

update

28 September 2007

Friday Facts: Sons of Gwalia revisited

In our 2 February 2007 edition of Friday Fact, we outlined the High Court decision in Sons of Gwalia Ltd v Margaretic ("Sons of Gwalia") and the basis upon which the High Court was prepared to acknowledge that shareholders were entitled to rank equally with creditors when a company became insolvent rather than coming last.

The Federal Government has this month released a discussion paper prepared by the Corporations and Markets Advisory Committee (the "Advisory Committee") on the implications of the Sons of Gwalia decision (the "Discussion Paper").

The Government asked the Advisory Committee to consider whether the legal position of the High Court should be retained or be changed to postpone aggrieved investor claims.

The Discussion Paper highlights that Sons of Gwalia may be seen as enhancing investor confidence in the equity market by making it clear that shareholders with investor protection claims have greater participation and recovery rights in an external administration than may previously have been anticipated. However, it also highlights that other unsecured creditors may consider that their participation and recovery rights in an external administration are detrimentally affected by the possibility of claims by aggrieved investors.

The Discussion Paper also considers the implications which may follow. They include the possibility that lenders may respond by imposing more burdensome restrictions or requirements on the provision of funds to

companies and that general creditors may be unable to protect themselves resulting in an increased exposure to loss in consequence of aggrieved investor claims.

In preparing the discussion paper the Advisory Committee looked at the comparative position in the UK, USA and Canada.

The three options referred to in the Discussion Paper include:

- Option 1: retain the current law as determined by the High Court allowing aggrieved investors to continue to be entitled to participate as creditors in a voluntary administration or liquidation and their claims will rank equally with other general unsecured creditor claims;
- Option 2: amend the Corporations Act to reverse the effect of Sons of Gwalia;
- Option 3: as per option 2, with an internal ranking of shareholders claims so that aggrieved investors would be in the same position as under option 2, except that their claims would rank above member claims that are postponed by s563A of the Corporations Act being debts owed by the company to shareholders.

The Discussion Paper does not make any recommendations as to which option should be accepted but presumably recommendations will be made once submissions have been received and reviewed by the Advisory Committee.

It does, however, consider the introduction of a statutory amendment to introduce a "fraud on the market" approach to facilitate proof of aggrieved investor claims. This would assist shareholder litigation against companies by establishing a rebuttable presumption of reliance on misleading and deceptive information from the company which would overcome the need to prove reliance.

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