



**CHARTERED SECRETARIES
AUSTRALIA**

Leaders in governance

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Committee Secretary
The Senate Standing Committee on Legal and Constitutional Affairs
Parliament House
CANBERRA ACT 2600

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Dear members of the Legal and Constitutional Affairs Legislation Committee

Inquiry into the Corporations Amendment (Sons of Gwalia) Bill 2010

CSA is the independent leader in governance, risk and compliance. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency. We represent over 8,000 governance professionals working in public and private companies, all of whom deal with shareholders, shareholder claims, corporate administration and compliance with the Corporations Act. We have drawn on their experience in the formulation of this submission.

Support for the Exposure Draft

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment on the Exposure Draft of the Corporations Amendment (No.2) Bill 2010 (the Bill).

We commend the government for undertaking action to overturn the effect of the High Court decision in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 (Sons of Gwalia). CSA remains of the firm belief that it is in the best interests of providing an orderly corporate administration that the Corporations Act be amended to reverse the High Court decision in Sons of Gwalia and strongly supports the Exposure Draft which gives effect to this.

CSA notes that concern has been expressed by some parties that reversing the Sons of Gwalia decision will disadvantage shareholders and in some fashion curtail their rights. However, the Exposure Draft, in reversing the Sons of Gwalia decision, merely restores the position, well understood by the market, creditors and shareholders, as to priorities of payment in the event of insolvency, to the way it was prior to the Sons of Gwalia decision. Existing shareholders rights and investor protection provisions under the Corporations Act and other legislation will not change.

CSA is of the view that the existing corporate law framework provides investor protection in the case of any breach of directors' duties, including misrepresentation by directors or a failure to comply with the continuous disclosure regime. Reversing the *Sons of Gwalia* decision does not curtail these rights or disadvantage shareholders, but rather restores certainty to creditors by confirming their rights as they have long been established by both statute and common law. The Exposure Draft restores priority to creditors over shareholders in having access to the company's equity base.

CSA supports the maintenance of the debt/equity distinction in a limited liability company, that is, shareholders, as the owners of the company, always carry the risk of losing their equity investment, but at the same time are able to participate in the distribution of dividends and capital gains. On the other hand, creditors can only recover from the company their principal and any interest provided for in their contract with the company.

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, that is, they should be liable for their equity investment if a company fails for whatever reason. Companies fail for multiple reasons, including fraud, corporate misconduct, currency collapses and changes in markets. Shareholders should be liable for their equity investment if a company fails for whatever reason.

Concerns with CAMAC recommendation not to amend the Corporations Act to reverse the effect of the *Sons of Gwalia* decision

CSA reviewed the Corporations and Markets Advisory Committee (CAMAC) report, *Shareholder Claims Against Insolvent Companies — Implications of the Sons of Gwalia decision*, released to the government in December 2008, and to the public early in 2009.

CSA has strong reservations concerning the findings of the CAMAC report, which is that the government not undertake action to overturn the effect of the High Court decision in *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1 (*Sons of Gwalia*).

Our reasons behind our belief that it is in the best interests of providing an orderly market that the Corporations Act be amended to reverse the High Court decision in *Sons of Gwalia* relate to the potential that the current law as determined in light of the High Court decision has to:

- diminish existing creditors' rights
- create uncertainty for external administrators in adjudicating the claims of aggrieved investors and risk substantial delay in distributions while those claims are adjudicated
- split the rights of shareholders, favouring some to the disadvantage of others
- create a climate conducive to speculative claims, which in turn could encourage class actions based on mere possibilities rather than substantiated claims
- create uncertainty for insurers, with a commensurate negative impact on insurance premiums
- create increased cost or reduced availability of finance for companies
- overturn the debt/equity distinction.

The relationship of the CAMAC recommendation to the global financial crisis

CSA also remains deeply concerned that, by affecting the opportunities for Australian companies to obtain debt finance or credit in the United States, or have the cost of doing so significantly increase, the current law thereby disadvantages Australian shareholders, as increased cost or reduced availability of finance would have implications for solvent companies, not only for those subject to external administration.

CSA opposes any law that reduces the opportunity for Australian shareholders and the companies in which they invest to compete with shareholders from other jurisdictions in relation to securing finance. Our opposition to any such reduction in opportunity is strengthened by the very real difficulties currently facing Australian shareholders and the companies in which they invest in attracting finance due to the ongoing ramifications of the global financial crisis.

Our detailed reasoning in relation to these concerns follows.

Detailed reasons for CSA support of the Exposure Draft

CSA believes that shareholders should absorb the risk of insolvency as part of the risks they take in acquiring shares, which includes the risk of corporate fraud, misconduct and the non-disclosure of price-sensitive information as well as company failure. That is, shareholders should be liable for their equity investment if a company fails for whatever reason. CSA notes that shareholders have existing rights to raise claims against the directors in relation to their actions in the event of default.

CSA supports the rationale supporting the postponement of claims arising from the purchase or sale of securities behind those of unsecured creditors in a liquidation on the argument supporting the US Bankruptcy Code that:¹

allowing equity-holders to become effectively creditors by treating these two classes as though they were one gives investors the best of both worlds: a claim to the upside in the event the company prospers and participation with creditors if it fails. It also dilutes the capital reserves available to repay general creditors, who rely on investment equity for satisfaction of their claims.

CSA notes that, until the High Court decision in *Sons of Gwalia*, creditors expected to have priority over shareholders in having access to the company's equity base. By ranking aggrieved investors equally with general creditors, this priority is no longer assured, which diminishes creditors' expectations and rights as they have long been supported by both statute and the common law. CSA is opposed to such a diminishing of creditors' rights.

Moreover, creditors have the choice to vote on whether a company should end the administration and resume trading (with the intent of trading out of difficulties), enter into a deed of company arrangement (DOCA) or be wound up; that is, they have the right to vote on any proposed reorganisation of the company. Voting by creditors in a voluntary administration on this, and other, matters is by number and value (though administrators have a casting vote where the voting outcomes by number and value differ).²

If aggrieved investors have the right to vote at a creditors' meeting, the weight of their numbers rather than the value of their (unsubstantiated) claims could decisively influence the voting, and in turn the administration outcomes. This provides aggrieved investors with an unwarranted influence in decisions affecting conventional unsecured creditors, which further diminishes creditors' rights.

¹ J Slain and H Kripke, 'The interface between securities regulation and bankruptcy—allocating the risk of illegal securities issuance between securityholders and the issuer's creditors', (1973) 48 *New York University Law Review* 286—287

² A resolution is carried by a vote in favour by a majority in number and value (Corp Reg 5.6.21(2)) and defeated by a vote against by a majority in number and value (Corp Reg 5.6.21(3)). In the event that votes by number and value differ, the administrator has the casting vote (Corp Reg 5.6.21 (4)).

CSA is opposed to the potential for investors with claims that have yet to be determined having the same rights as creditors in insolvency proceedings, particularly as their claims may never be substantiated.

The potential to create uncertainty for external administrators in adjudicating the claims of aggrieved investors and risk substantial delay in distributions while those claims are adjudicated

CSA supports the generally accepted principles of contemporary insolvency law, as identified in the Harmer Report (General Insolvency Inquiry ALRC 45, 1988, at para 5). These include provision for:

- a fair and orderly process for dealing with the financial affairs of insolvents
- the least possible delay and expense
- an impartial, efficient and expeditious insolvency administration
- the principle of equal sharing between creditors.

If aggrieved investors are given equal billing with creditors, CSA believes that there is a strong potential to disturb the application of these principles. In particular, CSA believes that the need for certainty of the resolution of claims, their efficient and prompt assessment and the payment of dividend returns to creditors will suffer.

CSA believes that each claim by an aggrieved investor may require separate adjudication, which would create undue delay and costs in an external administration. This in turn would reduce the return to general creditors. CSA also believes that the uncertainty created for external administrators in adjudicating the claims of aggrieved investors would add further to the delays.

CSA recommends that certainty should be granted to creditors and shareholders that they need not wait many years for payment in the winding up of a company.

The potential to split the rights of shareholders, favouring some to the disadvantage of others

CSA is concerned that privileging the claims of aggrieved investors over those of other shareholders would lead to ongoing uncertainty concerning shareholders' rights. The decision in *Sons of Gwalia* may afford recent purchasers of shares with a claim because of inadequate disclosure, when longer-term shareholders, who may have sold if such information was disclosed, may have no such claim.

CSA opposes the differentiating of shareholders and their rights based on how or when they purchased shares.

The potential to create a climate conducive to speculative claims

CSA is concerned that, if the law stands following the High Court decision in *Sons of Gwalia*, a shareholder can stake a claim to have equal billing with general creditors without having to prove their claim. It is left to the external administrator or liquidator to adjudicate the claim. CSA believes that this will lead to speculative claims being lodged.

The potential to create uncertainty for insurers

CSA is aware of concerns expressed by our members working in the insurance industry that there could be a detrimental effect on the recoveries that insurers would normally expect to receive via unsecured trade creditors' dividends if the present law is retained.

The potential to create increased cost or reduced availability of finance for companies

Should the law stand following the High Court decision in *Sons of Gwalia*, CSA believes that the resulting ambiguity with regard to the traditionally accepted investor hierarchy of claims in the event of corporate collapse has the potential to adversely affect the market for corporate debt in Australia. Banks as lenders, trade creditors and institutional investors as buyers of corporate bonds are all potentially affected, and CSA believes that the ability of Australian companies to issue debt into international markets (in competition for funds with overseas companies where creditor rights are not subject to such dilution effects) will be adversely affected if the legal position in Australia is different from that in the United States.

Potential lenders to any Australian company will be confronted with higher risk on unsecured debts (a lower recovery rate in the case of company failure) than before. Consequently, CSA is of the opinion that interest rates charged on unsecured debt will increase to compensate for the increased risk.

CSA also believes that debt investors, both in Australia and overseas, may be unlikely to acquire some corporate bonds in Australia, as such an investment would heighten their exposure to risk. In particular, US debt investors will note that

- shareholder claims can no longer be guaranteed to be postponed behind their claims as occurs in the United States, where all claims by shareholders relating to their shares, including as aggrieved investors, are subordinated to those of conventional unsecured creditors
- there is increased potential for speculative claims by aggrieved investors to give rise to class actions.

CSA is concerned that, by affecting the opportunities for Australian companies to obtain debt finance or credit in the United States, or have the cost of doing so significantly increase, the law thereby disadvantages Australian shareholders, as increased cost or reduced availability of finance would have implications for solvent companies, not only for those subject to external administration.

CSA opposes any law that reduces the opportunity for Australian shareholders and the companies in which they invest to compete with shareholders from other jurisdictions in relation to securing finance.

The potential to overturn the debt/equity distinction

CSA supports the maintenance of the debt/equity distinction in a limited liability company. Shareholders risk losing their equity investment but can participate in the distribution of dividends and capital gains, whereas creditors can only recover from the company their principal and any interest provided for in the contract. Moreover, shareholders have remedies for obtaining damages from a company for false or misleading conduct.

CSA believes it is important to maintain the distinction between those who deal with the company on a commercial basis, that is, creditors, and those who are members, that is, owners.

CSA supports the comments of Callinan J in the High Court decision of *Sons of Gwalia* that³:

shareholders' statutory rights, their voluntary abdication of control over their investment in favour of the directors as their appointees (who have considerable statutory and constitutional discretions and obligations), their rights to proceed against the directors personally as well as the company in some circumstances, their limited liability, and their rights to participate in any successes, sit uncomfortably with the notion that they should have equal billing, on the failure of the company, with ordinary unsecured creditors.

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, that is, they should be liable for their equity investment if a company fails for whatever reason. Companies fail for multiple reasons, including fraud, corporate misconduct, currency collapses and changes in markets. CSA does not believe that non-disclosure by directors of price-sensitive information should be singled out as requiring creditors to underwrite investors' speculative risks.

Conclusion

CSA believes that shareholders should continue to be required to absorb the risk of insolvency as part of the risks they take in acquiring shares, that is, they should be liable for their equity investment if a company fails for whatever reason. Companies fail for multiple reasons, including fraud, corporate misconduct, currency collapses and changes in markets. CSA does not believe that non-disclosure by directors of price-sensitive information should be singled out as requiring creditors to underwrite investors' speculative risks.

We strongly urge the Senate Standing Committee on Legal and Constitutional Affairs to support the legislation introduced by the government to overturn the *Sons of Gwalia* decision.

Yours sincerely



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³ Callinan J in *Sons of Gwalia* at [242]