwalia creditors’ loss was the same as the cause of the shareholders’ loss: a misinformed market.
5. To subordinate defrauded shareholders from claiming damages against a company, even though it is under external administration, would be to eschew the purpose for which the market protections were designed.

¹ Capital in this context is intended to cover all forms of capital, including debt and equity and all other forms of finance, including trade credit.

² Second Reading Speech of the Minister for Administrative Services introducing the Corporate Law Reform Bill (No 2) into the Senate, Parliamentary Debates, 26 November 1992 at p3561.

³ Ibid.

⁴ Before 1994, the regime was contained in the ASX Listing Rules and thereby remained a contractual issue between the listed entity and the ASX.

⁵ *Australian Securities and Investments Commission, in the matter of Chemeq Limited v Chemeq Limited* [2006] FCA 936. The *Financial Services Reform Act* of 2001 removed the “intentional, reckless or negligent” non-disclosure.

6. Chief Justice Murray Gleeson noted in the High Court of Australia’s decision in *Sons of Gwalia*⁶ (the “Sons of Gwalia decision”), at paragraph 18, that the need for shareholder protection often only occurs when a company becomes insolvent and those protections may become “illusory” if shareholder claims were subordinated:

“Corporate regulation has become more intensive, and legislatures have imposed on companies and their officers obligations, breach of which may sound in damages, for the protection of members of the public who deal in shares and other securities. This raises issues of legislative policy. On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The spectre of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.”

7. Since the High Court’s decision in *Sons of Gwalia*, a number of valid concerns have been raised about possible delays and increased costs to external administrations. The implications of cost and delay are serious and the legislature’s focus must be on an effective claims resolution process that resolves disputes fairly and quickly. At present, there are two barriers to affordable and speedy resolution of shareholder claims: the possibility that the circumstances of every shareholder be considered by the administrator adjudicating on the claims; and a lack of clarity as to the methodology to apply to calculate losses. Both barriers can be relatively easily overcome.
8. This submission has been structured into three parts, based upon the questions asked by the Parliamentary Secretary in his letter of referral to the Corporations and Markets Advisory Committee. When addressing specific issues raised by CAMAC in its Discussion Paper “Shareholder Claims Against Insolvent Companies: Implications of the *Sons of Gwalia* decision” (“Discussion Paper”), we refer to the relevant paragraphs of the Discussion Paper as appropriate.

Part 1

Should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct?

9. In answering this question, three presumptions will be made. First, “misleading conduct” in this context is presumed to include a breach of the duty to provide continuous disclosure. Secondly, “participation” is not presumed to mean participation at all, but rather participation *parri passu* with other unsecured creditors.⁷ Finally, this submission presumes that “shareholders” refers to shareholders on the register of the

⁶ *Sons of Gwalia (Subject to Deed of Company Arrangement) v Luka Margaretic* [2007] HCA 1 (31 January 2007).

⁷ It was not argued in the High Court in *Sons of Gwalia* that the respondent should not participate as a creditor, but rather that his rights were postponed pursuant to section 563A.

company at the time the external control commenced.⁸

10. Accordingly, this submission understands the question to be whether shareholders on the register of the company at the time external control commenced, who acquired shares as a result of a breach of section 674 or 1041 (“Shareholder Creditors”) should have payment of their debt postponed until all other debts have been paid in full.
11. This submission argues that any possible unfairness to creditors consequent upon the reduction of capital in the case of a limited liability company is matched by the unfairness which would result to innocent victims of fraud perpetrated by a company or its representatives if no remedy were available.⁹
12. The market protections in the *Corporations Act*, *ASIC Act* and *Trade Practices Act* should be construed and applied broadly and the rights to damage should not be limited in relation to companies in liquidation.¹⁰
13. As noted by the Chief Justice in the *Sons of Gwalia* decision:

*“What determines the present case is that the claim made by the respondent is not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of [Sons of Gwalia]...The obligations he sought to enforce arose, by virtue of [Sons of Gwalia’s] conduct, under one or more of [the Corporations Act, ASIC Act and Trade Practices Act.]”*¹¹
14. The Discussion Paper notes that reform to the Australian law would align Australia to the Federal Bankruptcy Code of the United States¹² which subordinates Shareholder Creditors’ debts to Other Creditors’ debts (see Discussion Paper section 6.3).
15. On the other hand, the Companies Act 1985 (UK)¹³ reflects a contrary policy and which expressly denies any such subordination of Shareholder Creditors’ debts (see Discussion Paper section 6.2).
16. Accordingly, Australian law is currently consistent with the relevant UK law and inconsistent with the relevant law in the United States.
17. The Chief Justice in the *Sons of Gwalia* decision pondered if the Australian Parliament were to introduce a provision similar to the United States provision:

“...it would need to consider what would be the practical effect upon the rights conferred upon people who deal in shares and securities by legislation of the kind relied upon by the respondent. One thing is clear. Section 563A does not embody a general policy that, in an insolvency, “members come last”. On the contrary, by distinguishing between debts owed to a member in the capacity as a

⁸ Clarity in respect of who is postponed and who is not will be a very difficult issue if legislative reform is considered appropriate.

⁹ *Re Pyramid* (1992) 10 ACLC 110 at 114 per Vincent J.

¹⁰ *Webb Distributors (Aust) Pty Ltd v Victoria* (1993) 179 CLR at 15 per McHugh J.

¹¹ *Sons of Gwalia (Subject to Deed of Company Arrangement) v Luka Margaretic* [2007] HCA 1 (31 January 2007) per Gleeson CJ at 31.

¹² 11USC§510(b).

¹³ s111A.

member and debts owed to a member otherwise that in such a capacity, it rejects such a general policy."¹⁴

1.1 The Assumption of Risk Argument

18. It is argued by those seeking legislative change that there are good policy reasons why a shareholder attending an AGM who slips as a result of the negligence of the company and suffers damage should rank above a shareholder who is lied to by the company at the AGM and thereby suffers loss.
19. The policy consideration justifying the distinction, so the argument goes, is that the slip victim does not assume the risk of negligence whereas shareholders must, as a matter of policy, assume the risk that they will be lied to when making their investment decision as part of the trade off for a share of any profit and capital gain.
20. Law professors John Slain and Homer Kripke wrote the seminal article on the policy considerations behind the statutory subordination of shareholders in the US Federal Bankruptcy Code.¹⁵ Slain and Kripke argued that it was justified for shareholders to bear the risk of a fraudulent or misleading conduct in relation to securities as they received the profits from a company's success.
21. However, the policy basis for this view seems increasingly anachronistic given the introduction in the US of legislation seeking to protect defrauded shareholders. As Hargovan and Harris note¹⁶ "the wisdom of the US legislation, it appears, has recently been doubted by Congress itself through its hasty actions in the aftermath of major US corporate scandals such as Enron and Worldcom. These events caused the US Congress to revise, whether intentionally or not, the importance of shareholder subordination in insolvency under the Sarbanes-Oxley reforms." The authors state that the introduction of Sarbanes Oxley undermines the strong policy foundations of US subordination laws by allowing the SEC to distribute penalties for breaches of securities laws to defrauded shareholders.
22. This submission supports the view of Hargovan and Harris, applying their analysis of the US position to Australia: "The resultant outcome arising from blanket subordination, which eschews notions of fairness to shareholder interests...cannot be justified. The US approach to statutory debt subordination is premised on the belief that shareholders as investors should justifiably bear the risk of fraudulent or misleading conduct and does not accommodate shareholder interests in such circumstances which, in our opinion, is a flawed approach."¹⁷
23. With respect, the argument that shareholders assume the risk of being lied to is cynical and debases our market protection regime. Shareholders, as with all other beneficiaries of the regime, should be able to expect the companies with whom they deal will comply with their market protection obligations and invest in and allocate capital within the

¹⁴ at 19.

¹⁵ Slain J and Kripke H, "The interface between securities regulation and bankruptcy – Allocating the risk of illegal securities issuance between security holders and the issuer's creditors" (1973) 48 NYULR 261.

¹⁶ Hargovan A and Harris J, "Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience" (2007) 20 AJCL 265

¹⁷ Ibid at 294.

market on that basis.

24. No policy can assume less, with any breach entitling compensation to rank equally with the slip victim and the other beneficiaries of the regime. Justifiable policy reasons to differentiate between and create priorities between beneficiaries of the market protection regime must be clearly articulated to justify legislative change.
25. For most shareholders who are still holding their shares at the time a company which has breached the market protection laws enters external administration, the first indication that the company is in trouble is typically an announcement to the Australian Securities Exchange that external administrators have been appointed.
26. This is because in the modern equity market, shareholders typically remain outside the company and have little influence on the company's operation, or insight into its performance, other than through the information which is publicly disclosed to the ASX.
27. As one commentator noted after *Sons of Gwalia* decision, "in large listed companies, ordinary shareholders, even institutional shareholders, have only notional ownership rights in most circumstances. They have no real ability to direct the company, are rarely able to influence the composition of the board or strategies of their management and are in reality more like financiers receiving equity returns and accepting equity risk."¹⁸
28. This is in contrast to trade creditors and unsecured finance creditors, who are typically much closer to the company. Many trade creditors would receive an indication that a company is in financial difficulty when accounts are overdue or not being paid. To continue to advance goods or services in this situation is to assume the risks that ultimately you will not be paid for those goods or services. Similarly, many unsecured finance creditors are in close contact with company management and some seek and receive access to the company's book and records to allow them to assess the risk of their loans.
29. Hence it is arguable that it is even *more* important that the investor protections are made available in the context of insolvency to protect shareholders who can prove their right to compensation, as it is the shareholders who practically have less opportunity to assess the company's performance when compared to the company's traditional creditors.
30. It seems logically inconsistent that shareholder claims be postponed while investors other than those who become shareholders (for example, those that purchase options or convertible notes) are creditors whose claims have never been postponed. Moreover, it seems curious that the claim of one shareholder who sells all of his shares prior to the company entering external administration not be postponed, whereas the claim of another shareholder who is still holding his shares on the date of administration would be postponed. And if the same shareholder buys shares in an uninformed market and only sells some of them prior to the company entering administration, it seems an unusual result for him to have a full claim in respect of some but not all of the shares. These issues and others will need to be addressed if shareholder subordination is

¹⁸ Bartholomeusz S, 'Shareholders win at cost to creditors', *The Sydney Morning Herald*, 1 February 2007 at page 24.

supported.

1.2 Detrimental Effect on the Debt Market Argument

31. Some representatives of the debt markets have said the effect of the Sons of Gwalia decision will be detrimental to Australian company's capacity to obtain debt finance and the terms on which any finance may be obtained. This is addressed in section 5.1 and 5.3 of the Discussion Paper.
32. Before the High Court decision was handed down, academics were *suggesting* that credit spreads (the difference between the yield on a government bond and a company's bond, reflecting the risk of the company bond) might be affected by a finding for Mr Margaretic. For example, one article argued "the resulting ambiguity with regard to the traditionally accepted investor hierarchy of claims in the event of corporate collapse has the potential to affect credit spreads in the market for corporate debt".¹⁹
33. At a seminar hosted by the Investment & Financial Services Association on 8 March 2007, Stuart Gray, a senior credit analyst at Deutsche Asset Management, said that he and his colleagues had expected that Australian credit spreads would widen after the Sons of Gwalia decision. However, he clearly stated that "this isn't happening".
34. Mr Gray cited the "benign credit environment" in support of this observation and said that "investors directly affected by [the] Sons of Gwalia [decision] were limited" since there were only 30 to 50 US investors in the private placement market in which Sons of Gwalia issued its debt, and there were only seven investors in the Sons of Gwalia debt itself. Mr Gray said the US private placement market was dwarfed by the size of the investment grade market, which would not be affected by the Sons of Gwalia decision.
35. Since these comments were made in March, credit spreads have widened. However, this has largely been caused by a reassessment of risk globally in the wake of concerns about the US economy and specifically the upheaval in the US subprime mortgage markets.
36. Any argument suggesting that the cost and availability of finance for Australian companies has been affected by the Sons of Gwalia decision would need to carefully explain how those increased costs have been caused by the decision, as opposed to other factors. It would be improper for the Parliament to consider changing the law until the persons raising concerns about the cost of debt can present tangible evidence to support their assertions.
37. We are not aware of any evidence in Australia that that the decisions in Sons of Gwalia of Emmett J, the Full Federal Court or the High Court caused any increase in credit margins or any difficulties for Australian companies seeking to raise debt finance.
38. In any event, you cannot generalise about the cost of debt and need to assess the provision of debt to a particular company on a case-by-case basis. Lenders will always assess the probability of default before estimating what losses will be if default does in fact occur. The High Court decision is not likely to influence lenders' assessments of

¹⁹ Brown C and Davis K, "Credit markets and the Sons of Gwalia Judgement" *Agenda* 13(3) (2006) 239 at 251.

the probability of default.

39. This point was clearly noted by Standard & Poor's which said the day after the High Court decision: "For debt investors, it is Standard & Poor's view that this decision should have no impact on the probability of a default in debt payments in the ordinary course, so we do not anticipate credit ratings being affected."²⁰
40. Standard & Poor's director Anthony Flintoff was quoted in the same release, stating: "In Standard & Poor's view, the case does not realign the debt-equity balance, rather it recognises that the market-protection laws are powerful and that absolute transparency in information flows is a key protection for companies and investors alike."²¹
41. The overwhelming majority of debt providers will not be affected by the Sons of Gwalia decision. In reality only a few reorganisations each year will be affected. This is because in order for shareholder claims to be viable:
 - (a) a listed company needs to have become insolvent;
 - (b) there must be sufficient assets to make distributions to unsecured creditors worthwhile;
 - (c) there must not be unpaid secured debt ranking in priority; and
 - (d) there must have been a reasonably clear breach of the market protection regime.
42. As stated previously, the legislature in the UK has allowed all shareholders, to claim in the situation of insolvency. Section 111A of the Companies Act 1985 (UK), which was inserted by the Companies Act 1989 (UK), provides that:

"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."

43. We are aware of no evidence from the UK that liquidity in the UK debt markets or the cost of debt finance has been affected by this provision. Moreover, there has been a relatively small number of shareholder claims against insolvent companies, and none that have adversely effected any significant administrations.

1.3 The Effect on Creditor Voting Argument

44. Arguments have also been raised that Shareholder Creditors, who will be entitled to vote at creditors' meetings, will seek to liquidate a company in situations where traditional creditors may want the company to be preserved.²² The Discussion Paper

²⁰ "Gwalia Court Decision Is Credit Neutral For Australian Ratings, But Recovery Risks May Rise, Says S&P", Standard & Poor's Ratings Services, Press Release dated 1 Feb 2007. Another ratings agency, Fitch, said the decision "is not expected to have any immediate major impact on Australian debt markets". (See "Fitch: Gwalia Shareholder Case Decision Unwelcome for Debt Markets; But No Major Impact Likely", Fitch Ratings, Press Release dated 1 February 2007.)

²¹ Ibid.

²² See Zwier L, 'Investors get more rights, but High Court decision is wrong', The Age, 5 February 2007.

addresses this and other arguments relating to the conduct of voluntary administrations in section 4.2. In addition to presuming that Shareholder Creditors should have a lesser vote for unstated policy reasons, the argument also presumes that Shareholder Creditors will be admitted to vote at the full value of their claim under the current regime.

45. If a vote is required and if a claim cannot be quantified by a just estimate (which will be the case for Shareholder Creditor claims), but it is clear that the Shareholder Creditor is a creditor for at least some amount, then it is appropriate to admit the creditor for voting purposes at a nominal value of \$1.00.²³

1.4 Cost and Delay Argument

46. In the aftermath of the Sons of Gwalia decision, a number of valid concerns have been raised about possible delays and increased costs to external administrations. A number of these concerns are noted in section 4.3 of the Discussion Paper.

47. Writing in *The Age* in February 2007, Mark Korda says it is difficult to prove the causal relationship between the breach of the market protection regime and loss.²⁴

48. Leon Zwier, also writing in *The Age* in February 2007, says that shareholder damages are complicated to calculate. A result of this he says is that the administrator or liquidator will not be able to determine the quantum of claims and advise creditors of likely returns in a timely manner.²⁵

49. Both of these concerns are valid and warrant the close attention of the legislature. However, it would be wrong for the legislature to react by abolishing the rights of shareholders arising from the market protections or subordinate these rights so as to make the rights illusory. If we abolished legal rights that were costly and time consuming to enforce, we would be left with very few rights.

50. Some insolvency practitioners have been calling on the legislature or Courts to clarify principles and methodologies to enable claims to be determined quickly. For example, after the decision of Justice Emmett in the first Sons of Gwalia case, Tony McGrath told the AFR in September 2005:

“I would hope there’s a fairly straight-forward decision tree we can all follow so the creditors at large don’t have to wait too long for their dividends.”²⁶

51. The request for a straight-forward decision tree, and the valid concerns relating to time and delay, illustrate the necessity to consider policies that will make the rights of shareholders arising from the market protections easier to enforce.

52. Once it is recognised that the misled shareholder is a creditor (and there is no question that this is the case), there is no logical reason why that creditor should be treated in a different way to other creditors. Simply changing the priorities (by postponing the

²³ See *Re Oriel Homes Pty Ltd* (1997) 15 ACLC 564 at 566.

²⁴ Korda M, ‘Gwalia ruling creates need for new legal category of aggrieved shareholder’, *The Age*, 2 February 2007.

²⁵ Zwier L, ‘Investors get more rights, but High Court decision is wrong’, *The Age*, 5 February 2007.

²⁶ *The Australian Financial Review*; 21 September 2005.

shareholder creditor's claim) does not relieve the external administrator of duties towards those postponed creditors.

1.5 Illusory Market Protections

53. Unless the law can actually protect, and ultimately provide compensation to, those victims of illegal conduct, the market protection regime risks becoming an irrelevancy, or, to repeat the words of the Chief Justice set out in paragraph 6 above, "illusory".
54. If the laws are not enforceable, then one of the main tools for preventing market misbehavior is severely restricted.
55. Very few cases alleging breaches of continuous disclosure have been brought, either by the corporate regulator or by investors.²⁷
56. The dearth of private actions is probably *not* illustrative of few companies acting in breach of their legal obligations to continuously disclose material information, but rather the access to justice barriers addressed later in this submission.²⁸

Part 2

Are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims?

57. There are several ways that shareholder claims in the insolvency context can be determined efficiently.
58. The market protections are clear in respect of duties companies have concerning their conduct. These submissions do not call for any changes concerning an external controller's capacity to efficiently determine whether the company has breached the market provisions and, if so, the period in which the breach was active.
59. As can be seen in the Sons of Gwalia administration, the fulfillment of the external controller's existing duties requires him or her to:
 - (a) report to ASIC in respect of possible offences in relation to the company;²⁹

²⁷ There are only three court decisions on continuous disclosure of any substance. *Australian Securities and Investments Commission v Southcorp Ltd (No 2)* [2003] FCA 1369 and *Australian Securities and Investments Commission, in the matter of Chemeq Limited v Chemeq Limited* [2006] FCA 936 were actions brought by the Australian Securities and Investments Commission; *Kim Riley in his capacity as trustee of the KER Trust v Jubilee Mines* [2006] WASC 199 was brought by a shareholder (who successfully recovered damages).

²⁸ These include:

- (a) lack of awareness of their rights (see 3.3);
- (b) the costs and delays in our civil justice system (see 1.5, 2.1, 2.2 and 3.1);
- (c) insufficient information about directors' capacity to meet any judgment (see 3.4);
- (d) statutory restrictions on accessing other shareholder contract details to enable collective action (see 3.3); and
- (e) the representative procedure created by Federal Parliament not being available for funded collective action (see 3.5).

²⁹ Section 438D.

- (b) determine the reasons for the failure of the company; and
 - (c) publish a Report to Creditors, which includes an analysis of the matters in (a) and (b), above.³⁰
60. This existing process enables the external controller to form an opinion as to whether, on the balance of probabilities, there have been relevant breaches of the market protection provisions by the company and, if existent, when the breaches were operative.
61. If this is not possible, the issue could be resolved for the benefit of the Company and all creditors by an application to the Court for declaratory relief or a decision binding on a representative Shareholder Creditor.
62. Accordingly, examinations specific to identifying relevant breaches will rarely cause material additional costs or delays.

2.1 Remove Consideration of Each Shareholder's Circumstances

63. If it is concluded that there were market protection breaches in a specified period prior to the commencement of external control, either personally by the external controller or through a test case, then:
- (a) it can be determined who may be Shareholder Creditors by determining who purchased shares in the relevant period; and
 - (b) the next question to be answered is whether each or all of these Shareholder Creditors suffered loss by the breaches.³¹
64. Section 3.2.3 of the Discussion Paper states that “to succeed in litigation based on a corporate misrepresentation, a plaintiff shareholder must prove that the plaintiff relied on the misrepresentation or another relevant person relied on the misrepresentation.” IMF submits, with respect, that this assumption is incorrect.
65. It is debatable as to whether proof of reliance on misleading statements or omissions is necessary in order to prove causally connected loss and thereby have each proof admitted. This will be a key determination in the (currently reserved) decision of Justice Stone in *Dorajay Pty Ltd v Aristocrat Leisure Ltd*.
66. The question of what causal link must be established between contravention and loss is to be assessed by reference to the discernable purpose of the particular statute that has been contravened.³²
67. The market protection laws contain no express limitation on the kinds of loss that may be recovered. Nor do they indicate what losses will be considered too remote to be recoverable. The test for causation under the misleading conduct provisions is whether any shareholder suffered loss and damage “by” conduct of the company. For

³⁰ Section 439A.

³¹ Refer to Attachment “A” in respect of proving causation and Attachment “B” in respect of proving quantum of the loss.

³² *I&L Securities v HTW Valuers* (2002) 210 CLR 109 at [26] per Gleeson CJ.

contraventions of the continuous disclosure provisions, compensation may be ordered in respect of damage which “resulted from” the contravention. Accordingly, reliance is clearly not expressly a requirement of the provisions.

68. Considering causally connected loss in the context of the *Trade Practices Act*, Lockhart J said in *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*,³³ in a passage quoted with approval by Gummow J in *Marks v GIO Australia Holdings Ltd*³⁴:

“What emerges from an analysis of the cases (and there are many of them) is that they do not impose some general requirement that damage [under s82 of the TPA] can be recovered only where the applicant himself relies upon the conduct of the respondent constituting the contravention of the relevant provision.”

69. In *Smith v Moss*,³⁵ the New South Wales Court of Appeal rejected the need for there to be specific evidence of a plaintiff’s reliance on misrepresentations in the plaintiff’s decision-making process for causation when it observed³⁶:

*“First, the essential question is causation. There may be causation from misleading or deceptive conduct if the conduct lies in failing to disclose that which in the circumstances should have been disclosed. It is not a natural use of the notion of reliance to say that there was reliance on the failure in disclosure, but causation can be found if disclosure would have caused inaction or action other than that which was taken... Secondly and more fundamentally, specific evidence of reliance is not essential for proof of causation. Such evidence may be one strand, perhaps an important one, in the factual skein, but causation may be found without it. So Wilson J said in *Gould v Vaggelas* (1985) 157 CLR 215 at 238.”*

70. Similarly, while reliance may be an important component of the factual inquiry as to whether causation exists, reliance is not an element or *sine qua non* of the statutory cause of action relied upon by shareholders in an action for breach of the continuous disclosure laws. There are also obvious logical difficulties in relying on an “omission”; if you are alleging that certain material information was not disclosed, on what did you rely?

71. IMF submits that necessary proof of causation ought to be limited to proving the shareholder:

- (a) acquired shares in the company during a period in which the company was in breach of its legal obligations; and
- (b) would not have purchased the shares at the price the purchase was made if the shareholder had known the true circumstances.

³³ (1992) 37 FCR 526 at 529-530

³⁴ (1998) 196 CLR 494 at [101]

³⁵ [2006] NSWCA 37

³⁶ at [25]

72. Inferred reliance has already been recognised in decisions considering the application of the *Trade Practices Act*. For example, where a representation is likely to induce the representee to enter into a contract and the person actually enters the contract, the Court may infer reliance³⁷.
73. This would remove the need to gather and provide evidence of detrimental reliance by each and every shareholder upon each and every particular representation.

2.2 An Efficient Method of Quantifying Loss

74. There are two kinds of loss that will be claimable by Shareholder Creditors, namely:
- (a) direct loss, being the amount paid for shares purchased during the period in excess of their true value³⁸; and
 - (b) consequential losses flowing from loss of use of the funds comprising the direct loss³⁹.
75. Calculation of the direct loss suffered by each shareholder currently requires expert evidence concerning the true value of the shares during the period in issue.
76. An efficient method of identifying the true value of the shares would be the appointment by the company and the shareholders of one independent expert who could provide a binding expert determination.
77. Alternatively, loss might be defined in the statute as the difference between the price paid for the shares and the subsequent price received or receivable for the shares (which in the case of insolvency, is likely to be zero).
78. Whichever definition is chosen, the focus of the legislature must be on creating a compensatory rule that is easily understood and workable. As the High Court has noted, referring to a judgment of Lord Steyn in the House of Lords:

*“The fundamental rule was that the plaintiff should be compensated; that the rule which turns on an assessment of value is only a means of giving effect to the overriding compensatory rule.”*⁴⁰

79. Consequential losses could be calculated by reference to the average return on investment on shares included in the Australian All Ordinaries or some other index such as the ASX200, from the date of the breach until the appointment of the external controller to the company.

³⁷ *Gould v Vaggelas* (1985) 157 CLR 215.

³⁸ see *Potts v Miller* (1940) 64 CLR 282; *Smith New Court Securities Ltd v Citibank NA* [1997] AC 254.

³⁹ *Marks v GIO Australia Holdings Ltd* (1998) 196 CLR 494.

⁴⁰ *HTW Valuers (Central Qld) Pty Ltd v Astonland Pty Ltd* [2004] HCA 15 at par 63. The decision of Lord Steyn was in *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1997] AC 254.

Part 3

Are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information?

80. If the legislature decides that shareholders are not entitled to rank with unsecured creditors it should not lose the opportunity to look at making the existing law enforceable. It is critical that shareholders are able to rely on their legal rights to take action against the perpetrators of the wrongdoing, which may include the directors of the company.

3.1 Making Determination of Claims More Efficient

81. The Discussion Paper notes in section 8.3.2 that “possible ways to expedite the claims procedure and make it more efficient” include providing for a single judicial determination for a common aggrieved investor issue, including through a single proof of debt, and having a rebuttable presumption that a court’s determination of a common question of fact in one proceeding applies in all subsequent proceedings. These proposals are sensible given this submission’s view that it is not necessary for each investor to prove individual reliance (and therefore there should be a sufficient commonality of claims).
82. If the legislature decides that shareholders are not entitled to rank with unsecured creditors, thought must be given to the suggestions in Part 2 above, namely by clarifying that a shareholder, in order to prove causation in any action that might be brought against the directors of a company under external administration, need only show that the shareholder:
- (a) acquired shares in the company during a period in which the company and its directors were in breach of their legal obligations; and
 - (b) would not have purchased the shares at the price the purchase was made if the shareholder had known the true circumstances.
83. Addressing the call in section 9.2 of the Discussion Paper regarding the introduction of a “fraud on the market” approach, IMF submits that the approach to causation described in paragraphs 65 to 71 of this submission is consistent with established authority and that one does not require that adoption of any particular “theory” to establish causation. (See **Attachment “A”**)
84. Similarly, the legislature ought to set out a clear methodology for quantifying losses in any action that is brought against company directors, as outlined in paragraphs 74 to 77 of this submission. (See **Attachment “B”**)
85. The present situation is untenable. Even though investors in the capital markets have been granted significant protections by the legislature, enforcing such rights is most often practically impossible. Excessive costs and delays are prevalent, due in part to a lack of clarity about the process and methodology for determination of claims.

Attachment “A” Causation

1. Causation

- 1.1 The word “by” in the context of the misleading and deceptive provisions requires that:
- (a) the company’s conduct must have materially contributed to the suffering of loss or damage; and
 - (b) the shareholder’s loss be caused by the conduct of the Company in breach of the relevant legislation. Reliance per se is not required.⁴¹
- 1.2 The words “resulted from” in S1317 HA (1) in the context of the material non disclosure provisions⁴² result in the same approach to causation as for misleading and deceptive conduct.

2. Circumstances in Which Causation Can Arise

- 2.1 Causation can arise at a series of graduated levels:
- (a) direct reliance on the Company’s conduct - the shareholder is induced to buy or not to sell in reliance on the conduct of the Company;
 - (i) the shareholder must currently be personally aware of the Company’s conduct. If the misrepresentation was calculated to induce the shareholder to buy shares and the shareholder buys shares, an inference arises that it was induced to do so;⁴³
 - (ii) the Company may attempt to rebut the inference of reliance by evidence (presumably after discovery from individual shareholders) to the effect that the shareholder did not rely on its conduct in making the purchase or hold decision;
 - (b) reliance on another, who relied on the Company’s conduct - the shareholder is induced to buy or not to sell as a result of the conduct of a third party, whose conduct was induced by the Company’s conduct;⁴⁴
 - (i) the third party might be a broker or it might be other shareholders or potential shareholders (ie the market);

⁴¹ (see *Wardley v State of Western Australia* (1992) 175 CLR S14, 525; *Henville v Walker* (2000) 206 CLR 454.

⁴² (see *Adler v ASIC* [2003] NSWCA 131 re S1317 H by analogy).

⁴³ (see *Gould v Vaggelas* (1985) 157 CLR 215; *Como Investments Pty Ltd (in Liquidation) v Yenald Nominees Pty Ltd* (1997) ATPR 43,617; *ACCC v Internic Technology Pty Ltd* [1998] 818 FCA; *Burg Design Pty Ltd v Wolki* [1999] FCA 388; *Blacker v National Australia Bank Ltd* [2000] FCA 681).

⁴⁴ (See *Hampic Pty Ltd v Adams* [1999] NSWCA 455; *Digi-Tech Australia Ltd v Brand* [2004] NSWCA 58; *Australian Breeders’ Co-operative Society Ltd v Jones* (1998) 150 ALR 488).

- (ii) to raise the inference of reliance by the third party, it is necessary to show that the third party was aware of the Company's conduct (including silence). Where the third party is the market, this may be established by inference as it is likely to be accepted that announcements (or lack of announcements) come to the attention of the market. Therefore, an inference is raised of reliance by the market, resulting in the Company's shares trading at an inflated price;
 - (iii) to raise the inference of reliance by the shareholder on the third party (being the market), the shareholder will need to have been aware of the prices at which the Company traded (at the time of the purchase and presumably through out the period if the case is one retention of shares);
- (c) no reliance on another, but that other's reliance results in loss to the shareholder - the Company's conduct induces a third party to act (or not to act) and that of itself causes the shareholder to suffer loss;⁴⁵
- (i) this circumstance would arise where the shareholder bought shares and held them in a market which had not been properly informed or was misinformed (where the third party is treated as the market) and therefore the shares are trading in a false market;
 - (ii) underlying this level of causation is the assumption (which may need to be proved by expert evidence) that purchasers of shares in the market rely on information disclosed by companies to make buy and sell decisions, which determines the prices at which the shares trade.

2.2 The last level of causation (ie 2.1 (c)) is the broadest and encompasses the levels discussed in 2.1(a) and 2.1(b). It is the logical type of causation to arise where there is failure to disclose material information because the whole purpose of the continuous disclosure regime is to ensure (as much as possible) that market prices reflect true value of the company by requiring material information to be disclosed.

2.3 In the case of a material non disclosure, causation could arise where:

- (a) immediately before the shareholder bought shares it checked the ASX disclosures to determine what announcements the company had made and bought in reliance on what the company had disclosed or that there were no negative disclosures; or
- (b) the shareholder relied on the advice of a broker who had been monitoring the Company's disclosures or checked the prices at which the Company was trading and relied on the fact that those prices would reflect all material information publicly available about the Company; or
- (c) the shareholder simply purchased shares in the Company and by virtue of the fact that others in the market relied on information available (or no negative information), which determined the price (which was a false price), suffered loss.

⁴⁵ (see *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd* (1992) 37 FCR S26, *Ford Motor Company Australia Ltd v Arrowcrest Group Pty Ltd* [2003] FCA FC 313).

Attachment “B” Calculation of Loss

1. Calculation of Loss

1.1 Direct Loss

- (a) direct losses will be incurred at the time the shares were purchased;⁴⁶
- (b) “the proper mode of measuring the damages ...[is] to ascertain the difference between the purchase money and what would have been a fair price to have paid for the shares in the circumstances of the company at the time of the purchase”;⁴⁷
- (c) “the real value of what the plaintiff got must be ascertained in the light of the events which afterwards happened; because those events may show, for instance, that what the shares might have sold for was not their true value or that it was a worthless company”;⁴⁸
- (d) what is recoverable is the price paid, giving credit for further benefits received as a result of the transaction, including the market value of the property acquired at the date of the transaction. This rule is not applied inflexibly so as to prevent full compensation being obtained. For example, it will normally not apply where the misrepresentation has continued to operate after the date of the acquisition of the asset so as to induce the plaintiff to retain the asset or where the purchaser is locked into a business that he has acquired;⁴⁹
- (e) the High Court in *HTW Valuers (Central Qld) Pty Ltd v Astronland Pty Ltd*⁵⁰ referred to *Smith New Court Securities Ltd* with approval (see para 63) and said:

"And Lord Steyn, who reached the same result, pointed out that the fundamental rule was that the plaintiff should be compensated; that the rule which turns on an assessment of value is only a means of giving effect to the overriding compensatory rule, and that the valuation of assets as at the date of the transaction is “simply a second order rule applicable only where the valuation method is employed”. [81] He went on... “If that method is in apposite, the Court is entitled simply to assess the loss flowing directly from the transaction without any reference to the date of transaction or indeed any particular date. Such a course will be appropriate whenever the overriding compensatory rule requires it”.

“The deduction of true value at the acquisition date from the price paid is no more than a guide to the assessment of damages under s82. Section 82 does not in terms

⁴⁶ (see *Potts v Miller* (1940) 64 CLR 282; *Smith New Court Securities Ltd* [1997] AC 254).

⁴⁷ (Dixon J in *Potts v Miller*).

⁴⁸ (Dixon J in *Potts v Miller*) (see also *Tay v Koh* [1998] WASC 138).

⁴⁹ (see Lord Brown – Wilkinson in *Smith New Court Securities Ltd*).

⁵⁰ [2004] HCA 54 (14 November 2004).

refer to that method, and the width of s82 permits other approaches to the assessment of damages so long as they work no injustice. The alternative approach advocated by the plaintiff has particular appropriateness in the present circumstances. That is because a primary reason for the common adoption, in assessing damages in deceit, of the test of comparing the price paid for an asset with its true value when acquired is the desirability of separating out losses resulting from extraneous factors in the later history of the asset [83]. Here, the trial judge found that the decline in value of the Plaza had no cause other than the completion of the Beach Road Shopping Centre”;

- (f) the measure of loss for a shareholder who purchased shares on the market after a certain date (and who establishes causation) may be:
 - (i) the difference between the price paid and the true value of the shares at the time of purchase; and
 - (ii) because the misrepresentations and non disclosure continued (and new misrepresentations were made or new acts of non disclosure occurred (or silence continued) until the shares were worthless, also the difference between the true value of the shares at the time of purchase and the present value (if still held) or the value at the time they were sold.
- (g) the result would be that loss is the difference between the price paid and the present value (zero) or the value at the time the shares were sold;
- (h) it may be that the shareholder will need to prove that the continuing misrepresentation or failure to disclose (or fresh misrepresentations or failure to disclose) caused the shareholder to hold the shares rather than sell them (or to hold them until they were sold) in order to obtain compensation as discussed in (g)(ii) above.

1.2 Consequential Loss/Loss of Opportunity

Loss of an opportunity to make a return by investing the money with which the Company’s shares were bought (or for which they could have been sold) in another asset is likely to be capable of recovery.⁵¹

⁵¹ (see *Sellars v Adelaide Petroleum NL* (1994) 179 CLR 332).