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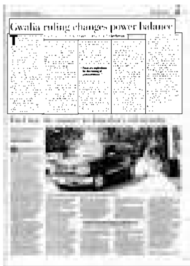

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Gwalia ruling changes power balance

Shareholders as creditors – it's a whole new world, writes **Ian Ramsay**.

The federal court decision last week in Sons of Gwalia is one of the most significant corporate law decisions this year. It's important for the rights of shareholders and creditors in insolvencies and the running of administrations.

Some of the newspaper headlines captured the importance of the decision – referring to it as a "landmark decision" that "boosts shareholder rights" and "ranks shareholders alongside creditors".

The administrators of Sons of Gwalia said that the decision was likely to have significant consequences for "commercial life in Australia". They have announced they will appeal against the decision in the full Federal Court and then in the High Court if necessary.

The key facts in the decision are as follows. On August 18, 2004, Luka Margaretic purchased on the stockmarket $26,000 of shares in the mining company Sons of Gwalia Ltd. Only 11 days later, the company went into voluntary administration. The shares were worthless when Margaretic bought them.

Margaretic was funded by a professional litigation firm, IMF, to bring an action alleging that when he bought the shares, Sons of Gwalia was in breach of its continuous disclosure obligations – in that the company knew but did not disclose that its gold reserves were insufficient to satisfy its delivery commitments to the extent that it could not continue to operate.

It is estimated Sons of Gwalia had $900 million of liabilities and only $400 million of assets. Could Margaretic be counted as a creditor with a claim against the company alongside all other unsecured creditors? Many would think not.

After all, section 563A of the Corporations Act states that payment of a debt owed by a company to the person in the person's capacity as a shareholder is postponed until all other debts are paid.

In other words, upon insolvency, shareholders rank behind creditors for distributions from the remaining assets of the company.

It is said this is the "deal" investors contract for when they buy shares – unlike creditors, they get certain benefits such as the possibility of sharing in the profits of the company by way of dividends and also the right to vote on certain matters including the election of directors.

They also have limited liability. However upon insolvency, shareholders rank behind creditors when company assets are distributed.

But the court said Margaretic's claim against the company was not brought in the capacity as a shareholder. Instead, the claim arose as a result of laws designed to prevent misleading and deceptive conduct in relation to financial products and services. Therefore, Margaretic does not have his claim against the company postponed while other claims or debts of unsecured creditors are paid.

> **"There are implications for the running of administrations."**

Indeed, the court went on to say that Margaretic is a creditor of the company in respect of his claim.

The consequences of the decision are very significant.

First, where shareholders can bring these types of claims as creditors, this will reduce the returns to the other unsecured creditors. It is the same pool of funds out of which all these claims must be paid. This can alter the risk/return calculation for creditors in other companies, who may now need to factor in to their financing decisions the implications of the court decision.

Second, there are major implications for the running of administrations. The intention is that these will be run efficiently so that it can be decided as quickly as possible whether the company can continue (albeit with some restructuring) or whether it should be wound up.

Lengthy delays in the administration can adversely affect the prospects of having the company continue. The decision will make administrations where these claims are brought more complicated, lengthier and more expensive.

This is because there will generally need to be litigation to determine the merits of the shareholders' claims before being able to work out the returns to creditors. This litigation will take time and money – with part of the litigation effectively being funded out of the returns to creditors.

Of course, it can be said in reply that this is just the price to be paid for ensuring that shareholders who are misled when they buy shares are able to be treated the same as unsecured creditors for the purposes of distribution of assets.

Third, where a shareholder with a claim against the company is counted as a creditor in an administration, the shareholder can vote along with other creditors on critical decisions such as whether the company should be wound up or allowed to continue. In other words, there is the prospect of the balance of power shifting in administrations.

Fourth, the claim by Margaretic was for breach of the continuous disclosure requirements. The period shortly before administration can be a challenging time for a company in terms of ensuring it complies with its continuous disclosure requirements while engaged in intensive discussions with creditors about its future.

If shareholders are going to be successful with claims, continuous disclosure looms large as the basis for these claims. So we can predict more litigation as these claims are pursued. An important lesson from the court decision is that companies contemplating administration need to ensure they have good advice concerning their continuous disclosure obligations.

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