

# *Legislative Subordination of Shareholder Claims*

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# Legislative Subordination of Shareholder Claims; the Response to the High Court Decision in *Sons of Gwalia*

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## Introduction

On 26 November 2010, the Federal Parliament passed the *Corporations Amendment (Sons of Gwalia) Bill 2010* ("Bill"). The Bill amends section 563A of the Corporations Act 2001 (Cth) ("Act") such that any claim brought by a person against a company that arises from the buying, selling, holding or other dealing with a shareholding will be postponed in an external administration until all other claims have been paid. The Bill has the effect of reversing the High Court decision of *Sons of Gwalia v Margaretic* [2007] HCA 1.

## The History leading to this Bill

### The Decision in *Sons of Gwalia*

In *Sons of Gwalia v Margaretic* the High Court held that claims by a shareholder for damages for losses sustained in the acquisition of shares arising from the company's misleading or deceptive conduct were not subordinated to the claims of unsecured creditors by the operation of section 563A of the Act. Section 563A acted to subordinate the claims of members of the company in that person's *capacity as a member* of the company only. The court held that a claim relating to misleading or deceptive conduct on the part of the company did not arise in a member's capacity as a member, as it was not founded on any rights or obligations incurred by virtue of membership. That being the case, the claim would be no different if the member had ceased to be a member at the time the claim was made and accordingly the court found that a member's claim in such circumstances was not subordinated by section 563A of the Act.

## Response to the decision

The High Court decision in *Sons of Gwalia* was controversial, as it challenged the historical assumption that equity will always rank behind credit in an insolvency context. While the decision was welcomed by the Australian Securities and Investments Commission at the time, it was criticised by academics, the banking industry and many insolvency practitioners, who recommended amending the Act to ensure claims by creditors rank ahead of those by members.

## Impact of the Bill

The Bill rewrites section 563A of the Act and inserts a new sub-section 563A(2), which has the effect of maintaining the subordination of claims for debts owed to a person in their capacity as a member until all other debts have been paid and, importantly, adding that any other claim that arises from a person buying, selling, holding or otherwise dealing in shares will be similarly subordinated, regardless of the capacity in which the person is acting. The new provisions only relate to dealings in shares, that is, it does not extend to quasi-equity interests such as convertible notes or options. Holders of such interests would still be treated as contingent creditors.

The effect has been to reverse the decision in *Sons of Gwalia*, by subordinating all claims arising from a person buying, selling, holding or otherwise trading in shares until all other claims have been paid. Accordingly, claims by shareholders for damages for losses sustained in the acquisition of shares arising from the company's misleading or deceptive conduct will now rank behind all claims by creditors. More generally, the Bill restores certainty of the primacy of creditors over

equity holders, and reduces the risks and costs involved in providing credit to companies.

## Conclusions

As a practical matter, the Bill returns shareholders to their previous position prior to the *Sons of Gwalia* decision. In summary:

- (i) shareholders should be aware that misleading or deceptive conduct on the part of the company will no longer cause a claim for debt or loss to rank equally with unsecured creditors
- (ii) in an insolvency context, any claim arising from buying, selling, holding or otherwise trading in shares will be subordinated until all other claims have been paid, and
- (iii) claims by unsecured creditors will receive priority in an insolvency context over any claim arising from buying, selling, holding or dealing in the shares of the company.

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