SHAREHOLDER ACTIONS

"Come senators, congressmen
Please heed the call
Don't stand in the doorway
Don't block up the hall
For he that gets hurt
Will be he who has stalled
There's a battle outside
And it is ragin'
It'll soon shake your windows
And rattle your walls
For the times they are a-changin'.

- Bob Dylan "*The Times They Are A-Changin*"

Changing Times

1. In the last year there have been significant advances in the areas of law concerning the rights of shareholders where they have been misled or not received material information. These advances have corresponded with a rising consciousness of the existence of those rights, and the avenues available for them to be exercised.

2. There has also been much debate, conducted in part through the media, of the merits of allowing shareholders with valid claims against insolvent companies to rank equally with other unsecured creditors.

3. The advances in the law concern three principle areas:

   (a) clarification that shareholders who have bought shares under a prospectus that contained misleading or deceptive statements or omissions can claim compensation from the issuing company for loss suffered, even if they have sold their shares (*Cadence Asset Management Pty Ltd v Concept Sports Ltd* [2005] FCAFC 265 (16 December 2005)).

   (b) restricting the capacity of representative parties in class actions to limit the definition of the class of the persons they represent (*Dorajay Pty Ltd v Aristocrat Leisure* [2005] FCA 1483 (20 October 2005)); and

   (c) confirmation that shareholders who bought shares on the market in a company which subsequently becomes insolvent and who have valid claims against that company for loss connected in some way with the share purchase may rank equally with other unsecured creditors (*Crosbie, in the matter of Media World Communications Ltd* (Administrator Appointed) [2005] FCA51 (31 January 2005), *Johnston v McGrath & Ors* [2005], NSWSC 1183 (23 November

2005) (to the contrary), *Sons of Gwalia Limited* (Subject to Deed of Company Arrangement) v *Margaretic* [2006] FCAFC17 (27 February 2006).

4. Most of the cases referred to above were commenced by a representative person, either as part of a formal class action procedure under the Federal Court Rules, or by way of a test case. The advantage of such procedures are that issues arising in one case which reflect the same or similar issues in other cases, can be ventilated and resolved in the expectation that, in so doing, many other cases will also be resolved. The result is a significant saving in time and cost.

5. The emergence of recent shareholder cases has been a factor of:

   (a) the availability of these court procedures which enable multiple claims to be resolved contemporaneously;

   (b) the availability of litigation funding to allow shareholders to bring such actions without being exposed to legal fees or adverse costs; and

   (c) an increasing awareness amongst large and small shareholders of their statutory rights to take action for loss suffered and the avenues open to them to do so.

7. In spite of these factors however, there has not been, and is unlikely to ever be, an avalanche of shareholder class actions in Australia. The reasons for this will be expanded on later in this paper, but include the likelihood that in Australia the losing party will have to pay the other side's costs, which is not the case in the United States.

8. This paper addresses the following:

   (a) the protections provided to shareholders by the Corporations Act;

   (b) the importance of private actions (as opposed to those taken by regulators) for breaches of the Corporations Act provisions;

   (c) the role of institutions in private actions;

   (d) the availability of litigation funding to assist in the enforcement of shareholder rights;

   (e) what is the rule in Houldsworth's case?

   (f) shareholder rights to claim damages from companies that have become insolvent; and

(g) will there be a proliferation of shareholder class actions (are we becoming more like America)?

A: The Corporations Act protections

9. The Corporations Act seeks to protect shareholders (and others) by:

   (a) prohibiting misleading or deceptive conduct;

   (b) making companies (and other persons involved) liable for misleading or deceptive statements or omissions in disclosure documents; and

   (c) requiring ASX listed companies to disclose to the market information of which it is aware, or should be aware, that a reasonable person would expect to have a material effect on the price or value of the relevant shares.

Misleading and Deceptive Conduct

10. Most commonly, statements made by the company constitute the alleged misleading and deceptive conduct. However, in some cases, silence (that is, the failure to say something) may constitute misleading and deceptive conduct.

11. In determining whether there was misleading and deceptive conduct:

   (a) the court seeks to determine objectively whether the conduct was misleading or deceptive;

   (b) where there is a statement to the public or a section thereof, the court considers the effect on an ordinary or reasonable member of the class who can be expected to take reasonable care for his/her own interests and otherwise behave reasonably; and

   (c) the conduct must have caused the person who acts on it to "labour under some erroneous assumption" or be expected to do so.

12. The law distinguishes between representations as to present matters and representations as to future matters. A financial forecast or forward looking statement, is a representation as to a future matter. The Corporations Act and the ASIC Act provide that if a person makes a representation about a future matter and the person does not have reasonable grounds for making the representation, the representation is taken to be misleading.

13. Even if it is established that there has been misleading and deceptive conduct, the shareholder must also prove that it suffered loss or damage and that the loss or damage was caused by the conduct. This element of "causation" is normally proved by establishing that the shareholder relied on the misleading and deceptive

conduct in some way that resulted in loss, for example by purchasing shares. The conduct does not have to be the sole cause of the loss, but it does have to have been a cause.

14. A common source of complaint by shareholders relates to the contents (or lack of contents) of a disclosure document.

15. A disclosure document comprises either:

    (a) a prospectus;

    (b) a short form prospectus;

    (c) a profile statement; or

    (c) an offer information statement.

16. The Corporations Act sets out the circumstances in which one or other of the above types of disclosure documents can be used when a company is making an offer of securities and the required content of each. The Corporations Act also sets out the circumstances where no disclosure document is required. For example, issues of shares to "sophisticated" investors do not need a disclosure document, nor does an issue of shares under a dividend reinvestment plan.

17. In respect of a prospectus for the issue of shares, the Corporations Act provides that it must contain all the information that investors and their professional advisors would reasonably require to make an informed assessment of:

    (a) the rights and liabilities attaching to the shares; and

    (b) the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue the shares.

18. In deciding what information should be included in a prospectus for the issue of shares regard is to be had to:

    (a) the nature of the securities and of the company;

    (b) the matters that likely investors may reasonably be expected to know; and

    (c) the fact that certain matters may reasonably be expected to be known to their professional advisors.

19. Furthermore, a prospectus is only required to contain information:

(a) which it is reasonable for investors and their professional advisors to expect to find in the prospectus; and

(b) if a person whose knowledge is relevant (eg the company offering the securities or a director):

   (i) actually knows the information; or

   (ii) in the circumstances ought reasonably to have obtained the information by making enquiries.

20. If the disclosure document does not contain the information that it should, or contains a misleading or deceptive statement, the Corporations Act specifically provides that a person who suffers loss or damage as a result, can recover the loss or damage from a number of persons including the company offering the securities and the directors.

21. There are defences open to persons who might otherwise be liable including (in respect of a disclosure document):

   (a) the reasonable inquiries and reasonable belief defence (all inquiries (if any) that were reasonable in the circumstances were made and after doing so, the person believed on reasonable grounds that the statement was not misleading or deceptive); and

   (b) the reasonable reliance on information given by someone else defence (the person placed reasonable reliance on another).

Continuous disclosure

22. The other circumstance shareholders may come across which might give rise to a right of action against a company (and possibly its directors) is where the company fails to disclose material information to the market and the shareholder has, for example, bought shares at an inflated price, which did not reflect the price which would have prevailed had the information been known to the market.

23. Maurice Newman, ASX chairman, said in a speech to the CEDA Copland Program in 2003: "The integrity, efficiency and international standing of Australia's capital market is to a large extent dependent on a sound system of disclosure." He said continuous disclosure is a "core ASX listing requirement".

24. Section 674(2) of the Corporations Act requires listed disclosing entities to notify the ASX of any information which:

   (a) the listing rules require the entity to notify the ASX;

(b) which is not generally available; and

(c) which a reasonable person would expect, if it were generally available, to have a material effect on the price or value of the company's shares.

25. The listing rules require a company, once it becomes aware of any information concerning the company that a reasonable person would expect to have a material effect on its share price, to inform the ASX of that information. There are exceptions to this rule which excuse disclosure, such as with respect to negotiations which are incomplete where the information is confidential and a reasonable person would not expect disclosure.

26. The Corporations Act provides that a reasonable person would expect information to have a material effect on the price or value of shares if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of the shares.

27. A person who is involved in a listed entity's contravention of s 674(2) (which could include directors of the company) also contravenes the section. Where a shareholder (or ex shareholder) suffers damage as a result of a contravention of the continuous disclosure provisions, the Court can order compensation be paid.

B: The importance of private actions to redress breaches of the Corporations Act

28. In an environment of limited regulatory budgets, it is increasingly important for private investors to act as enforcers of the Corporations Act. Also, action by ASIC is not necessarily focused on compensating the investors who have lost money as a result of a contravention, but on "civil penalties", which are paid into Treasury's coffers.

29. The utility of the private enforcement of public laws has frequently been discussed in the United States in the context of the role of litigants as "private attorneys general". The private attorney general theory is based on the premise that a positive public good is secured when a private litigant enforces a publicly endorsed standard or norm contained in a statute.

30. The general counsel of the Federal Trade Commission, William E Kovacic, provided strong justification for the acceptance by regulators of private actions. In a 2003 speech, Kovacic highlighted the interdependencies between the operation of private rights of action and public enforcement of competition law, noting "the dosage of private rights injected into the enforcement mix is crucial to the policy result".

31. ASIC has also recognised the importance that private actions can play in complementing its enforcement efforts. Deputy chairman of ASIC Jeremy Cooper said, in December last year:

> "Vigilant shareholders and a vigorous, but appropriately balanced, shareholder class action landscape will play an important part in maintaining the integrity of the equity capital markets in years to come."

32. Mr Cooper said shareholder actions play an important "preventative role…in demanding compliance with corporate governance principles".

33. Similarly, the Australian Competition and Consumer Commission has thrown its support behind private enforcement. ACCC chairman Graeme Samuel, in a speech in September last year, said the ACCC saw private proceedings "as a legitimate and valuable avenue of redress." Mr Samuel went on to say:

> "There seems to be a growing recognition by victims of cartels that they are entitled to seek redress. This coincides with an increased interest from private legal firms (and litigation funders) to pursue such private claims. Compensating victims in private damages actions has been the norm in North America for some time. My expectation is that compensation is set to become more common in Australia too, and this will surely act as a further deterrent."

34. Both Messrs Cooper and Samuel have recognised that the move towards more vigorous private enforcement has arisen in the context of litigation funders being willing to take on the risks of actions in return for a percentage of the outcome.

C: The role of institutions in the enforcement of shareholder rights

35. While institutions (typically fund managers and superannuation trustees) have typically become more "active" with respect to their shareholdings in recent years, illustrated by the increased numbers of institutions voting their proxies at company meetings, taking legal action remains an accountability device of last resort.

36. Participation in shareholder actions by institutions is likely only when companies' behaviour is egregious. In our experience, fund managers become angry than when they believe a company has lied to them and we are seeing more fund managers and trustees pursuing such companies with vigour and determination to uncover the truth and hold management accountable.

37. Action by institutions has the capacity to benefit a wide section of the community as commonly those institutions represent multiple unit holders, ranging from small to large.

38. An example of such activism is the action being led by the Australian Council of Super Investors against News Corporation, involving ACSI members including PSS/CSS, HESTA, Cbus, UniSuper, CARE Super and MTAA. Those funds have joined overseas institutions in filing a complaint in the Delaware Court of Chancery

seeking performance by News of its agreement not to extend its "poison pill" beyond 12 months without shareholder approval.

39. IMF has dealt with some of the largest Australian superannuation funds and fund managers, many of whom are clients in shareholder actions being funded by IMF including actions against Aristocrat, Sons of Gwalia, ION, Concept Sports and Village Life. Many institutions have been developing internal procedures to deal with assessment of class action proposals.

40. These institutions now understand that their rights can be enforced without necessarily devoting much time to the action, spending money on legal fees, or taking on the risk of the payment of adverse costs if the case is unsuccessful.

41. In the United States, legislation has been introduced (the 1995 Private Securities Litigation Reform Act) which was aimed at encouraging more institutions to take the role of lead plaintiff in securities class actions.

42. The legislation recognises that institutions are usually the investors with the most at stake and are expected to act responsibly in any litigation.

43. By way of example, the following US shareholder actions have had institutional investors as lead plaintiff:

    (a) Cendant Corp;

    (b) WorldCom;

    (c) Lucent Technologies;

    (d) DaimlerChrysler; and

    (e) Oxford Health Plans.

44. The importance of encouraging institutional involvement also assists the size of recoveries. Economic consultants NERA found in a recent study that the settlement fund is likely to be 20% larger with an institution as lead plaintiff.

45. The 1995 Reform Act also increased the quality of pleadings, thereby discouraging abusive suits by requiring complaints alleging fraud to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind".

46. One recent US study that investigated the effects of the 1995 Reform Act, concluded:

"….the [Act] had a positive impact on equity values, on average… the [Act] has improved the balance between investor protection and the deterrence of frivolous lawsuits, but there is still an important role for securities class actions in situations where other mechanisms for curbing fraud are inadequate."

47. In Australia, the rise of litigation funding has occurred along side the increasing realisation by share market investors that corporations should be held accountable if they breach the law.

D: The availability of litigation funding to assist in the enforcement of shareholder rights

48. In many cases in recent years, the Australian Courts have recognised the important role that litigation funding plays in increasing access to justice. In *QPSX v Ericsson Australia Pty Ltd* [2005] FCA 933 (6 July 2005), Justice French said litigation funding:

    (a) spread the costs and risks of complex litigation, which in turn helped to support the enforcement of legitimate claims;

    (b) injected a welcome element of commercial objectivity into the way legal budgets are framed and the efficiency with which litigation is conducted; and

    (c) was responding to a gap in the market place which did not compromise the integrity of the court's process.

49. A litigation funding agreement provides for the following:

    (a) to pay a claimant's legal costs and disbursements;

    (b) to provide any "security for costs" the claimant may be ordered to put up;

    (c) to pay any "adverse costs order"; and

    (d) where appropriate, to assist the claimant with investigations and project management.

50. In return for these services, the litigation funder is entitled to receive from any "resolution sum" (ie moneys received pursuant to a settlement or judgment):

    (a) reimbursement of all money it has expended; and

    (b) an agreed percentage of the "resolution sum" – usually between 20% and 40%.

51. If the funded party receives nothing, neither does the litigation funder.

52. Because it wears the risk of a case failing, IMF conducts a thorough due diligence process before deciding whether to fund a case.

53. Because IMF is interested in a successful outcome for shareholders in the shortest and most cost effective manner, it will remain willing to fund only if the legislature, judiciary and legal profession are prepared to make enforcement viable. Even though the Federal Parliament has introduced statutory protections for the benefit of shareholders into the Corporations Act, and provided the mechanisms to enforce such protections, IMF has encountered defendants willing to delay resolution of the claims by engaging in 'interlocutory proceedings'. A number of such proceedings have questioned the role of the funder and suggested the Court's processes are being abused as a result of the funder's involvement. Courts have rejected such arguments and on 4 April 2006 the High Court heard a case (*Fostif*) that ought to address these arguments.

Hurdles to funding class actions

54. Although shareholder actions may be brought individually, they are normally taken by way of a class or group action. This is because:

    (a) normally the relevant conduct of the company being complained of will have impacted on a number of shareholders;

    (b) the cost of running an individual action against a normally well resourced defendant, relative to the claim size of the individual action will often make the claim uneconomic on its own;

    (c) negotiating power and therefore the capacity to reach an appropriate settlement will be increased the greater the numbers of shareholders involved. Further, settlement will be more attractive to a company if it can resolve all disputes at once, rather than having to run multiple actions.

55. If the claim is run as a class action, it is done so pursuant to certain rules of the Federal Court or the Victorian Supreme Court. There must be seven or more members of the class and the issues arising must be the same or similar amongst them. There is one representative party who bears the costs and who is liable for the costs of the other side if the case is lost and the court makes such an order.

56. Class actions are an opt out regime meaning that if a shareholder falls within the description of the class then they are bound by the outcome of the case unless they opt out by providing a notice of opt out.

57. The possible hurdles in the way of funding class actions is demonstrated by the class action IMF is funding against Aristocrat in the Federal Court. The claim is

based on misleading and deceptive conduct and a failure to disclose material information.

58. The class was defined as all persons who purchase shares in a certain period and who instruct the solicitors, Maurice Blackburn Cashman (MBC), to act for them.

59. All persons who had instructed MBC had also entered into a funding arrangement with IMF to fund any legal costs and to provide an indemnity to them for any adverse costs. The representative party was unwilling to become a representative and assume exposure to adverse costs without IMF's indemnity.

60. Aristocrat asserted that the case should not continue as a class action because the manner in which the class was defined (by reference to a requirement to instruct MBC) was contrary to the intention of the class action regime.

61. This is because the class action regime was said to be premised on the basis that people should be able to be a member of the class without having to instruct the lawyers and without having to take a positive step to join the action.

62. One of the advantages of having a class limited to those people who retain the solicitor acting (apart from the fact that it could be readily funded by IMF) is that it results in easier and quicker communications, lower costs and a quicker resolution.

63. Also, it ensures that there are not people in the class who have received funding from IMF and other people who have not, which has the potential to give rise to practical problems.

64. Ultimately, if the provision of funding by a funder was the only way a class action could get off the ground and if IMF was unable to secure funding agreements with sufficient members to make the provision of funding worthwhile, it would result in no funding and therefore no class action. In such circumstances the objects of the class action procedures would also be frustrated.

65. The Court held that the requirement to retain MBC (in order to be part of the class) was contrary to the intention of the class action procedure. Accordingly, on behalf of the lead plaintiff, MBC applied to amend the definition of the class to delete the necessity to retain MBC to be included in it.

66. That amendment has been made and the case has been allowed to continue as a class action with the result that some of the members of the class will not have entered into funding agreements with IMF.

67. The effect of opening the class up is likely to increase the size of the claim against Aristocrat. But it also means that all claims against Aristocrat arising out of the circumstances alleged in the case will be dealt with once and for all.

68. Without litigation funding, class action proceedings will only be brought if:

(a) lawyers "spec" their fees (agree not to be paid unless the action is successful); and

(b) the shareholder leading the claim (the so-called lead plaintiff) is willing to accept the potential liability for adverse costs.

69. Both situations are becoming increasing unlikely, due to risks inherent in complex, multi-party litigation including:

(a) the delays and costs of the adversarial process;

(b) the uncertainty of outcome; and

(c) the requirement that a losing party pays the other side's costs if the case is unsuccessful.

E: What is the rule in Houldsworth's case?

70. In the cases discussing the rights of shareholders to take action against companies a distinction has been made between "subscriber" shareholders, being those who purchase shares directly from the company, and "transferee" shareholders, who purchase shares from others.

71. Much of the debate on the rights of subscriber and transferee shareholders to maintain actions for misleading and deceptive conduct or non disclosure of material information against solvent and insolvent companies centres on:

(a) the applicability of the principle in the 1887 English case of Houldsworth; and

(b) in the context of insolvent companies, the approach of the High Court in *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1993) 179 CLR 15 to the issue.

72. The Court in *re Addlestone Linoleum Company* 1887 37 CHD (Lindley LJ) described the rule in Houldsworth's case as follows:

> "The principle on which the House of Lords decided Houldsworth v City of Glasglow Bank was that a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that it is inconsistent with this position as a shareholder, while he remains such, to claim back any of that money – he must not directly or indirectly receive back any part of it".

73. For a shareholder to do so (that is, receive back its capital) while remaining a shareholder and retaining the benefits bestowed on a shareholder, would, so the

reasoning goes, be “approbating and reprobating”. There would be an inconsistency between the shareholder retaining his shares and on the other hand seeking to recover the amount he subscribed for those shares.

74. However, if the shareholder has rescinded or renounced the subscription contract, the rule will not prevent an action against the company. Rescission or renouncing the subscription contract will not be possible where:

    (a) the contract has been affirmed;

    (b) the shares have been sold; or

    (c) the company goes into administration or liquidation. (This is discussed further below.)

75. The contract might be affirmed where, for example, after becoming aware of a misrepresentation by the company causing the share purchase, the shareholder accepted a dividend paid by the company.

76. The different manner in which the common law and legislation has been held by the Courts to apply to subscriber shareholders and transferee shareholders can create confusion.

Rights of Subscriber Shareholders to Sue the Issuing Company for Misleading and Deceptive Statements and Omissions in a Prospectus under s728 of the Corporations Act

77. An issue arose in the context of a shareholder action IMF is funding against Concept Sports Ltd, a company listed on the Australian Stock Exchange, as to whether persons who bought shares under a prospectus that contained misleading or deceptive statements or omissions can claim compensation from the issuing company for loss suffered, if they have sold their shares.

78. Concept Sports listed on 15 June 2004 after issuing a prospectus in mid May 2004 to raise capital at 50 cents per share. The prospectus contained financial forecasts for the six month period ending 30 June 2004.

79. On 18 August 2004 Concept Sports announced that it had failed to meet its prospectus forecasts for the six months ended 30 June 2004 and the share price plummeted. Persons who acquired shares in Concept Sports under the prospectus sued it under section 728 of the Corporations Act in relation to statements made and omissions.

80. Two matters complained of (among others) are that the prospectus failed to:

(a) identify the trading results for that part of the 6 month period actually past (ie January to May 2004) which must have, or ought to have, been known at the time the prospectus was issued; and

(b) identify the break up in the forecast between its events business and other aspects of its business. It is alleged that Concept Sports was relying very heavily on one event (revenue from the soccer event Euro 2004) and the extent of this reliance and the associated risks was not apparent from the prospectus.

81. Concept Sports raised an argument that shareholders who bought shares under the prospectus, but subsequently sold them, could not sue it because of the rule in Houldsworth's case. Concept Sports argued that this rule prevented shareholders from suing it unless they first "rescinded" the contract pursuant to which they bought the shares from Concept Sports.

82. It is a little unclear what a shareholder must do to "rescind" the contract between it and the company for the sale of shares. It probably requires the shares to be transferred (or offered to be transferred back) to the issuing company and a request made for the return of the subscription money.

83. If the shares cannot be transferred back because they have been sold then the contract under which the shares were bought from the company cannot be "rescinded".

84. If Concept Sports was correct in its argument, the effect would be that people who bought shares from a company under a misleading prospectus, or one that omitted required material, but who subsequently sold those shares (normally at a loss) could not sue the company for compensation.

85. This would reduce the scope of sections 728 and 729 of the Corporations Act considerably.

86. The Court at first instance agreed with Concept Sports' argument. However, on appeal the Court found it was incorrect.

87. The case against Concept Sports, its directors and a third party firm of accountants (who it is alleged were involved in the relevant contraventions) is continuing and is set down for hearing in September 2006.

Subscriber Shareholders' Actions Arising out of Purchasing Shares from the Company Other than Under a Disclosure Statement

88. In the matter of *Media World Communications* (2005) 52 ACSR 346, Justice Finkelstein of the Federal Court found that:

> "The rule which was established in Houldworth's case (*Houldsworth v City of Glasgow Bank and Liquidators* (1880) 5 App Cas 317) is that a person who has subscribed for shares in a company may not, while he retains those shares (that is, if he has not renounced the contract by which he acquired those shares), recover damages against the company on the ground that he was induced to subscribe for those shares by fraud or misrepresentation. In *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1993) 179 CLR 15, the High Court held that this rule bars not only common law claims but also statutory causes of action unless of course the statute itself overrides the rule." (My emphasis).

89. This statement does not apply where action is taken under s728 of the Corporations Act, because of the Full Federal Court's decision in *Concept Sports.* Unless the reasoning in that decision can be applied to other sections of the Corporations Act, the rule in Houldsworth's case will apply to subscribers for shares where capital was raised through means other than a disclosure document. The effect would be that unless such purchasers of shares renounced or rescinded the subscription contract they could not sue the issuing company for misleading and deceptive conduct inducing the purchase of shares.

Transferee Shareholders

90. The position of shareholders who purchase shares from another shareholder (ie transferee shareholders) is different.

91. Finkelstein J's view in the Media World case was that transferee shareholders would not be bound by the rule in Houldsworth's case and so could maintain an action against the company. This position is supported by a House of Lords decision (*Soden v British & Commonwealth Holdings PLC* [1998] AC 298) and by the Full Federal Court decision in Sons of Gwalia.

92. The reasoning (as Finkelstein J said) is that:

> "The claim of a transferee shareholder is the same as any other civil claim a person may have against a company, and will not either directly or indirectly produce a reduction of capital."

F: Shareholder rights in the context of insolvent companies

93. Where a company goes into administration or liquidation, where does this leave subscriber shareholders and transferee shareholders, who maintain that they have been misled into purchasing shares or who rely on continuous disclosure breaches?

94. The answer turns on the effect of the priority section, section 563A of the Corporations Act, and primarily on the meaning of the words "in the person's capacity as a member". Section 563A says:

> "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".

Transferee shareholders

95. The Full Federal Court of Appeal in *Sons of Gwalia Limited (subject to Deed of Company Arrangement) v Margaretic* [2006] FCAFC17 (27 February 2006) held that the transferee shareholder's claim was not brought in his capacity as a member of the company and therefore ranked equally with other unsecured creditors.

96. Mr Margaretic purchased 20,000 shares in Sons of Gwalia for $26,200 on the market on 18 August 2004, 11 days before administrators were appointed. After receiving a proof of claim from Mr Margaretic alleging Sons of Gwalia had breached its continuous disclosure obligations and misled Mr Margaretic in respect of its gold reserves and hedge position, the Administrators sought a declaration that Mr Margaretic's claim:

    (a) would not be provable in the proposed Deed of Company Arrangement; or

    (b) payment of the claim would be postponed until all debts owed to creditors, otherwise than in their capacity as shareholders of Sons of Gwalia, were paid in accordance with section 563A of the Corporations Act.

97. In the Full Federal Court, Finkelstein J adopted the approach of the House of Lords in *Soden v British and Commonwealth Holdings PLC* [1998] AC 298 (in relation to an equivalent section) to construing the meaning of the words "in [his] capacity as a member". In that case, Lord Browne-Wilkinson said:

> "Section 72 (2)(f) requires a distinction to be drawn between, on the one hand, sums due to a member in his character of a member by way of dividends, profits or otherwise and, on the other hand, sums due to a member otherwise than in his character as a member. In the absence of any other indication to the contrary, sums due in the character of a member must be sums falling due under and by virtue of the statutory contract between the members and the company and the members inter se constituted by section 14(1) of the Companies Act 1985. …
>
> To the bundle or rights and liabilities created by the memorandum and articles of the company must be added those rights and obligations of members conferred and imposed on members by the Companies Acts … as the 'statutory contract'. … In my judgment, in the absence of any contrary indication sums due to a member 'in his character of a member' are only those

sums the right to which is based by way of cause of action on the statutory contract. …

… the principle must apply equally to negative claims; claims based upon having paid money to the company under the statutory contact which the members says that he is entitled to have refunded by way of compensation for misrepresentation or breach of contract. These, too, are claims necessarily made in his character as a member".

98. Finkelstein J concluded that the High Court decision in *Webb Distributors* did not apply to claims by on market purchasers (ie transferee shareholders) and accordingly, following the test in *Soden* as to "in [his] capacity as a member", Mr Margaretic's claim was not caught by section 563A (ie it ranked equally with other unsecured creditors).

99. An application for leave to appeal to the High Court has been lodged by the Deed Administrator of Sons of Gwalia.

Subscriber Shareholders

100. The position in relation to subscriber shareholders seeking to claim in the administration of an insolvent company remains unclear.

101. In the Full Federal Court case of Sons of Gwalia, Finkelstein J said: "The High Court accepted (an acceptance which on any view must be correct) that a shareholder who has not rescinded his subscription contract has no claim against the company. Once that conclusion is reached then it seems clear enough that one simply does not get to s563A. That provision is only concerned with provable claims."

102. However, the Full Federal Court in Concept Sports suggests that section 563A would still apply to a subscription shareholder even if the subscription contract had not been rescinded, but the claim would be in the capacity of a member and therefore rank behind other unsecured creditors, but ahead of other members not so claiming.

103. The table below summarises the position:

Can the Shareholder Claim Against the Company?

	Company Not Insolvent	**Company Insolvent**
1. Subscriber shareholder with action under prospectus provisions of Corporations Act (s728).	Yes	Yes, but claim will rank behind other unsecured creditors.
2. Subscriber shareholder with	Probably not, unless	Probably not unless share

action for misleading & deceptive conduct not under prospectus provisions.	share contract is rescinded.	contract is rescinded (but unclear).
3. Transferee shareholder.	Yes.	Yes (s563A does not apply). Ranks equally.

104. Interestingly, in *Johnston v McGrath & Ors* [2005] NSWSC 1183 (23 November 2005) Gzell J said:

> "I would have thought that damages payable by a company to a shareholder under the Trade Practices Act 1974 (Cth), s82 were not owed by the company to the shareholder in the capacity of a member of the company. The damages are payable because of the company's misleading and deceptive conduct. They have nothing to do with the congeries of rights the member of the company has under the shareholding. They do not stem from the statutory contract between the company and its members that had its origin in s16 of the Companies Act 1862 (UK)."

The Practical Effect of the Full Court Decision in Sons of Gwalia on debt markets

105. In the United Kingdom, the legislature has abolished the rule in Houldsworth's Case, leaving all shareholders (both subscription and transferee shareholders) able to claim. 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".

106. The equity and debt markets in the UK have not collapsed as a result.

107. There are conflicting views of the effect of transferee shareholders (with valid claims) ranking equally with other unsecured creditors.

108. Fitch Ratings is quoted as saying that:

> "Sub investment grade issuers and possibly lower-investment grade issuers may have some reduced ability to issue senior unsecured debt due to lower investment demand or appetite for such issues."

109. Standard & Poors takes a broader view and is quoted as saying:

> "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."

110. It is important to remember that the continuous disclosure regime is available to protect both the equity and the debt markets.

111. In the report of the Companies and Securities Advisory Committee on the need for a legislatively based continuous disclosure regime (referred to in *ASIC v Southcorp Limited* (No. 2) [2003] FCA 1369) the committee recommended the introduction of such a regime which would, among other things:

- "ensure that equity and loan resources in the Australian market are more effectively channelled into appropriate investments, and that funds are withheld or withdrawn from poorly performing disclosing entities. This will promote capital market efficiency;

- assist debt holders in monitoring the performance of disclosing entities and thereby determine whether, or when, to exercise any right to withdraw or reinvest their loan funds, or convert debt to equity;

- act as a further, or substitute warning device for holders of charges over corporate assets, that breaches in covenants may have taken place, or the risk of default has increased;

- assist potential equity or debt holders of disclosing entities to better evaluate their investment alternatives".

112. Many of the Sons of Gwalia institutional creditors at the date the company went into administration sold their right to prove at about 60 percent of the debt's face value. Creditors who have assigned their right to prove in respect of the original debt remain entitled to prove in the administration of Sons of Gwalia for any loss suffered as a result of any breach of the Corporations Act provisions in the same way as shareholders.

113. Clearly it is open to lenders to obtain a fixed and floating charge over some or all of the assets, which would give them priority over shareholder claims. If lenders choose to be unsecured, presumably the return sought will be such as to compensate for the perceived risk. Having a robust continuous disclosure regime, capable of being enforced, surely reduces those risks as observed by the Committee report referred to above.

Time and Delay

114. Another ground of opposition is that permitting shareholder claims will delay the distribution of dividends in the administration and increase the cost.

115. If all claims that are likely to be costly to resolve and to cause delays were eliminated by the legislature, there would not be many legal rights for our Courts to protect.

116. Whilst the elements of the causes of action for misleading and deceptive conduct and breach of continuous disclosure obligations are different, the essential factual matrix required to be proved is the same; namely the investor will contend that what the company told the market in a defined period regarding the state of its business was significantly different to the true state of the business.

117. Accordingly, shareholders or bondholders bringing evidence to prove their claim (at least until their proof is initially determined) are likely to rely heavily upon reports by external controllers concerning the cause of the failure of the company and detailing any claims the company may have against third parties.

118. If shareholder or bondholder proofs are not accepted by external controllers, then any subsequent Court proceedings is likely to require expert opinion evidence in respect of liability to establish:

    (a) the true state, from an accounting perspective, of the company's business;

    (b) the materiality of various factors to the company's share value;

    (c) the influence on investor behaviour of various factors and its affect on share or bond value; and

    (d) the type of information which ought to have been disclosed to the market.

119. Shareholder claims can be approached on a group basis (just as they tend to be run against a solvent company). Tony McGrath of McGrath Nicol said "liquidators will have to develop a streamlined method for assessing shareholder claims if the decision is upheld" (AFR 21 September 2005 p61).

120. Such sentiments are sensible. An efficient resolution process is likely to have the hallmarks of:

    (a) identifying common legal and factual issues that might be resolved by way of a test case; and

    (b) appointment of an expert on, for example, the value of the shares whose opinion it is agreed will bind both parties.

121. One issue that may be suitable for resolution by way of test case is whether causation of loss can be established by virtue of the fact that the shareholder bought shares in a market which had not been properly informed (or was misinformed) and thereby suffered loss; with no need to prove direct reliance on any conduct by the company.

122. The loss is suffered because others have relied on the company's conduct, which has resulted in a false market for the shares. This concept (loss flowing from reliance by others) is not new in other contexts in Australian law and reflects a theory prevalent in the United States called "fraud on the market".

123. That theory states that when shares are purchased on the market, reliance can be assumed because all public information is reflected in the market price of a security and shareholders rely on the market being fully informed.

124. The theory acknowledges that the reality of sharemarket investing is that not every investor will scope every line of every market announcement before coming to a decision to buy shares. Unlike a traditional face-to-face transaction, where there might not be a readily available market price, when buying stocks the "market" is interposed between buyer and seller and transmits information to the investor in the form of a market price.

125. The theory as it has been adopted in the US creates a "rebuttable presumption of reliance", meaning the burden shifts to a defendant to show the shareholder did not in fact rely on the information.

G: Will there be a proliferation of class actions in Australia?

126. Many critics of class actions point to the problems with the litigation culture of the United States, where "ambulance chasing" plaintiff law firms sue companies when a stock price has collapsed, and race to be first to file a case in the Court.

127. It is unlikely that Australia will go in the same direction, despite the rise of shareholder actions in Australia in recent years.

128. There are key differences between the USA and Australian legal systems that will prevent this from occurring, namely:

(a) In the USA:

(i) attorneys race to be first to file to control the class;

(ii) attorneys fees, usually around 30% of the recoveries (subject to Court approval), is payable from the global recovery, without the need for contractual consent of the class members; and

(iii) neither attorneys, nor the class members, are liable for adverse costs orders.

(b) In Australia:

(i) solicitors are ethically and legislatively prohibited from charging their clients a percentage of the recovery;

(ii) funders, with contractual agreement of each client, charge a percentage of the recovery and pay all costs associated with the litigation; and

(iii) funders pay all adverse cost orders.

129. Because they are potentially exposed to the costs of the other side if a proceeding is unsuccessful, funders must conduct an extensive due diligence *prior* to the proceeding commencing and continuously review the merits of the case once proceedings are commenced.

130. Litigation funding companies act as a *merits check* on speculative cases as:

(a) no funder will be willing to fund proceedings that do not have a very strong prospect of success; and

(b) institutions will not be willing to sign up to speculative actions as to do so will undermine the institutions' credibility.

131. Further, actions in respect of breaches of the continuous disclosure laws are only available against listed companies. In so far as litigation by shareholders against companies that have become insolvent is concerned, a large number of such companies are unlikely to have sufficient assets to make such actions worthwhile.

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IMF (Australia) Ltd
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