A corporate bombshell for New Zealand? The Australian High Court case *Sons of Gwalia Ltd v Margaretic*

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INTRODUCTION

In 2007, the High Court of Australia handed down the landmark decision of *Sons of Gwalia v Margaretic.*[1] Variously described as a corporate "bombshell,"[2] delivering "unprecedented rights to shareholders,"[3] establishing a principle that should be "changed urgently"[4] and "simply wrong,"[5] the decision was met with an overwhelmingly adverse reaction among Australian commercial and insolvency circles.

Sons of Gwalia Ltd was a publicly listed gold mining company in Western Australia. Mr Margaretic purchased 20,000 shares in the company on the secondary market at a price of A$26,000, only to find a few days later the company had gone into voluntary administration. The company's gold reserves were inadequate to meet its contractual obligations, resulting in the value of its shares dropping to zero. Mr Margaretic commenced an action against Sons of Gwalia Ltd, claiming it had breached its continuous disclosure obligations by not notifying the Australian Stock Exchange its gold reserves were inadequate;[6] or alternatively that it was liable for misleading or deceptive conduct.[7] He claimed that had he known the company could not meet its contractual obligations, he would not have purchased the shares. Accordingly, he lodged a proof of debt with the administrator for the difference between the share's purchase price and their true value. The case turned on the procedural issue of where Mr Margaretic's claim ranked in the administration under section 563A of the Corporations Act 2001 (Cth). The company administrator and a major unsecured creditor, ING Investment Management LLC, argued that the "debt" owed by Sons of Gwalia Limited to Mr Margaretic should be postponed until after all general creditors

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[1] [2007] HCA 1, ("*Sons of Gwalia"*).
[2] L Gettler, "Court drops shareholder bombshell" *The Age* 1 February 2007 <www.theage.com.au> (accessed 20 May 2009).
[3] R Keenan 'High Court hands big victory to Sons of Gwalia Investors' *The West Australian* February 1 2007 <http://au.news.yahoo.com/thewest> (accessed 18 May 2009).
[4] J Stumbles 'Creditors have new reason to worry' *Australian Financial Review* 1 February 2007 <http://www.afr.com> (accessed 14 May 2009).
[5] L Zwier "Investors get more rights, but High Court decision was wrong" *The Age* 5 February 2007 <www.theage.com.au> (accessed 20 May 2009).
[6] The specific provisions were section 674 of the Corporations Act 2001 and Rule 3.1 of the Australian Stock Exchange Listing Rules.
[7] The specific provisions were section 52 of the Trade Practices Act 1974; section 1041H of the Corporations Act 2001, and section 12DA of the Australian Securities and Investments Commission Act 2001.

had been paid, since it was owed in Mr Margaretic's "capacity as a member of the company." Section 563A provides that:

> 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. *(emphasis added)*

Upholding Mr Margaretic's previous successes at first instance[8] and in the full Federal Court,[9] the High Court found by a majority of six to one that Mr Margaretic's claim was not made in his "capacity as a member of the company" and thus ranked equally with the claims of unsecured creditors. This departed from the previous understanding in Australia that shareholder claims rank below the claims of all other creditors; a position formerly assumed to be entrenched beyond question by the 1880 House of Lords decision *Houldsworth v City of Glasgow Bank.*[10]

The leading concern among the critics of *Sons of Gwalia* was that allowing shareholders to claim as general creditors significantly diminishes returns for the existing unsecured creditors of the company, who receive a lesser proportion of the insolvent company's assets upon distribution.[11] They predicted shareholder class actions for misleading and deceptive conduct in Australia would "rise exponentially" as a direct result of *Sons of Gwalia,*[12] significantly complicating insolvency procedures and further reducing creditors' rights.[13] A good illustration of this is the *Sons of Gwalia* case itself. Mr Margaretic was the representative shareholder in a class action of about 8000

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[8] *Sons of Gwalia Ltd (admin apptd) v Margaretic* [2005] FCA 1305.
[9] *Sons of Gwalia Ltd v Margaretic* [2006] 226 ALR 42.
[10] (1880) 5 App Cas 317, ("*Houldsworth."*)
[11] Blake Dawson "Sons of Gwalia and the CAMAC Report: where to from here?" *Restructuring and Insolvency Client Alert March 2009* <www.blakedawson.com> (accessed 14 May 2009).
[12] L Griggs "Sons of Gwalia paves road for trade practices issues for shareholder investments" (2007) 23 AMLB 1, 9. Indeed, the number of class actions in Australia tripled between 2007 (the year in which *Sons of Gwalia* was decided) and the end of 2008. While breach of continuous disclosure obligations was the most common cause of action, it is impossible without thorough analysis to determine the extent to which the *Sons of Gwalia* decision was responsible for this increase (the credit crisis of course being a major factor in many company collapses). For present purposes it is enough to note that almost all commentators agree *Sons of Gwalia* is a contributing factor to this rise in class actions: A Ferguson "Shareholder class actions have tripled" *The Australia* 2 January 2009, <www.theaustralian.news.com.au> (accessed 18 May 2009).
[13] S Wilson "Mislead investors should be given creditor status, says CAMAC" *The Australian,* 3 February 2009 <www.theaustralian.news.com.au> (accessed 14 May 2009).

shareholders with identical claims against Sons of Gwalia Limited.[14] Allowing those 8000 shareholders to claim resulted in both those shareholders and the 200 or so unsecured creditors of Sons of Gwalia Ltd all receiving between 15 and 20 cents on the dollar.[15] To put this value in context, the total value of the shareholders' claims was estimated to be more A$250 million[16]. No mathematical calculations are needed to see that the unsecured creditors received severely diminished returns compared to what they would have recovered had those 8000 shareholder claims been subordinated. This criticism was not universal however, with some commentators downplaying the decision as a "major tangle with minor impact,"[17] and others advocating shareholder rights.[18] However the furor was enough to spur the Federal Government of Australia to immediately commission a report on *Sons of Gwalia* from the Corporations and Markets Advisory Committee (CAMAC): "Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision."[19] Published at the end of last year, the report ultimately supported the *Sons of Gwalia* decision.

Although described by one Australian commentator as "probably the most significant [decision] in the last decade,"[20] *Sons of Gwalia* seems at first glance to have little relevance to New Zealand law. Unlike in Australia, class actions are not (yet) established in New Zealand, so an immediate flood of shareholder claims is unlikely. Further, the decision was a procedural strike out application, turning on the interpretation of an Australian statutory provision to which New Zealand has no direct equivalent,[21] and did not even consider the law behind Mr Margaretic's substantive

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[14] J Sarra "Risk allocation and efficient administration: A comparative analysis of the treatment of equity securities claims in insolvency" Corporate law Teachers Association Conference 2007, Sydney, Australia, 24.

[15] A Main 'Gwalia case holds out hope for ordinary investors' *The Australian* 30 January 2009 <http://www.theaustralian.news.com.au> (accessed 18 May 2009).

[16] Blake Dawson "Shareholder Litigation" *Inside the Courts: Year in Review 2007- February 2008*; <www.blakedawson.com> (accessed 14 May 2009).

17 See for example: T McCrann 'Major tangles for minor impact' *Herald-Sun* 2 February 2007 <http://www.heraldsun.com.au> (accessed 20 May 2009); Fitch Ratings, 'Gwalia Shareholder Case decision Unwelcome for Debt Markets; But No Major Impact Likely', 1 February 2007 <www.fitchratings.com.au> (accessed 14 May 2009).

[18] S Wilson "Mislead investors should be given creditor status, says CAMAC" *The Australian.*

[19] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision,* December 2008. <www.camac.gov.au> (accessed 29 March 2009).

[20] L. Griggs "Sons of Gwalia paves road for trade practices issues for shareholder investments" (2007) 23 AMLB 1, 9.

[21] Discussion of whether or not class actions will become established in New Zealand is beyond the scope of this paper.

claim. As will become evident in this paper however, the issues raised by *Sons of Gwalia* are still good cause for excitement on this side of the Tasman. In chapter one of this paper I outline the High Court's decision in *Sons of Gwalia* in detail. Chapter two argues that contrary to the common presumption, an equivalent rule to section 563A of the Corporations Act 2001 does indeed exist in New Zealand. This paper poses several factual scenarios in which a shareholder "X" makes a claim similar to that made by Mr Margaretic in *Sons of Gwalia*, and considers in chapter three whether shareholder X would be able to claim against his or her company in the capacity of a creditor. Chapter four and the conclusion to this paper then assess the practical implications of allowing these *Sons of Gwalia* type claims, and whether the combination of these will really be a "corporate bombshell" for New Zealand. Underlying this discussion is a deeply problematic conflict between principles of insolvency law on the one hand, and principles of investor protection law on the other, which is not easily resolved. Despite the need for certainty in this area, prior to *Sons of Gwalia* this conflict had largely been overlooked by the legislature and commentators alike. As will become clear, this area of law is in urgent need of reform.

CHAPTER I: The *Sons of Gwalia* decision

In order to lay the groundwork for meaningful analysis and evaluation of the New Zealand law, this chapter examines the High Court's reasoning in *Sons of Gwalia* in depth.[22] Each of the seven judges delivered separate judgments in deciding the appeal. All majority judges were in substantial agreement with Gleeson CJ and Hayne J, with Callinan J dissenting.[23] Rather than applying case law or policy considerations, the majority focused on the statutory interpretation and legislative history of section 563A. Typical of their approach was Hayne J's observation that the issues in the appeal:

> …are to be answered by reference to the applicable statutory regime: in particular, the provisions of Pt 5.6 of the 2001 Act...The answer to the questions in this case do not depend upon any principle of judge-made law. In particular, they do not depend upon the application…of what is sometimes called "the rule in Houldsworth's case."[24]

Both Gleeson CJ and Kirby J noted the policy conflict between enhanced investor protection provisions and the fact that creditors suffer if shareholder claims are not subordinated in a winding up.[25] Gleeson CJ considered this conflict should be resolved in favour of shareholders. Otherwise, the protection given by provisions such as the continuous disclosure regime would be "illusory" as "the need for protection…often arises only in the event of insolvency."[26] Ultimately however they agreed with the majority that policy analysis was of "little or no assistance." The issue was simply one of statutory construction,[27] and unlike the equivalent legislation in the United Kingdom or United States, "the provisions of section 563A do not manifest any clear legislative policy."[28]

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[22] Note this analysis does not assess the Australian academic commentary or whether their Honours were right or wrong under Australian law.
[23] Gummow J agreed with Hayne J at [46]; Kirby J agreed with Gleeson CJ at [134]; Heydon J agreed with Hayne J [260-264] and Crennan J agreed with Gleeson CJ and Hayne J at [256].
[24] *Sons of Gwalia,* per Hayne J, at [136].
[25] *Ibid,* per Gleeson CJ at [18], and Kirby J at [104].
[26] *Ibid,* per Gleeson CJ at [18].
[27] *Ibid,* per Hayne J at [200].
[28] *Ibid,* per Gummow J at [42]. See also Gleeson CJ at [19]. Discussion and analysis of the approach taken to the issues in this area in other jurisdictions (such as the United Kingdom or the United States) is beyond the scope of this paper.

Using this statute-based approach, all members of the majority allowed the appeal on essentially the same grounds. Whether Mr Margaretic owed the debt in his capacity as a member depended on whether it arose under his "statutory contract" with the company; that is, whether the debt was within the rights and obligations created by the constitution of Sons of Gwalia Limited or directly created by the Corporations Act 2001.[29] The majority held that Mr Margaretic's right to damages arose from the investor protection provisions, which were open to anyone and not limited only to members of the company. As Gleeson CJ pointed out, Mr Margaretic could have made his claim even if he had already sold his shares before the administration had begun, or if for some reason his name had never been entered on the company's register of members.[30] The debt was therefore not owed in his capacity as a member, since it "stands altogether apart from any obligation created by the 2001 Act and owed by the company to its members."[31]

Despite their explicit rejection of the rule in *Houldsworth* as important to interpreting section 563A, the majority discussed *Houldsworth* at length. Described as "famously elusive"[32] and of "legendary impenetrability,"[33] the rule prevents a shareholder from recovering damages for fraud or misrepresentation against the company while they remain a shareholder. The rationale is that doing so is inconsistent with the shareholder's contractual promise with the company to contribute a certain amount upon insolvency, and is unfair to the company's other creditors.[34] In other words, *Houldsworth* embodies the doctrine of maintenance of capital. As mentioned above, prior to *Sons of Gwalia* this rule was assumed to be beyond question, as it had been accepted in Australia for the past 120 years.[35] However it was precisely the rule's age that was a major factor in the majority's dismissal of it. *Houldsworth* was decided before *Saloman v A Salomon & Co Ltd*[36] established the fundamental concept that a company

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[29] The majority applied the definition of "statutory contract" used by the House of Lords in *Soden v British and Commonwealth Holdings* [1998] AC 298, 323.
[30] *Sons of Gwalia,* per Gleeson CJ at [10].
[31] *Ibid,* per Hayne J at [206]. This reasoning was by no means novel: see the authorities cited by Hayne J in support of this principle at [195]-[199].
[32] *Ibid,* per Gleeson CJ at [63].
[33] *Ibid,* per Hayne J at [183].
[34] *Houldsworth's case,* 325.
[35] A Hargovan & J Harris "Sons of Gwalia Ltd v Margaretic: The shifting balance of shareholder's interests in insolvency: Evolution or revolution?" [2007] 31 MULR 591, 595.
[36] [1897] AC 22.

has a separate legal personality from its members; and referred to principles of partnership law in justifying the rule.[37] Thus Gummow J warns "excessive significance should not be attributed to statements in 19th century British cases," as often they are only "endeavours to 'flesh out' the developing body of statute law by use of principles derived from a range of sources in general law."[38] Similarly, Gleeson CJ doubted that the rationale behind *Houldsworth* (of maintaining capital for the protection of creditors) reflected modern commercial conditions, as the company's balance of assets and liabilities are usually much more significant for creditors than paid-up capital.[39]

Houldsworth was approved by a differently constituted High Court of Australia in *Webb Distributors* in 1993.[40] However the majority in *Sons of Gwalia* distinguished both *Webb Distributors* and *Houldsworth* on a factual basis. Those cases considered whether a claim for damages for misrepresentation by a subscribing shareholder was admissible at all. In contrast, the issue in *Sons of Gwalia* was where Mr Margaretic's claim ranked *after* it was admitted to the administration.[41] Furthermore, Mr Margaretic was a transferring shareholder whose claim was based on the market price of the shares, rather than a subscribing shareholder whose claim was based on the shares' paid-up capital value.[42] As Gummow J points out, an award of damages to Mr Margaretic would therefore not be charged upon any fund representing capital.[43] A distinction of this nature was made in *Soden v British and Commonwealth Holdings,*[44] where the House of Lords considered the United Kingdom equivalent of section 563A. Lord Browne-Wilkinson held transferring shareholders should not be barred from claiming damages against the company, as "the general body of creditors are in exactly the same position as they would have been had the claim been wholly unrelated to shares in the company,"[45] which suggested subscribing shareholders on the other hand could not claim. *Soden* was supported in obiter by Finkelstein J in *Re Media World Communications.*[46] In *Concept*

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[37] *Houldsworth*'s *case*, 325.
[38] *Sons of Gwalia,* per Gummow J at [37].
[39] *Ibid,* per Gleeson CJ at [5].
[40] *Webb Distributors (Australia) Pty Ltd v Victoria* (1993) 170 CLR 15. ("*Webb Distributors"*).
[41] See for example Hayne J's reasoning at [190] and Gleeson CJ at [24] in *Sons of Gwalia.*
[42] *Sons of Gwalia* per Hayne J at [190].
[43] *Ibid,* per Gummow J at [85].
[44] [1998] AC 298 (*"Soden"*).
[45] *Ibid,* 326.
[46] *Re Media World Communications (admin apptd)* (2005) 216 ALR 105.

Sports[47] the Full Federal Court went further and accepted that section 563A did apply to subscribing shareholders, but only where the company was in liquidation. However the majority in *Sons of Gwalia* declined to directly address whether a subscribing shareholder would be subordinated under section 563A, with Gummow J commenting "it is fruitless to pursue narrow factual distinctions of [this] kind."[48]

Callinan J in dissent found that Mr Margaretic's claim was subordinated to those of the other creditors under section 563A. In contrast to the majority, Callinan J relied heavily on policy considerations, stating "it cannot be seriously argued here that…s 563A is unambiguous, or, to use the language of Kirby J, not "contestable"".[49] He felt section 563A should be interpreted "so as to maintain coherence in the law and promote fairness, if a construction to achieve those ends is reasonably available."[50] Thus he lists the "ample and superior statutory rights" of shareholders in comparison to creditors.[51] In his view:

> …up to the point of insolvency, liquidation or administration of a company, its members enjoy superior opportunities, rights and advantages to creditors, yet the latter are no less likely to be disadvantaged by deceptive conduct of a company lying in a failure to comply with the continuous disclosure rules…That being so, it seems intuitively…that it [section 563A] means what SOG, rather than Mr Margaretic, contends it to mean.[52]

Kirby J was sympathetic to Callinan J's reasoning, and emphasised that shareholders "engaged in an inescapably risky and speculative operation" when choosing to purchase shares and become members of a company.[53] He contrasts this voluntary assumption of risk to general creditors, who will mostly "be innocent of the business and entrepreneurial decisions of the company that led to its insolvency," and argues "such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risks."[54] He felt that ranking shareholders and creditors equally

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[47] *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 55 ACSR 145.
[48] *Sons of Gwalia,* per Gummow J at [42]. See also Hayne J at [190] and Gleeson CJ at [28].
[49] *Ibid,* per Callinan J at [225].
[50] *Ibid,* at [255].
[51] *Ibid,* at [231]-[239]
[52] *Ibid,* at [241]
[53] *Ibid,* per Kirby J at [110].
[54] *Ibid,* at [109]. See also Callinan J at [208] – [210].

was "counter-intuitive" and difficult to reconcile with the case law.[55] Ultimately however, he joined the majority in holding that the issue was "from first to last, one of statutory interpretation," and Mr Margaretic should rank equally.[56]

Callinan J again differed from the majority in his approval of *Houldsworth.* Responding to the majority's argument that paid-up capital is "wholly irrelevant"[57] and replaced by the companies' balance of assets and liabilities, he stated capital was of "continuing importance, relevance, indeed sanctity" as:

> The difference between liabilities and assets, members' equity, is the product of, and stands in place of, and assumes the importance of paid-up capital, and is the real measure of the worth of the company.[58]

He then points out that the Corporations Act specifically ensures capital is maintained through making "elaborate provision" for the return of paid-up capital in an insolvent company and limiting the circumstances in which it may be returned.[59] In contrast to the majority, Callinan J took a concrete position in respect of the *Soden* distinction, and felt whether the shareholder was transferring or subscribing would make no difference to his conclusion. As each claim stemmed from the same wrong of misrepresentation, each would "inevitably effect a major reduction in the net funds of the company" and be of intense concern to creditors.[60] Callinan J notes in conclusion that given the long history of section 563A, Parliament could and would have changed its language "if it were intended that creditors should be left to scramble, in competition with the shareholders who paid too much for their shares, for the remains of a company."[61]

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[55] *Sons of Gwalia,* per Kirby J at [104].
[56] *Ibid,* at [114].
[57] *Sons of Gwalia,* per Gleeson CJ at [5].
[58] *Sons of Gwalia,* per Callinan J at [240].
[59] *Ibid,* at [250].
[60] *Ibid,* at [252].
[61] *Ibid,* at [258].

CHAPTER II: A New Zealand equivalent to section 563A of the Corporations Act 2001?

1 Introduction

Any remaining doubts over whether the majority's decision was correct were put to rest with the publication of the CAMAC report last December.[62] As noted above, this report upheld *Sons of Gwalia* and was a clear approval by the legislature of the current law in Australia. However the legal position in New Zealand following the *Sons of Gwalia* "bombshell" is not so certain. In this paper I discuss whether in New Zealand the claims in the following scenarios would be admissible in a liquidation:

a) A New Zealand shareholder ("shareholder X") suffers the same misfortune as Mr Margaretic, and purchases shares in a listed company from another shareholder on the basis of false information; for example if the company did not disclose its true financial position. Like Sons of Gwalia Ltd, the company goes into liquidation not long after, and the shares become worthless. Naturally, the shareholder wishes to claim compensation from the company for the difference between the purchase price of the shares and their current market value. As the company is listed, the shareholder argues the company is in breach of its continuous disclosure obligations, and applies for a compensation order under the Securities Market Act 1988.

b) As in (a), except the company is proprietary rather than listed; so the continuous disclosure provisions do not apply. Therefore shareholder X argues the company is liable to pay compensation for misleading or deceptive conduct under the Fair Trading Act 1986; or is liable at common law under the tort of deceit or negligent misstatement.

c) Similar to (a), but shareholder X subscribes for shares directly from the listed company (rather than buying them from another shareholder) on the basis of a

[62] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision.*

misrepresentation made in the company prospectus. Shareholder X claims compensation under the Securities Act 1978.

d) The company in each of the above scenarios (a)-(c) only makes the non-disclosure or misrepresentation after shareholder X had bought the shares; so that the shareholder was not actually induced by the false statement(s) to buy the shares. Thus in each situation shareholder X claims compensation on the basis that he or she would have sold the shares, had the company's true position been known.[63]

In this chapter I discuss the conflict between insolvency law and investor protection provisions that arises in the above situations. I then discuss the reasons behind the removal of the New Zealand statutory equivalent to section 563A of the Corporations Act, and argue that the law relating to our solvency test has the same effect as section 563A. In chapter three I address whether under this rule shareholder X could successfully argue he or she is claiming in the capacity of a creditor rather than as a shareholder. While it is likely shareholder X would be able to do so, this arena where securities and insolvency law intersect raises very difficult questions relating to risk allocation, fairness and efficiency.

2 The conflict between securities law and investor protection provisions

CAMAC summarises this conflict forced into the spotlight by *Sons of Gwalia* (and at issue in the scenarios above) as "the largely unforeseen conflict between the recent provision to shareholders of statutory investor protection remedies and traditional notions of shareholder interests being postponed behind those of conventional unsecured creditors in a liquidation."[64] In order to fully understand the nature of this conflict, the general objectives of both securities and insolvency law must be discussed in detail.

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[63] Although the scope of this paper is limited to considering these four scenarios, the issues discussed in this paper and in *Sons of Gwalia* could apply much more broadly. As CAMAC notes, "the right to be treated as a creditor in an external administration could equally apply to anyone who purchased, sold, or retained shares during a period where any form of relevant corporate misconduct took place." Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision,* 8.

[64] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 39.

2.1 General principles of insolvency law

Insolvency law can be (somewhat unhelpfully) defined as the area of law governing corporate collapse due to insolvency. A company is insolvent if it fails to meet either or both of the limbs of the solvency test in section 4 of the Companies Act 1993 (NZ). That is, a company must be able to pay its debts as they fall due in the normal course of business,[65] and the value of the company's assets must be greater than the value of its liabilities (including its contingent liabilities).[66] Though an insolvent company may be subject to one or more of five formal procedures, we are only concerned with the process of liquidation in the above scenarios.[67]

Maximising returns to creditors in a company liquidation and distributing those returns to creditors according to their relative entitlements are the principal objectives of insolvency law.[68] The importance of creditor interests in a liquidation is reflected in the order in which an insolvent company's assets are distributed.[69] Secured creditors are paid first, and trump all other claims to the company's secured property.[70] Next to be paid are the administrative costs of the liquidation and other preferential claims such as wages of company employees.[71] These are listed in schedule 7 of the Companies Act. Once these preferential claims have been satisfied, unsecured creditors are paid on a pari passu basis.[72] Finally, the company's shareholders have a right to an equal share in any remaining assets.[73] In practice however an insolvent company will

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[65] Companies Act 1993, s 4(1)(a); often referred to as the "cash-flow test."
[66] Companies Act 1993, s 4(1)(b); often referred to as the "balance-sheet test."
[67] The other four formal procedures a company may become subject to upon insolvency are: receivership, a compromise with creditors, voluntary administration and statutory management. For detailed discussion of New Zealand law relating to these procedures see L Taylor "Part 5: Corporate Collapse" in *Company and Securities Law in New Zealand* (Brookers, 2008). For detailed discussion of the process of liquidation see L Taylor "Liquidation" in *Company and Securities Law in New Zealand* (Brookers, 2008).
[68] Ministry of Economic Development *Insolvency Law Review: Insolvency law Reform Bill 2005, Explanatory Note* (Ministry of Economic Development, 2001), 15.
[69] P Blanchard and M Gedye *"Private Receivers of Companies in New Zealand"* (LexisNexis, 2008), 351.
[70] This secured property is excluded from the liquidation by part 16 of the Companies Act, as a secured creditor enforces a right to their own property rather than against the company.
[71] Companies Act 1993, s 312.
[72] Companies Act 1993, s 313.
[73] Companies Act 1993, ss 313(4) and 36(1)(c).

rarely have any surplus assets for the shareholders once all other claims are satisfied, and the shareholders are likely to lose some or all of their investment.[74]

This subordination of shareholders to unsecured creditors in a winding up is linked to the principle that "in liquidation, the 'company' no longer belongs to the shareholders, their equity is worthless, and the real owners are the creditors"[75] can be traced back to the basic distinction between equity and debt in a limited liability company. Shareholders who invest in a successful limited liability company have an unlimited potential upside in the form of dividends and capital gains. While they face the possibility of making no profit if the company does not prosper and (like creditors) risk losing their investment if the company fails, this risk is limited to the extent of their investment in the company's shares. As Callinan J points out, shareholders also enjoy vastly superior rights to creditors, such as the right to vote for directors at general meetings, the right to bring a derivative action on behalf of the company, and the right to enforce the constitution and class rights.[76] In contrast, creditors of even the most successful limited liability company will only receive repayment of their investment and a fixed interest rate if they are lenders, and probably no interest at all on indebtedness if they are trade creditors. Yet their risk is equal to the full amount of their investment.[77] In addition, equity investors can often manage their risk by diversifying their share portfolio, whereas creditors often do not have this flexibility.[78] Thus the risk and burden of insolvency falls on shareholders in order to deny them "enjoying the best of both worlds – gains when the company prospers and participation

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[74] T Clarke "Case study: Sons of Gwalia," 17 October 2007, <http://www.bellgully.com/resources/resource.01467.asp> (accessed 5 April 2009), 1.
[75] D Brown "Sons of Gwalia – relevant for New Zealand?" NZ Lawyer 17 August 2007, <http://www.nzlawyermagazine.co.nz/Archives/Issue71/F2/tabid/420/Default.aspx> (accessed 5 April 2009).
[76] *Sons of Gwalia,* per Callinan J at [231]-[239].
[77] T Clarke "Case study: Sons of Gwalia," 17 October 2007; Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision,* 52; M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," Corporate Law Teachers Association Conference 2008, Sydney, Australia, 12.
. The divergence between shareholder and creditor rights is of course crucial to the *Sons of Gwalia*-type claims in the scenarios listed above, and is discussed in detail in chapter three.
[78] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 52.

with creditors if it fails."[79] This ranking also encourages debt investment, as creditors rely on the fact they can access the cushion provided by the company's residual capital before shareholders.[80] The other major justification for subordinating the claims of the above shareholders to creditors is that a damages claim is inconsistent with the shareholder's obligation to contribute capital to the company.[81] This dichotomy between creditor and shareholder risks and rights in a liquidation is discussed further in chapter three.

2.2 General principles of the investor protection provisions

"Investor protection provisions" is the umbrella term used in the literature to describe the statutory provisions designed to give shareholders remedies against their company where they suffer loss through certain forms of corporate misconduct. This paper focuses on the provisions referred to in the scenarios above, which protect against misleading and deceptive statements and breach of continuous disclosure in the securities market. These provisions are discussed in detail later in this paper. For present purposes it is sufficient to note that protecting shareholders against this type of fraudulent harm is a fundamental objective of New Zealand securities legislation. The basis of this objective is the 1970s financial theory of the "Efficient Markets Hypothesis," which argues that the market value of equity is a reflection of and directly relates to all available price sensitive information in the marketplace.[82] The general philosophy is that timely and accurate disclosure by companies about their financial position and prospects results in fair and efficient equity prices in the securities market. Investors with access to accurate information can better assess the potential risks and rewards of their investments, and thus better protect their own interests.[83] This is

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[79] J. Harris & A. Hargovan "Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies" (2007) 25 C&SLJ 7, 24. Callinan J makes a very similar point in *Sons of Gwalia* at [210].

[80] J Sarra "Risk allocation and efficient administration: A comparative analysis of the treatment of equity securities claims in insolvency" Corporate law Teachers Association Conference 2007, Sydney, Australia, 3.

[81] T Clarke "Case study: Sons of Gwalia," 17 October 2007, 1.

[82] For more detail see Gilson & Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Virginia L R 549.

[83] A Borrowdale & F Chan et al *Morison's Securities Law (NZ)* <http://www.lexisnexis.com> (accessed 16 April 2009), at [1.6]. For a detailed outline of the principles behind securities regulation, see: International Organization of Securities Commissions *Objectives and Principles of Securities Regulation* (May 2003) <www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> (accessed 9 August 2009).

essential to the development, strength and growth of the securities market, and hence the overall economy. As Easterbrook and Fischel put it:

> Fraud reduces allocative efficiency. So too does any deficiency of information. Accurate information is necessary to ensure that money moves to those who can use it most effectively and that investors make optimal choices about the contents of their portfolios. A world with fraud, or without adequate truthful information, is a world with too little investment, and in the wrong things to boot.[84]

This disclosure philosophy is not universally accepted however. Many critics argue that the expense of providing information and the burden of compliance is unjustified, since empirical studies of investor behaviour show most of those receiving the information will act irrationally in response to, or even ignore, the signals.[85] While the New Zealand Securities Commission has acknowledged this criticism, it nevertheless views the disclosure philosophy as the ideal basis for securities law in New Zealand.[86]

2.3 The nature of the conflict

Given these two objectives, it is not difficult to discern the conflict that will arise when shareholder X claims compensation from his or her company. If the general principles of insolvency law outlined above are followed and the shareholder's claim is subordinated to all other creditor claims, then as David Brown observes, the investor protection provisions would be "rendered redundant on insolvency, which [is] often…the very circumstance in which loss of share value will occur."[87] As noted above, a major reason behind Gleeson CJ and Kirby J's decision in *Sons of Gwalia* was to ensure the investor protection provisions did not become "illusory" in a liquidation.[88] Similarly, CAMAC thought this conflict should be resolved in favour of shareholders, as "any move to curtail the rights of recourse of aggrieved shareholders where a company is financially distressed could be seen as undermining the apparent

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[84] F Easterbrook & D Fischel "Mandatory disclosure and the protection of investors" (1984) 70 Virginia L R 669, 673.
[85] Securities Commission of New Zealand *Proposals for the Enactment of Regulations under the Securities Act 1978,* (Securities Commission, 1980), 13. A Borrowdale & F Chan et al *Morison's Securities Law (NZ),* Chapter One; S Griffiths "Securities Regulation" in *Company and Securities Law in New Zealand* (Brookers, 2008), pg 988.
[86] Securities Commission of New Zealand *Proposals for the Enactment of Regulations under the Securities Act 1978,* 13, 15-20.
[87] D Brown "Sons of Gwalia – relevant for New Zealand?" NZ Lawyer 17 August 2007.
[88] *Sons of Gwalia,* per Gleeson CJ at [18], and Kirby J at [104].

legislative intent to empower investors."[89] The principal retaliation to this argument is that allowing shareholders to prove as contingent creditors will "lead to an insolvency process laden with complexity, increased costs, delays, protracted litigation and applications for directions and appeals,"[90] and will "increase the difficulty of the administrator's task exponentially."[91] For example, in the administration of Australian company Ion Ltd, the distribution of assets took eleven months longer than expected as each shareholder claim had to be examined as a result of *Sons of Gwalia.*[92] Whether or not these procedural difficulties will occur in New Zealand is discussed in chapter four. However, if they do, then allowing shareholders to claim will not only be contrary to the insolvency law objective of providing "a predictable and simple regime for financial failure that can be administered quickly and efficiently, impos[ing]…minimum necessary compliance and regulatory costs on its users,"[93] but also contrary to the securities law objective of having a cost-effective and efficient enforcement regime.[94]

3 Does New Zealand have an equivalent to section 563A of the Corporations Act 2001?

3.1 Section 52 of the Companies Act 1993

New Zealand law does not explicitly indicate whether or not shareholder X may lodge a proof of debt against their company in a liquidation which would then rank equally with the existing unsecured creditors upon distribution of the insolvent company's assets. Considering the incompatibility of our insolvency and investor protection law in a liquidation, this lack of legislative direction seems somewhat strange. Boros attributes the lack of discussion in this area before *Sons of Gwalia* to the historical fact that shareholder litigation has not usually involved shareholders suing the company of

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[89] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 64.
[90] A Bilski & P Brown "Sons of Gwalia versus shareholder subordination: Fairness versus efficiency" (2008) 26 C&SLJ 93, 106.
[91] *Ibid,* 105.
[92] E Sexton, "Gwalia Ruling to Delay Ion Payouts" *Sydney Morning Herald,* 2 February 2007 <http://www.smh.com.au> (accessed 18 May 2009).
[93] Ministry of Economic Development *Insolvency Law Review: Insolvency law Reform Bill 2005, Explanatory Note,* 15. Similarly, section 5(e) of the Companies Act 1993 states one of the purposes of the Act is "to provide straightforward and fair procedures for realising and distributing the assets of insolvent companies."
[94] A Borrowdale & F Chan et al *Morison's Securities Law (NZ),* at [1.6].

which they are members, but rather derivative actions brought on behalf of the company, or oppression or personal actions brought directly against the wrongdoer.[95] However as Boros observes, claims based on misleading or deceptive conduct and breach of continuous disclosure (like those in the scenarios above) are different as primary liability is likely to fall on the company rather than human beings.[96] Furthermore, as Anderson and Morrison comment, before *Sons of Gwalia* it was simply assumed that a shareholder had no interest in an insolvent company.[97] Significantly, New Zealand formerly had a provision alike to that interpreted by the House of Lords in *Soden*[98] and similar to section 563A of the Corporations Act 2001. Section 211(1)(j) of the Companies Act 1955 provided:

> A sum due to any member of a company, in his character of a member, by way of dividends, profits, or otherwise, shall not be deemed to be a debt of the company payable to that member in a case of competition between himself and any other creditor not a member of the company…

This provision was removed from the Companies Act 1993, with the Law Commission simply stating it was "an unnecessary complication."[99] Brown argues this deliberate removal shows a clear legislative intent to allow shareholders to claim in a liquidation, and that the distinction made in *Sons of Gwalia* between the different capacities in which a shareholder might bring a claim has no place in the Companies Act 1993.[100] Similarly, Clarke states that New Zealand shareholders would not be subordinated as there is no explicit equivalent to section 563A of the Corporations Act in New Zealand's statutory regime.[101] While Brown's finding is correct, and Clarke's ultimate conclusion that shareholder X would be able to bring a claim in a liquidation is accurate, in my view they were wrong to assert New Zealand has no equivalent to

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[95] E Boros "Shareholder litigation after Sons of Gwalia Ltd v Margaretic" (2008) 26 C&SLJ 235. 246. Boros notes that while actions based on statutory contract to enforce the constitution may be suing the company, the inherent nature of these actions means these are usually seeking injunctive or declaratory relief rather than a monetary remedy for compensation. While Boros is of course referring to shareholder litigation in Australia, her comments apply equally to shareholder litigation in New Zealand.

[96] *Ibid.*

[97] C Anderson & D Morrison "Seen but not heard? The significance of shareholders under Pt 5.3A of the Corporations Act", (2008) 16 Insolv LJ 222.

[98] The equivalent provision considered in *Soden* is section 74(2)(f) of the Insolvency Act 1986 (UK): see *Soden,* 306.

[99] New Zealand Law Commission *Company Law: reform and restatement* NZLC R16, (Law Commission, 1989), 154.

[100] D Brown "Sons of Gwalia – relevant for New Zealand?" NZ Lawyer 17 August 2007.

[101] T Clarke "Case study: Sons of Gwalia," 17 October 2007, 11.

section 563A, as the solvency test contains a rule to similar effect.[102] Described as a "pivotal provision" of the Companies Act 1993,[103] the solvency test was introduced at the same time section 211 was removed to replace the "arbitrary and inconsistent" rules relating to capital maintenance.[104] Rather than intending to dispose of the rule in section 211, it is quite possible the legislature removed the section as the solvency test replaced it with an equivalent rule, rendering section 211 unnecessary and "too complicated."

The relevant provision for present purposes is section 52 of the Companies Act 1993, which prevents shareholders from receiving a "distribution" from a company that does not meet the solvency test.[105] A "distribution" consists of three cumulative elements:

(a) the direct or indirect transfer of money or property (or the incurring of a debt) by a company,

(b) to or for the benefit of the shareholder, and

(c) in relation to shares held by that shareholder.[106]

In *DML Resources Ltd (in liq)* Heath J noted that to satisfy this definition of distribution there must be "an outflow of wealth from a company…linked to a positive impact on the shareholder."[107] Dividends[108] and the acquisition by the company of its own shares[109] are common forms of distribution, however they are not the only possible type. Heath J in *DML Resources* states a wide interpretation should be taken to the term "distribution," as this facilitates the purpose of the distribution provisions to avoid prejudice to creditors and higher-ranking shareholders.[110] Thus even if shareholder X is successfully awarded compensation against his or her company, section 52 may prevent shareholder X from being paid if the award falls within the definition of "distribution." The compensation is literally a "transfer of money" or "outflow of

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[102] See the definition of the solvency test at part 2.1 above.
[103] New Zealand Law Commission, *Company Law: reform and restatement*, 52.
[104] M Berkahn & L Trotman "Equity Finance" in Company and Securities Law in New Zealand (Brookers, 2008), 615.
[105] Similarly, section 56(1) of the Companies Act 1993 provides that if a distribution is given out when the solvency test is not met, the shareholder will be required to repay the amount of that distribution.
[106] Companies Act 1993, s 2.
[107] *Re DML Resources Ltd (in liq)*, [2004] 3 NZLR 490, at [64] ("*DML Resources").*
[108] See section 53(1) of the Companies Act 1993: "a dividend is a distribution other than a distribution to which section 59 [Acquisition of a company's own shares] or section 76 [Financial assistance by a company in the purchase of its own shares] of this Act applies.
[109] M Berkahn & L Trotman "Equity Finance" in *Company and Securities Law in New Zealand,* 614.
[110] *DML Resources* at [86]. See also New Zealand Law Commission, *Company Law: reform and restatement*, 97.

wealth" from the company to the shareholder. Classing the compensation as a distribution also fits well with the rationale of section 52. Heath J in *DML Resources* describes this rationale as that "it is inappropriate for a shareholder to receive benefits, ahead of creditors, [such as damages] at a time when the company is insolvent," since "shareholders stand behind creditors in the priorities in which they are paid on insolvency."[111] This rationale is of course identical to that behind section 563A of the Corporations Act. Indeed, the statutory context of section 52 is similar to section 563A. Whilst Australia has no equivalent to our solvency test, section 563A is found in the midst of insolvency provisions relating to proof and ranking of claims which (like the New Zealand solvency test) are aimed at protecting creditors.[112] However like section 563A's requirement that the claim must be made "to a person in the person's capacity as a member", section 52 possesses a crucial qualification: the distribution must be "in relation to shares held by that shareholder."[113] Heath J in *DML Resources* confirmed this as a clear statutory recognition that a bona fide transfer of money from the company to a shareholder acting in some other capacity will not be a distribution.[114] Thus shareholder X may claim for wages against his or her company as an employee, as the wages are nothing to do with his or her status as a shareholder. Similarly, if shareholder X loaned money to the company he or she may receive repayment of the loan in the capacity of a creditor.[115] Clearly the same conundrum arises under section 52 as in *Sons of Gwalia:* if shareholder X claims for compensation for the lost value of shares in the scenarios above, is that claim made in relation to his or her shares? In other words: is shareholder X claiming in the capacity of a shareholder? Thus it seems that Brown and Clarke erred in assuming no equivalent to section 563A existed in New Zealand.[116]

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[111] *DML Resources,* at [2].
[112] See discussion of the general objectives of insolvency law at part 2.1 above.
[113] Although the wording of section 52 ("in relation to shares held by that shareholder") is of course different to the wording of section 563A ("capacity of a member") there is no real difference between the effects of these two provisions.
[114] *DML Resources,* at [66]. This confirmed Heath J's earlier tentative conclusion to the same effect in *Kitchener Nominees Ltd v James Products Ltd* (2002) 9 NZCLC 262, 882.
[115] *DML Resources,* per Heath J at [67].
[116] Note that there is an exception to this prohibition against a shareholder recovering distributions under section 56 of the Companies Act 1993. However section 56 will never apply to our shareholder X, as it requires that the shareholder did not know of the breach of the solvency test, and here we are only discussing companies that do not meet the solvency test and have gone into liquidation. There would be no problem with a shareholder claiming against a solvent company.

3.2 Other New Zealand statutory provisions and common law

Ultimately, the existence of this rule makes little difference to our shareholder X. As will be discussed in the next section, shareholder X's claim would almost certainly be deemed made in the capacity of a creditor rather than as a shareholder. However before doing so, I examine whether there are any other indications in New Zealand statutory or common law that a rule equivalent to section 563A in New Zealand exists. This analysis is important for later discussion of whether shareholder X can claim. It also reveals further conflict and uncertainty in our law arising from the uncomfortable intersection between insolvency and investor protection objectives.

The interpretation of section 52 as an equivalent to section 563A is supported by the scheme of the Companies Act 1993, which suggests shareholder X would not be able to claim against his or her company as a shareholder. No mention of any such right is made by section 36 of the Companies Act, which describes the rights and powers attaching to shares. Significantly, section 248(1)(e) prevents a shareholder's rights or liabilities from being altered once liquidation intervenes. While there are exceptions to this rule, the right for shareholder X to claim against his or her company is not one of them. However many of the other exceptions explicitly permit a shareholder to apply to a court for various reasons: for example to enforce a liquidator's duties,[117] or to impose supervision of the liquidation.[118] If the legislature had intended to permit shareholder X to alter his or her rights by claiming compensation on the grounds outlined in the scenarios above, then surely the Companies Act 1993 would have included an exception to that effect. A further indication shareholder X cannot make a claim in his or her capacity as a shareholder is found in the statutory definition of the types of claims admissible in a liquidation. Section 303(1) defines an admissible claim as a "debt or liability, present or future, certain or contingent, whether it is an ascertained debt or a liability for damages." While the section does not explicitly mention who can make these claims, it is clear from the scheme of the Act that only claims made by creditors are admissible. Section 303 is directly associated with creditors by section 240(1), which defines a creditor as "a person who, in a liquidation, would be entitled to claim in accordance with section 303 of this Act that a debt is

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[117] Companies Act 1993, s 286.
[118] *Ibid*, s 284(1).

owing to that person by the company." The procedure by which shareholder X would lodge a claim against his or her company further supports this argument. Section 304 of the Companies Act 1993 allows an unsecured creditor to claim for damages, however the Act confers no specific right on shareholder X to claim as a shareholder against a company in liquidation. Thus if shareholder X wishes to lodge a proof of debt for damages, he or she must argue they are doing so in the capacity of an unsecured creditor and not as a shareholder.[119] Lastly, the word "claim" is used to refer to creditor claims throughout the Companies Act 1993. It would therefore be very odd if claims made by shareholders were admissible under section 303. Of course it seems equally odd to say shareholder X's right to a remedy under the investor protection provisions (outlined in each scenario above) is suddenly extinguished upon liquidation; especially as often the very wrong complained of by the shareholder has caused the liquidation. However section 52 does not actually render the investor protection provisions redundant. It only prevents shareholder X from claiming in the capacity of a shareholder: shareholder X can of course use this difficulty to argue the separate issue that he or she should be able to claim in the capacity of a creditor.

In addition to section 52 of the Companies Act 1993, shareholder X is arguably prohibited by a rule at common law from claiming against his or her company. In *Coupe v JM Coupe Publishing Ltd*[120]the New Zealand Court of Appeal held that a shareholder who acquired his or her shares under a voidable contract could no longer rescind that contract once liquidation intervenes.[121] Cooke J stated "if [a shareholder] has not taken sufficient steps before the winding up to set the contract aside, it is too late, because he is a member of the company at the date of the winding up and the creditors and the other contributories have accordingly obtained in effect crystallised rights against him."[122] Cooke and Somers JJ (and Richardson P in obiter) held that this rule had "long been settled" by authorities such as the House of Lords cases *Oakes v*

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[119] This process by which he or she does so is discussed further in chapter four.
[120] [1981] 1 NZLR 275 ("*Coupe").*
[121] P Heath J & M Whale (eds.) *Heath and Whale on Insolvency* <http://www.lexisnexis.com> (accessed 15 April 2009) at [23.11]; A Beck & A Borrowdale et al *Morison's Company Law (NZ)* <http://www.lexisnexis.com> (accessed 15 April 2009) at [61.11].
[122] Cooke J's use of language is confused here: the crystallised rights of the contributories and creditors are not against "him" (the shareholder) at all, but are against the company. However the meaning of his Honour's statement is clear: the primacy of creditor rights in a liquidation over shareholders prevent the shareholder from claiming, and for the shareholder to do so would be inconsistent with the shareholder's contract with the company.

Turquand (1867)[123] and *Tennent v City of Glasgow Bank* (1879)[124], and the New Zealand Supreme Court cases *Re Nenthorn* (1890)[125] and *Fleming v Eclipse Laundry Co Ltd* (1928)[126]. More recently, *Coupe* was approved in the 1997 Court of Appeal case *Daalman v Official Assignee.*[127] In my view however this line of authority is an uncertain foundation for a rule preventing shareholder X from claiming against his or her company in a liquidation.

First, both *Coupe* and *Daalman* can be restricted on a narrow factual basis. These cases are the only recent New Zealand authorities for the rule against rescission, yet both deal with shareholders challenging the validity of an increase in share capital. This is quite different to the factual basis of the older authorities such as *Oakes,* which concern shareholders wishing to claim for misrepresentation. Given the complete lack of recent authority other than these two very factually similar cases, it seems strange to say it is "long settled"[128] and "not in doubt"[129] that no shareholder may for any reason claim against their company in a liquidation. Thus it is quite possible *Coupe* would not apply to shareholders wishing to rescind on grounds of misrepresentation, and only apply to shareholders in factual situations like *Coupe* and *Daalman.* Secondly, it is uncertain whether all shareholders would be prevented from claiming, or if New Zealand has a *Soden*-type distinction between transferring and subscribing shareholders. Unlike subscribing shareholders, transferring shareholders do not contract for shares directly with their company. It is therefore impossible for them to comply with *Coupe* and rescind by returning their shares to the company.[130] Prohibiting their claims and depriving them of a remedy on this basis would thus be both unfair and artificial, suggesting the rule would not apply to transferring shareholders. It is possible even subscribing shareholders would be excluded from the rule in *Coupe* on the grounds that they have "lost" the value of their capital through their company's breach of its

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[123] (1867) LR 2 HL 325 ("*Oakes").*
[124] (1879) 4 App Cas 615 (*"Tennent").*
[125] *Re Nenthorn Public Battery Co Ltd* (1890) 9 NZLR 197.
[126] *Fleming v Eclipse Laundry Co Ltd* [1928] NZLR 598 where Reed J stated at 601 that a shareholder cannot rescind their contract once the company has gone into liquidation as the "creditors of the company are vitally interested…the sole assets are the truck and the claim on these shares."
[127] *Daalman v Official Assignee* CA238/95 Richardson P, Henry J and Elias J, 1 September 1997, 9 (*"Daalman").*
[128] *Coupe,* 7.
[129] *Ibid,* 45.
[130] D Brown "Sons of Gwalia – relevant for New Zealand?" NZ Lawyer 17 August 2007.

continuous disclosure obligations. Thus they should be excluded from the rule in *Coupe,* as (like the transferring shareholders) they cannot rescind what they do not have.

Coupe is further problematic for many of the reasons outlined by the majority's discussion of *Houldsworth* in *Sons of Gwalia*. Although the Court of Appeal in *Coupe* does not mention *Houldsworth*, the rules in each case are very similar: both requiring a shareholder to rescind their contract with the company before they can claim against a company in liquidation. Like *Houldsworth,* the older authorities cited in *Coupe* such as *Oakes* and *Tennent* are outdated, as they were decided at a time when modern company law was only just developing. The need for disclosure was thought of very differently in this period since (as mentioned above) the financial theory of the Efficient Markets Hypothesis only dates from the 1970s. Thus the older authorities cited in *Coupe* should not apply to the scenarios above as they were decided long before this theory or either the Securities Act 1978 (NZ) or Securities Market Act 1988 (NZ) were conceived. Similarly, *Oakes* is outdated due to the evident confusion between limited liability and partnership law in the case. For example, Lord Colonsay questioned why companies are not called partnerships, and held it would be a mistake "to hold that these companies are stripped of all the characteristics of mercantile partnerships."[131] Like in *Houldsworth,* their Lordships in *Oakes* relied heavily on the partnership law principle that for a shareholder to claim from his company and fellow creditors is inconsistent with his contract it and them.

This view of a company may not be altogether irrelevant however, as it seems to fit nicely with the modern economic "nexus of contract" theory of the company.[132] This theory sees the company as a complex web of contractual relationships, rather than as an individual "person."[133] On this view, the contract between shareholders and their company referred to in *Houldsworth* and *Oakes* will exist where creditors rely upon an

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[131] *Oakes,* 26.
[132] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 9.
[133] For detailed discussion of the economic "nexus of contracts" theory of the company, see: S Copp & C Maughan "Company Law Reform and Economic Methodology Revisited" (2000) 21.1 *Company Lawyer* 14.

express or implied term that the company will not return capital to shareholders.[134] The flaw in this argument becomes quickly apparent however upon a search for the legal basis of such an express or implied term. As Duffy puts it: "if contracting shareholders and creditors expect their contracts to ascribe them the rights and liabilities prescribed by "the law", it becomes somewhat circular to use the nexus view to attempt to find the content of that "law" in those contracts."[135] Clearly this nexus of contract view focuses too much on contract and takes insufficient account of the company as a separate legal entity.[136] Thus it does not justify applying *Oakes* in the modern commercial context of *Daalmans* and *Coupe.*

The alternative "stakeholder" view of a company also provides some support for applying *Oakes* and *Houldsworth.*[137] On this view, interests of other parties or "stakeholders" beyond the shareholders are seen as vital to the company. These stakeholders include "all affecters and affectees of corporate policies and activities," including employees, creditors, customers and society as a whole.[138] Under this stakeholder view of the company, "the primacy of capital (shareholders) is questioned and other interests such as creditors are to be elevated."[139] This view certainly seems to be upheld in the insolvency provisions described above, which subordinate shareholder claims to all other "stakeholder' claims. Yet this theory alone without other legal justification is insufficient reason to apply *Oakes*.

4 Conclusion

From the discussion above, it is clear that there are strong grounds upon which the rule in *Coupe* can be restricted, so that it would not prohibit shareholder X from claiming against his or her company. Grounding the New Zealand equivalent of section 563A in the statutory solvency test (rather than the rule in *Coupe*) fits in well with Gummow and Hayne JJ's observation in *Sons of Gwalia* that a company is a statutory creature,

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[134] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 9.
[135] *Ibid.*
[136] *Ibid.*
[137] *Ibid,* 10.
[138] R Freeman, *Strategic Management: A Stakeholder Approach*, (Pitman 1984).
[139] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 11.

and the principles governing it must be derived from statute.[140] Perhaps the most cogent reason is Brown's argument that the Fair Trading Act and New Zealand securities legislation "show a clear statutory policy to allow shareholders a remedy, and should not be defeated by a common law, nineteenth-century principle."[141] Thus it seems section 52 remains the only bar to shareholder X claiming in the above scenarios.

[140] *Sons of Gwalia,* per Gummow J at [34]-[37]. See also Hayne J at [200]-[205].
[141] D Brown "Sons of Gwalia – relevant for New Zealand?" NZ Lawyer 17 August 2007.

CHAPTER III: The *Sons of Gwalia* conundrum: Is shareholder X claiming in the capacity of a creditor?

1 Introduction

As discussed above, the effect of section 52 of the Companies Act 1993 seems virtually identical to section 563A of the Corporations Act 2001. However there is one difference: the New Zealand Companies Act 1993 seems to prohibit shareholder X from claiming at all, whereas the Australian section 563A simply subordinates his or her claim rather than prohibiting it outright. This distinction between the Australian and New Zealand rules is of little practical importance however. Given the *Sons of Gwalia* decision, most Australian shareholders would only bother claiming if they could do so as a creditor. Litigation is costly, and a claim in the capacity of a shareholder would recoup few assets once all other claims are paid and would likely not be worth making. Nevertheless, there is still potential for the New Zealand legal position to differ from Australia. Though highly persuasive, the majority's conclusion in *Sons of Gwalia* is not actually binding on a New Zealand court. In addition, there are significant differences between Australian and New Zealand corporate law, despite our Closer Economic Relations Agreement 1983.[142] As Fitzsimons observes, "New Zealand never has, and probably never will have, the corporate regulatory regime that characterises Australian corporate law."[143] In the present context however these differences are not significant, as the securities law regimes in New Zealand and Australia are still substantially similar.

2. Do the investor protection provisions automatically allow shareholder X to be classed as a creditor?

The complex question of whether shareholder X's claim for compensation is made in relation to his or her shares seems to have a rather simple answer. As indicated above, preventing shareholder X from making a claim would render the investor protection provisions redundant. As Gleeson CJ and Kirby J point out in *Sons of Gwalia,* this

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[142] Ministry of Foreign Affairs and Trade, Australian and New Zealand Closer Economic Relations, (last updated 23 June 2008) <http://www.mfat.govt.nz/Trade-and-Economic-Relations/TradeAgreements/Australia/index.php> (accessed 3 October 2009).

[143] P Fitzsimons "Australia and New Zealand on different corporate paths" (1994) Otago Law Review Vol 8 No 2, 267.

would surely be contrary to parliamentary intent.[144] The provisions all broadly apply to any "person" wishing to make a claim. If the legislature had intended those provisions to only protect investors of solvent companies so that the provisions become of no use to shareholder X the moment his or her company fails the solvency test, then it would have specifically stated so. Arguably then, the statutory rights conferred by these investor protection provisions automatically give shareholder X the right to claim as a creditor. In *Sons of Gwalia* Gleeson CJ noted that:

> "modern legislation…has extended greatly the scope for 'shareholder claims' against corporations…corporate regulation has become more intensive, and legislatures have imposed on companies and their officers obligations, breach of which may sound in damages, for the protection of members of the public who deal in shares and other securities."[145]

In enacting these reforms, it is likely the legislature did not overtly consider whether it should override the traditional objectives of insolvency law against shareholders claiming in a liquidation, and it may not have even realised it was doing so. Yet this is the effect of allowing shareholder X to claim. In my view, given the clear legislative intent that shareholder X should be protected, shareholder X should be classed as a creditor for the purposes of section 52. Attractive as this argument is however, there are many other complex considerations that must also be taken into account which add a cloud of uncertainty to the proposition. As CAMAC observes, this is an area of law where interests are polarised,[146] and there are strong arguments that can be made for either side.[147]

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[144] *Sons of Gwalia,* per Gleeson CJ at [18] and Kirby J at [106].
[145] *Sons of Gwalia,* per Gleeson CJ at [18].
[146] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 39.
[147] Given our solvency test is directly adopted from Canadian legislation, it is worth noting similar confusion exists in Canada on where a shareholder claim for misrepresentation should rank in a company liquidation. In *Re Blue Range Resource Corp* 2000 CarswellAlta 12, (Alta QB), the Court held shareholder claims should be subordinated. While this was endorsed in *National Bank of Canada v Merit Energy Ltd* 2001 CarswellAlta 913 (Alta. Q.B.), two later unreported judgments indicate a different approach should be taken, though without determining the question: see *In the Matter of Bell Canada International Inc.*, Court File No. 02CL-4553 (14 September 2004) (Ont. S.C.J. (Commercial List)), endorsement of Farley J; and *Menegon v. Philip Services Corp.* [1999] O.J. No. 4080 (Ont. S.C.J. (Commercial List)).

3 Do the purpose and language of section 52 of the Companies Act 1993 allow shareholder X to claim as a creditor?

The starting point is the general principle outlined by Kirby J in *Sons of Gwalia,* that "[t]he ultimate duty of a court in a case of this kind is to give effect to the meaning of the law as expressed by the parliament" as "ascertained from the language of the enactment."[148] Here, the relevant language is whether shareholder X's claim "is made in relation to" his or her shares; or (as Hayne J would put it) whether the basis for shareholder X's claim can be found in his or her "statutory contract" with the company. Like Mr Margaretic's claim, shareholder X's claim is based on the investor protection provisions outlined above, which stand altogether apart from any obligation created by the Companies Act 1993 and owed by the company to its shareholders.[149] For example, had shareholder X bought options rather than shares, or sold the shares before the liquidation began, then he or she would still be able to claim.[150] It is evident that shareholder X's right to claim does not depend on his or her status as a shareholder, and so is not made "in relation to those shares." However Harris and Hargovan that argue the ability of non-shareholders to claim under the investor protection provisions is "beside the point," as "[t]he issue is not whether *any* claim should be subordinated…but rather whether Mr Margaretic's particular claim should be subordinated;" or in this case our shareholder X. On their view, shareholder X's claim relates to his or her shares, as the quantum of that claim is limited to costs associated with purchasing shares in the company: if shareholder X had not purchased shares in the company then he or she could not maintain his or her present claim for compensation. Thus they argue that the claim is "derived simply from the circumstances surrounding his [or her] purchase of the company's shares," and should be subordinated.[151] This seems however to take too literal a view of the statutory language in section 52. Again it would be absurd to prevent the investor protection provisions from operating just when they are needed most, especially as the Securities Market Act 1988 and the Securities Act 1978 are specifically aimed at protecting shareholders.

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[148] *Sons of Gwalia,* per Kirby J at [108].
[149] *Sons of Gwalia,* per Hayne J at [205].
[150] E Boros "Shareholder litigation after Sons of Gwalia Ltd v Margaretic" 235, 237.
[151] A Hargovan & J Harris "Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies," 18.

Allowing shareholder X to claim as a creditor is also consistent with the purpose of section 52 of the Companies Act. As Peter Watts observes, "there can be little doubt that the purpose of the section is only to catch enrichment on the part of shareholders at the company's expense."[152] However shareholder X's claim for compensation is of a quite different nature to the sorts of distributions section 52 aims to prevent being made in a liquidation. While shareholder X is "enriched" in the literal sense that he or she gains money from the company, the real effect of compensation is to place him or her in the position he or she would have been in had the company not committed the wrong.[153] This is not "enriching" shareholder X at all but simply remedying what he or she had lost as a result of the company's misbehaviour.[154] On the other hand, section 52 is found in the context of the solvency test, whose goals in relation to distribution are "avoidance of prejudice to creditors," and "avoidance of prejudice to higher ranking shareholders with fixed entitlements, for example in preference shares."[155] As Heath J stated in *DML Resources*, "[t]he policy underpinning s 52(3) has a firm foundation in the rule that shareholders rank after creditors on insolvency."[156] Thus it seems allowing shareholder X to claim would be against the parliamentary intent of protecting creditors. However this reasoning is somewhat circular. It could be argued that shareholder X is really a creditor due to the rights conferred by the investor protection provisions (as discussed above), and so should be protected.

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[152] P. Watts "Review: Company Law" [2004] NZLR 123, 137.
[153] J Cartwright "Compensatory damages: Some central issues of assessment," in *Commercial remedies: Current issues and problems"* (Oxford University Press, 2003) 3.
[154] This situation is different to where a company suffers a loss that results in the value of that company's shares being reduced. As Boros observes, in the latter scenario, a shareholder cannot recover the loss from the wrongdoer, as the diminution in value of their shareholding reflects the loss suffered by the company. Allowing them to claim would thus result in double recovery: *Prudential Assurance Co Ltd v Newman Industries Ltd (no 2)* [1982] Ch 204, upheld in the House of Lords case *Johnson v Gore Wood* [2002] AC 1. Boros points out this rule does not apply to a shareholder who suffers loss for the same reasons as Mr Margaretic, as the diminution in share value is *caused* by the company rather than suffered by the company, so there is no issue of double recovery in allowing that shareholder to sue: E Boros "Shareholder litigation after Sons of Gwalia Ltd v Margaretic" 235, 248. Note however that *Christensen v Scott* [1996] 1 NZLR 273 suggests *Prudential* does not apply in New Zealand.
[155] New Zealand Law Commission *Company Law: reform and restatement,* [400].
[156] *DML Resources,* at [57].

4 Shareholder X as a "consumer-investor"

A further argument in favour of classing shareholder X as a creditor is the importance of protecting investors, discussed at part 2.2 above. Intervention by the legislature to achieve this protection is essential, especially in listed companies. Shareholders in these large companies are unable to protect themselves as they "are no longer a small group of entrepreneurs; rather, they are a broadly dispersed group that cannot easily monitor officer conduct."[157] For example they do not have access to internal company decisions or reports and must rely on the company disclosing this information.[158] Thus the concept of caveat emptor or "let the buyer beware" is considered inappropriate when dealing with offers of securities to the public.[159] One reason for this is the Efficient Markets Theory noted above. Coleridge CJ in *Twycross v Grant*[160] describes another reason as follows:

> It is utterly immaterial to an ordinary purchaser to know what the vendor will do with the purchase money when he gets it: the purchaser has no further interest in it. But an applicant for shares in a company is in a totally different position. This money becomes part of the capital of the company; and to him it is all important to know what sort of persons are to have the control of his money where he has paid it, and how that money is to be applied…[161]

These rationales are of course equally applicable to the secondary market of securities trading. Consumerism is also becoming an increasingly strong rationale behind protecting shareholders. Legg describes consumerism as embodying the perception that "if a product does not work it is the fault of the manufacturer or seller." He argues that viewing shareholders as consumers "changes the moral colouration of a share price fall or a corporate collapse."[162] Where previously a shareholder might have seen the loss as simply bad luck or as part of the risk of investing on the stock market, the shareholder now demands (and expects) remedy for his or her injury.[163] Indeed, Mr Margaretic himself explained his successful action against Sons of Gwalia Ltd as "a moral

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[157] J Sarra "Risk allocation and efficient administration: A comparative analysis of the treatment of equity securities claims in insolvency," 14.
[158] T Clarke "CAMAC Report released on Sons of Gwalia decision" Bell Gully Commercial Quarterly, Summer 2009. <http://www.bellgully.com/newsletters/14corporate/company_3.asp> (accessed 20 May 2009).
[159] A Borrowdale & F Chan et al *Morison's Securities Law (NZ),* at [1.6].
[160] (1877) 2 CPD 469.
[161] *Ibid,* 483.
[162] M Legg "The transformation of a share price fall into litigation- shareholder class actions in Australia" 2008 Corporate Law Teachers Association Conference, Sydney, Australia, 2.
[163] *Ibid,* 4.

victory," putting "trust into the whole system of buying and selling shares."[164] The need to protect "consumer-investors" such as Mr Margaretic is a dominant theme underlying the majority's judgment in *Sons of Gwalia*.[165] Significantly, Kirby J explicitly states Mr Margaretic did not receive the disclosures as a shareholder of the company at all, "but as a consumer of corporate information and as an investor."[166] Thus it could be argued that shareholder X is actually claiming in the capacity of a consumer rather than as a shareholder. This argument would be particularly forceful where shareholder X is claiming under the Fair Trading Act 1986: which of course is consumer protection legislation.

Difficulties arise when it is considered that some shareholders are considerably more sophisticated than the average "consumer-investor." Should institutional or professional investors be treated the same as individual "mum and dad" investors, who may not have the same understanding of the risks involved in investing? A distinction of this sort is already made by the Securities Act 1978. The Act excludes offers to "habitual investors,"[167] as they are "presumed by the legislature to be...able to protect themselves, because of their expertise."[168] Similarly, an offer is exempt from almost all the requirements of the Securities Act 1978 if the only "eligible persons" for subscription are either "wealthy," "experienced in investing money" or "experienced in the industry or business to which the security relates."[169] This strongly suggests institutional or professional investors would be prevented from claiming under the "consumer" rationale. This seems somewhat strange however as they will have suffered the same wrong from the company's misconduct as the consumer-investors.

Furthermore, deliberate encouragement of this consumerism is undesirable at a policy level due to the very nature of investing as "an inescapably risky and speculative

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[164] A Trounson "Historic win for duped investors" *The Australian* 1 February 2007 <www.theaustralian.news.com.au/story/0.20867.21151270-601.11.html> (accessed 18 May 2009).
[165] See part 2.3, chapter two.
[166] *Sons of Gwalia,* per Kirby J at [122].
[167] Section 3(2)(a)(ii) of the Securities Act 1978 defines "habitual investor" as a person whose "principal business" is the investment of money, or who habitually invest in money "in the course of and for the purposes of their business" from being an offer of securities to the public.
[168] *Lawrence v Registrar of Companies* [2004] 3 NZLR 37, at [32].
[169] Securities Act 1978, s 5(2CB)-(2CG).

operation."[170] As a senior executive of the New Zealand Securities Commission explains:

> New Zealand's emphasis on disclosure means that investors are expected to take responsibility for their own investment decisions. We do not try to prevent investors taking risks - we see risk taking as an essential element of our economy - rather our effort is directed at ensuring that investors have all the information at their disposal to assess the risk, to evaluate and assess the investment and make up their own minds.[171]

The counter argument to this view is that allowing shareholder X to rank equally with unsecured creditors is not insulating him or her against the normal economic risk of insolvency (which may occur for an infinite number of reasons); it is insulating him or her against the specific risk of misleading conduct, which was not bargained for. These considerations of risk are addressed in more detail at part 5 below. Overall however it seems more sensible to allow shareholder X to claim as a creditor on the basis of a direct right given by the investor protection provisions, and to view the consumer rights as supporting this argument, rather than as a basis for the claim in themselves.

5 The dichotomy between creditor and shareholder rights and risks in a liquidation

As McCracken observes, the nature of the debate provoked by *Sons of Gwalia* is "often portrayed rather starkly in terms of "shareholders' rights" versus "creditors' rights."[172] Bilski and Brown argue this view is misconceived, as the real issue in *Sons of Gwalia* is "the apportionment of risk between shareholders and creditors."[173] Though not traditionally viewed as such, fraud and misrepresentation are inherent risks of investing, especially given their prevalence of in recent years.[174] As described above,

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[170] *Sons of Gwalia,* per Kirby J at [110].
[171] N Millar, New Zealand Securities Commission, "Disclosure as a Regulatory Tool" (Speech given at ASIC Summer School in Brisbane on 22 February 2002). <http://www.seccom.govt.nz/speeches/2002/nms220202.shtml?print=true> (accessed 10 October 2009). See also: Ministry of Economic Development, Cabinet Paper for Securities Disclosure and Financial Advisers Amendment Bill, (last updated 11 March 2009) <http://www.med.govt.nz/templates/MultipageDocumentPage___40433.aspx?&MSHiC=65001&L=0&W=%22material+information%22+&Pre=%3cb%3e&Post=%3c%2fb%3e> (accessed 24 September 2009).
[172] S McCracken "'Shareholder creditors": Further risk for directors of corporate trustees?" (2008) 19 JBFLP 114, 120.
[173] A Bilski & P Brown "Sons of Gwalia versus shareholder subordination: Fairness versus efficiency," 99.
[174] J Sarra "Risk allocation and efficient administration: A comparative analysis of the treatment of equity securities claims in insolvency," 14. As Sarra notes at 15, the most well known example is of course the collapse of Enron, which was caused by the fraud of several wayward executives.

shareholder X should arguably bear the risk of the company's misconduct due to his or her "ample and superior rights" compared to the other unsecured creditors. Yet in contrast to the "consumer-investor" described above, most creditors (such as banks) are commercially sophisticated and well able to protect themselves through contracting for securities or by increasing the interest rates they charge on their unsecured loans.[175] As Wishart states, "creditors cannot complain that insolvency…caused them loss because they have contracted to bear that risk, and have built compensation for bearing it into the cost of credit."[176] Thus it seems fair for shareholder X to be classed as a creditor, as he or she is unable to compensate for the risk in this manner. From a practical perspective however this theory is flawed, as it assumes perfect information, many buyers and sellers, and perfect competition, when in reality this will not be the case.[177] As Duffy points out, unsecured creditors (who do not have enough bargaining power to obtain securities over company property) may not be in any position to charge higher interest rates.[178] Further, the costs of acquiring accurate information about the level of risk may be disproportionate to the size of the individual debt owed to the unsecured creditor.[179] Lastly, trade creditors will rarely have a mechanism to bear risk at all as they do not typically charge interest.[180]

Bilski and Brown avoid directly answering whether unsecured creditors should charge increased interest for the risk of this sort of misconduct by a company. Instead, they argue that shareholders like "X" should not be subordinated as unsecured creditors can charge higher interest rates to compensate for the corresponding risk increase in shareholder litigation.[181] As a result of these increased interest rates, the loss caused by singular instances of shareholder litigation are spread diffusely throughout the wider market, so that "both shareholders and creditors are burdened…not by virtue of their

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[175] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 16-18.
[176] D Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323, 335.
[177] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 16.
[178] *Ibid,* 17.
[179] H Anderson, *Corporate Directors' Liability to Creditors* (Thomson, 2006), 21.
[180] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 12.
[181] A Bilski & P Brown "Sons of Gwalia versus shareholder subordination: Fairness versus efficiency," 99.

position in the market but simply by being market participants."[182] Bilski and Brown contend it is reasonable for the market as a whole to absorb the risk. They note shareholders currently bear the cost of company compliance with the mandatory disclosure regime (and other investor protection provisions) through the resulting reduction in equity returns. Thus "to ask shareholders to bear the cost of operating the system, as well as the costs when it fails…seems to be too great a burden."[183] This argument is very persuasive in terms of fairness, and the ability of creditors to offset their loss onto the market seems a valid justification for allowing shareholder X to claim. Again however, this theory gives rise to the same practical difficulties discussed in the previous paragraph.

Another way to view the dichotomy between creditor and shareholder risks in a liquidation is that "neither shareholders nor creditors bargain for the risk of being deceived by misleading statements to the markets."[184] CAMAC takes this view, stating that "both debt and equity markets rely on the investor protection provisions and should receive the same protections in the event of corporate misconduct."[185] As Harris and Hargovan put it, "[i]n circumstances where shareholders and creditors have equally been defrauded or misled…why should creditors receive favourable treatment over such misled shareholders?"[186] Viewing an unsecured creditor as equally vulnerable to risk as shareholder X seems both fair and accurate. Again this argument supports giving full effect to the investor protection provisions and allowing shareholder X to claim, so that these protections are not rendered illusory.

A forceful reason for preventing shareholder X from claiming is the "need to avoid having a massive shift in the balance of power from creditors to [shareholders] in insolvencies."[187] If shareholder X is classed as a creditor, then in addition to the "ample and superior" rights enjoyed while the company was solvent, he or she will acquire all

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[182] *Ibid,* 100.
[183] A Bilski & P Brown "Sons of Gwalia versus shareholder subordination: Fairness versus efficiency," 102. Their observations apply equally in a New Zealand context due to the identical operation of Australian and New Zealand securities regimes.
[184] A Hargovan & J Harris "Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience" (2007) 20 AJCL LEXIS 3, 94.
[185] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 49.
[186] A Hargovan & J Harris "Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience," 94.
[187] A Hargovan & J Harris "Sons of Gwalia Ltd v Margaretic: The shifting balance of shareholder's interests in insolvency: Evolution or revolution?" 620.

the rights of an unsecured creditor. The most important of these are voting rights in the course of liquidation. As Clarke points out:

> ...this entails some risk that shareholder claimants may affect voting rights to the detriment of other creditors, who may have diverging interests…especially in large shareholder claims, where there is a material risk of shareholders "swamping" the vote.[188]

Furthermore, if shareholder X is classed as an unsecured creditor, then he or she will receive a significantly greater proportion of company assets upon distribution than if he or she were classed as a shareholder. As discussed in the introduction to this paper, this will result in the existing creditors suffering reduced returns, particularly in a class action where many shareholders are claiming.[189] Just as Callinan J (dissenting) predicted in *Sons of Gwalia*, allowing shareholder X to claim in a liquidation has the potential to dilute the rights of the other unsecured creditors "to less than a trickle."[190] The likelihood of this occurring is considered in detail in chapter four and the conclusion to this paper.

6 Should a *Soden*-type distinction between transferring and subscribing shareholders be made in New Zealand?

Shareholder X in scenario (c) is a subscribing shareholder, and will be unable to claim if the *Soden* distinction is upheld in New Zealand. This distinction was discussed in detail in chapter one. As will be recalled, the majority in *Sons of Gwalia* did not directly decide whether subscribing shareholders should be prevented from claiming, leaving the issue unsettled in Australia. The basic argument for upholding the *Soden* distinction turns on the importance of capital maintenance. Awarding shareholder X damages here arguably indirectly returns his or her subscription capital, as those damages are equal to the subscription price paid for those shares. In contrast, since the shareholders in scenarios (a) and (b) bought their shares from a third person, it is irrelevant to the company and its creditors whether the value of those shares is indirectly returned through damages.[191] This is of course the rationale behind *Coupe* and *Houldsworth,* which for the reasons discussed in chapter two are unlikely to apply to shareholder X.

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[188] T Clarke "Case study: Sons of Gwalia," 17 October 2007, 10.
[189] Maybe state reference to intro example?
[190] *Sons of Gwalia,* at [256].
[191] *Soden*, 326.

As noted above, the capital maintenance doctrine has been replaced by the solvency test. Thus there is nothing to distinguish shareholder X in scenario (c) from the shareholders in the other scenarios. Boros takes a similar view regarding the Australian position, saying that since *Houldsworth* no longer applies there is no reason to prevent claims by subscribing shareholders, and the question should be left for a future court to decide.[192] CAMAC also supported the abolition of the *Soden* distinction for similar reasons.[193] Further, there is no indication by the legislature that whether shareholder X's claim is a distribution "in relation to his or her shares" differs depending on whether he or she was a transferring or a subscribing shareholder. For example, section 96 of the Companies Act 1993 defines "shareholder" without making any distinctions of that kind. As already discussed, the investor protection provisions apply to all "persons" and do not exclude shareholders of any sort from claiming. Therefore shareholder X in scenario (c) should be treated the same as the shareholders in the other scenarios.[194]

7 What if shareholder X purchased his or her shares before the company actually committed any wrong?

Harris and Hargovan argue that while "new" shareholders such as shareholder X in scenarios (a), (b) and (c) should rank equally with unsecured creditors, pre-existing shareholders such as shareholder X in scenario (d) should be subordinated. They reason that:

> A prospective investor is not a member of the company (either in law or equity) prior to the purchase of shares. This means that when a misrepresentation is made by the company to the market, the existing shareholder has a power and informational advantage over both the company's general creditors and the prospective investors.[195]

They argue that pre-existing shareholders in a company approaching insolvency may misuse this informational advantage to improve their own position as creditors by attracting new capital. Thus they should be subordinated to remove this incentive and to balance out their unequal advantage over the new shareholders. Note however that

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[192] E Boros "Shareholder litigation after Sons of Gwalia Ltd v Margaretic" 235, 245.
[193] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision,* 89.
[194] Clarke also takes this position: T Clarke "Case study: Sons of Gwalia," 17 October 2007.
[195] A Hargovan & J Harris "Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience," 100.

this argument assumes all pre-existing shareholders will be privy to information that the prospective shareholders are not, which may not always be the case. Uncertainties also arise as to how much time should pass before a "new" shareholder is classed as a "preexisting shareholder" and subordinated to creditors.[196] Further, in the words of Callinan J it seems a "very unfair and incoherent result" to discriminate against shareholder X in this scenario, when he or she suffered the same wrong as the new shareholders.[197] Thus for the reasons given in parts 3-7 of this chapter, in my opinion they should not be subordinated.

8 Conclusion

While persuasive arguments have been raised on both sides, it appears that shareholder X would be classed as a creditor in each of the scenarios (a)-(d), in order to prevent the investor protection provisions from becoming an illusory protection to shareholder X upon insolvency. As CAMAC observes, giving effect to the investor protection regime benefits not just shareholders, but also the market generally.[198] One important issue is yet to be addressed however: the impact of allowing claims on the efficiency of company administrations. Chapter four therefore discusses whether considerations of efficiency justify subordinating shareholder X's claim.

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[196] Duffy suggests a specific cut-off time limit for claims such as 90 or 120 days from when the disclosure should properly have been made to the market: M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 23.
[197] As will be discussed in chapter four, they may not have suffered the same loss however.
[198] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision,* 47.

CHAPTER IV: Practical implications of allowing shareholder X to rank equally with unsecured creditors

1 Introduction

The starting point in evaluating the efficiency and practical implications of allowing shareholder X to claim as an unsecured creditor is the procedure by which he or she can lodge a claim. As discussed in chapter two, shareholder X must argue they are claiming as an unsecured creditor in order to lodge a claim under section 304 and receive any damages under section 52. Shareholder X does not have to actually prove his or her claim in order to lodge a proof of debt, as the liquidator can simply estimate the amount of the damages or refer the matter to the Court to decide.[199] The decision of whether to accept or reject shareholder X's proof of debt is made by the company liquidator.[200] In doing so he or she is of course deciding both the procedural issue of capacity and the substantive merits of the claim. If the liquidator rejects the proof of debt, shareholder X may apply for permission to commence litigation against the company,[201] where the court will decide both the procedural issue of capacity and the substantive merits of the claim.

Though it seems straightforward enough, this process may give rise to significant problems if class actions do eventually become established in New Zealand, or if shareholder litigation increases. No distributions may be made to unsecured creditors until *all* the proof of debts lodged with the company have either been rejected or accepted, and any appeals heard.[202] Thus if a plethora of shareholders like "X" lodge claims with the company in a liquidation, up to ten years could pass until their claims are proved and these other unsecured creditors are paid.[203] As discussed in chapter two, this would be contrary to the fundamental objective of both insolvency law and investor protection law for their respective regimes to be efficient, cost effective and certain. In addition, this substantial cost and delay would result in a corresponding diminution in the funds available for distribution to creditors and shareholders.[204]

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[199] Companies Act 1993, s 307(1).
[200] *Ibid*, s 304(2).
[201] *Ibid,* s 248(1)(c).
[202] L Zwier '"Fine-tuning" Australia's VA regime' NZLawyer, 16 March 2007, 24.
[203] *Ibid.*
[204] T Clarke "Case study: Sons of Gwalia" (17 October 2007), 10.

Across the Tasman, critics of *Sons of Gwalia* predicted an increase in shareholder claims would have a "revolutionary effect" in the debt market;[205] deterring United States lenders from entering the Australian market[206] and discouraging potential "white knight" investors with the ability to turn distressed companies around.[207] The same concerns are equally valid in New Zealand.

In this chapter I therefore discuss whether these fears of extreme inefficiency and a flood of shareholder claims will be realised in New Zealand. If so, then this may justify subordinating shareholder X's claim, despite the arguments discussed in chapter three. Indeed, Bilski and Brown describe the effect of *Sons of Gwalia* as "fatal" to the efficiency of the insolvency regime in Australia, and conclude for this reason alone that shareholder claims should be subordinated.[208] Sarra makes a similar point, saying that unless the validity and value of shareholder claims can be determined in an expeditious manner, "whatever increase in fairness towards wronged securities holders is achieved [by subordination] will be outweighed by the increased transaction costs generated by a lengthy and complex process for resolving securities holders' claims in insolvency proceedings."[209] In-depth analysis and critique of the legal issues arising in each scenario is for more detailed consideration elsewhere. Instead, this chapter aims to give an overview of the legal obstacles faced by shareholder X in each scenario: as the greater the difficulties faced by shareholder X in proving each claim, the longer a court will take to decide whether to admit that claim. This chapter then broadly assesses the likely practical implications of allowing shareholder X to rank as a creditor. While quantitative analysis or predictions of the level of shareholder litigation is impossible, in my view considerations of efficiency are unlikely to justify subordinating shareholder X's claim. Despite this, reform of this area of law is long overdue, as the last part of this paper will argue.

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[205] C Dalton (Managing director of Standard & Poor's in Australia and New Zealand) 'Australian debt dilemma' 21 February 2007 <www.financeasia.com> (accessed 20 May 2009).
[206] R Gluyas "Gwalia ruling leaves US lenders wary" *The Australian* 12 May 2008 <http://www.theaustralian.news.com.au> (accessed 18 May 2009).
[207] Blake Dawson "Sons of Gwalia and the CAMAC Report: where to from here?" *Restructuring and Insolvency Client Alert March 2009,* 2. Other common concerns of Australian commentators after *Sons of Gwalia* are noted in the introduction to this paper.
[208] A Bilski & P Brown "Sons of Gwalia versus shareholder subordination: Fairness versus efficiency," 93.
[209] J Sarra "Risk allocation and efficient administration: A comparative analysis of the treatment of equity securities claims in insolvency," 34.

2 Scenario (a): Shareholder X claims for breach of continuous disclosure under the Securities Markets Act 1988.

Continuous disclosure is the ongoing obligation for "public issuers" (listed companies[210]) to inform the securities market of events and developments as they occur, rather than reporting on a periodic six monthly or annual basis.[211] The cornerstone requirement is that once a public issuer "becomes aware" of "material" information that is "not generally available to the market," it must "immediately release" that information.[212] At first glance it seems as if it would be relatively easy for shareholder X to succeed here, as the court has a very broad discretion to make a compensatory order against the issuer. Shareholder X must simply prove a breach on the balance of probabilities,[213] and that he or she suffered loss or damage as a result.[214] There is no need to prove reliance, negligence or even misstatement. Furthermore, shareholder X has a relatively large window of time in which to apply for compensation: at any time within six months after the date on which a declaration of contravention is made.[215]

In reality however the chances of shareholder X successfully recovering damages in this scenario are slim. First, determining whether information is "material" is notoriously difficult. As Cunliffe comments, "[m]ateriality is a murky concept…and is commonly known as an "ulcerating experience.""[216] Materiality means "of serious or substantial import,"[217] and is defined by reference to a "reasonable person" test.[218] It is not easy to ascertain whether this test is satisfied, as it depends on the specific facts and circumstances of the particular issuer[219] and "requires expert evidence on the

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[210] Securities Markets Act 1988, s 2(1).
[211] S Griffiths "Aussie Rules? "Reform" of New Zealand Securities Law" (2004) 22 C&SLJ 73. The goals of the regime are outlined in section 19A(2) of the Securities Markets Act 1988.
[212] Securities Markets Act 1988, s 19B. For detailed information on these elements and the mechanics of the regime see: New Zealand Exchange Limited, *Guidance Note: Continuous Disclosure,* March 2005, <http://www.nzx.com/market-supervision/rules/nzsx-and-nzdx-listing-rules> (accessed 20 September 2009).
[213] Securities Markets Act 1988, s 42ZI.
[214] Securities Markets Act 1988, ss 42ZA and 42ZB.
[215] Securities Markets Act 1988, s 42ZJ.
[216] S Cunliffe "Materiality: An obstacle to enforcement of insider trading law" (2008) 1 NZLSJ 449.
[217] *Haylock & Ors v Patek & Anor* [2009] 1 NZLR 351, [462].
[218] See Harrison J's comments in *Auckland International Airport Ltd v Air New Zealand Ltd* (2006) 9 NZCLC 264, 279 at [57].
[219] S Griffiths "The Secondary Market" in *Company and Securities Law in New Zealand* (Brookers, 2008), 1079. H Ford, R Austin & I Ramsay *Ford's Principle of Corporations Law* (Butterworths, 2005), 545-546.

hypothetical price implications of releasing information to the market at a particular time."[220] These difficulties are further compounded by the exception in NZX Listing Rule 10.1.1(a) to when information is material. In broad terms, it excludes confidential information that a reasonable person would not expect to be disclosed, where that information is in some sense "embryonic" or in the early stages of development.[221] However it is very difficult to assess when this exception no longer applies where the information is "ripening" from a mere conception to concrete implementation, or where prospective facts relating to a contingent event such as a takeover are involved.[222] Furthermore, the due diligence defence[223] may significantly diminish the potential for shareholder X's company to be found liable, depending on the effectiveness of the company's policies and procedures to ensure appropriate continuous disclosure.

Secondly, even if shareholder X manages to prove liability, it would only be worth making a claim if the company has substantial unsecured assets. As Harris and Hargovan point out, "if a company had all of its assets secured to the full value of the secured loan, the company's general creditors (including shareholders such as Margaretic [or shareholder X]) would receive nothing."[224] A New Zealand example of this is the Feltex Carpets litigation, where although the company was found to have breached the continuous disclosure provisions, it had no material assets, so was not worth claiming against in court.[225] It may also be very difficult to assess the quantum of the loss and damage where the value of the claims has fluctuated during an extended period of breach of continuous disclosure obligations.[226] The practical implications of allowing shareholder X to claim in this scenario are further limited as the continuous

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[220] T Clarke "Case study: Sons of Gwalia," 17 October 2007,10. For an example of how expert estimates of share price variability can affect materiality, *Haylock & Ors v Patek & Anor* [2009] 1 NZLR 351, at [464]-[469].
[221] S Griffiths "The Secondary Market" in *Company and Securities Law in New Zealand,* 1080.
[222] G Golding & N Kalfus "The continuous evolution of Australia's continuous disclosure laws" (2004) 22 C&SLJ 385, 392.
[223] Securities Markets Act 1988, s 19PA.
[224] A Hargovan & J Harris "Sons of Gwalia Ltd v Margaretic: The shifting balance of shareholder's interests in insolvency: Evolution or revolution?" 611.
[225] Securities Commission of New Zealand *Feltex Carpets Limited IPO Prospectus, Financial Reporting and Continuous Disclosure,* 11 October 2007, <http://www.seccom.govt.nz/publications/documents/feltex/index.shtml> (accessed 20 September 2009), at [91]-[92].
[226] J Sarra "Risk allocation and efficient administration: A comparative analysis of the treatment of equity securities claims in insolvency," 27.

disclosure provisions only apply to listed companies, and in New Zealand the vast majority of companies are unlisted.[227] Thus while a claim for breach of continuous disclosure will incur high costs of time and money due to the difficult issues involved, in reality shareholder X would only litigate against his or her company in exceptional circumstances. Thus allowing a claim will only have minor implications for the efficiency of the insolvency regime, and will not justify subordinating shareholder X's claim.

3 Scenario (b): Shareholder X claims compensation under the Fair Trading Act 1986, or under the tort of deceit or negligent misstatement

3.1 Section 9 of the Fair Trading Act 1986 (NZ)[228]

Section 9 of the Fair Trading Act 1986 provides that "no person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive." Although whether the Fair Trading Act 1986 applies to all securities is doubtful,[229] it certainly applies to shareholder X's shares in this scenario.[230] This type of claim is of most concern to the efficiency of the insolvency regime, as it is here shareholder X is most likely to successfully claim damages from his or her company. As Trotman and Wilson note, section 9 is "intended as a catch-all, anti loophole provision"[231] of very broad scope, and "is based upon a broadly stated standard of commercial probity…not limited to knowing or intentional conduct."[232] It is difficult to draw any blanket hypotheses as to how difficult shareholder X will find it to prove liability, as this question depends on the particular facts and circumstances and whether the other shareholders in the same "class" as shareholder X have been misled.[233] For example,

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[227] D Brown "Sons of Gwalia – relevant for New Zealand?" NZ Lawyer 17 August 2007.
[228] Note this discussion of section 9 of the Fair Trading Act 1986 excludes claims made by subscribing shareholders which would be covered by the Securities Act 1978: this is considered below in part four of this chapter.
[229] "Security" is defined in section 2 of the Securities Markets Act 1988 by a relationship to a collection of "rights," rather than as an item of personal property such as a share (see n 230 below): S Griffiths "The Secondary Market" in *Company and Securities Law in New Zealand*, 1116.
[230] *CBP Industries Ltd v Bowker Holdings* No 16 Ltd (1987) 3 NZCLC 100,035; *Miln v Stratford Fisheries Ltd* (1988) 4 NZCLC 64,428; *Jagwar Holdings Ltd v Julian* (1992) 6 NZCLC 68,040. See also the definition of "goods" in section 2(1) of the Fair Trading Act 1986, which states that a good is an intangible or tangible item of personal property, and section 35 of the Companies Act 1993 which states that a share is an item of personal property. Furthermore, as Griffiths notes, the inclusion of section 19A of the Securities Markets Act 1988 is also evidence of a clear policy choice that the Fair Trading Act 1986 may apply to shares: S Griffiths "The Secondary Market" in *Company and Securities Law in New Zealand,* 1115.
[231] L Trotman & D Wilson *Fair Trading: Misleading or Deceptive Conduct* (LexisNexis NZ Ltd, 2006), 3.
[232] *Ibid,* page 4.
[233] *Savill v NZI Finance Ltd* [1990] 3 NZLR 135, 136.

the company may not be liable for silence, a misleading prediction, a statement of intention, belief or opinion on its own. Yet the latter conduct may very well be misleading or deceptive if it involves something "more" such as a half-truth, or there is a material change of circumstances.[234]

Even if shareholder X successfully proves breach of section 9, this will not necessarily result in an award of compensation.[235] First, shareholder X must prove detrimental reliance on the company's conduct. Though the misleading conduct need not be the sole reason for shareholder X's loss or damage, he or she must show that a reasonable person would also have been misled.[236] Again the likelihood of success will depend on the circumstances. However proving reliance in a representative order or class action may be troublesome, as each individual shareholder must establish reliance: the main plaintiff's evidence cannot be relied upon collectively by the other shareholders.[237] This of course could add considerable time to a liquidation, and significantly delay payment to the other unsecured creditors. Lastly, as Cooke P pointed out in *Goldsbro v Walker*, the Court has a discretion to award shareholder X only a small amount or nothing at all.[238] In such a case, allowing shareholder X to claim would naturally have little or no effect on the other unsecured creditors or the efficiency of the liquidation.

Further complexity is added to shareholder X's claim as the court or liquidator must also find the company liable under section 13 of the Securities Markets Act 1988.[239] This section has a very broad ambit, and is similar to section 9 of the Fair Trading Act 1986. It applies to all securities in both listed *and* non-listed companies, and applies to all "dealings" in securities, rather than just trading.[240] A key result of the requirement for consistency between the two Acts is that the exceptions to section 13 also apply to the Fair Trading Act 1986. Thus a company in this scenario will not be liable if the

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[234] See generally: L Trotman & D Wilson *Fair Trading: Misleading or Deceptive Conduct* (LexisNexis NZ Ltd, 2006); S Todd "Negligence: The Duty of Care" *The Law of Torts in New Zealand* (Brookers Ltd, 2009), 217, [5.808].
[235] Sections 43(1)(a) and (2)(d) of the Fair Trading Act 1986 allow the Court to order the company to pay shareholder X compensation.
[236] L Trotman & D Wilson *Fair Trading: Misleading or Deceptive Conduct,* chapter 12.
[237] *Houghton v Saunders* (HC Christchurch, CIV 2008-409-000348, 7 October 2008, French J) [107]-[110] (*"Houghton v Saunders").*
[238] *Goldsbro v Walker* [1993] 1 NZLR 394, 399.
[239] Fair Trading Act 1986, s 5A; Securities Markets Act 1988, s 19.
[240] Securities Markets Act 1988, ss 13(2) and 2(1). Note section 13 will also apply to an offer of unlisted shares to shareholder X.

misleading conduct relates to a takeover,[241] repurchase of shares[242] or an offer of listed securities to the public.[243] Unless one of these exceptions apply however, if the company is liable under section 9 of the Fair Trading Act 1986, it will likely also be liable under section 13 of the Securities Markets Act 1988. Shareholder X could then claim under section 42ZA of the Securities Markets Act 1988. It is possible the limits to a section 43 award of compensation in the Fair Trading Act 1986 (discussed above) would also apply to any award made pursuant to section 42ZA.[244] However this is uncertain as there is no specific section stating the available remedies between the two Acts must be consistent.[245]

3.2 The tort of negligent misstatement

The courts take a very strict approach to the tort of negligent misstatement, in order to avoid imposing "liability in an indeterminate amount for an indeterminate time to an indeterminate class."[246] Mere foreseeability that shareholder X would be affected by the misstatement is not enough: the company must make the misstatement knowing and intending that potential investors like shareholder X will rely upon it for the particular purpose of buying shares on the secondary market.[247] Shareholder X will have difficulty proving this however. First, no proximate relationship will exist where shareholder X uses a statement made by the company for some purpose other than that specifically intended by the company. For example, in *Al-Nakib Investments* a duty of care existed to persons who subscribed for shares in reliance on a prospectus. Yet no duty was owed to shareholders on the secondary market who used the same prospectus for the different purpose of buying shares on the stock market.[248] As Richmond P noted in *Scott Group*, "the annual accounts of a company can be relied on in all sorts of ways

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[241] *Ibid,* s 14.
[242] *Ibid,* s 15.
[243] *Ibid,* s 16.
[244] Fair Trading Act 1986, s 5A; Securities Markets Act 1988, s 19.
[245] Section 19 of the Securities Markets At 1988 refers to "liability" only, and not to remedies.
[246] *Ultramares Corporation v Touche* 174 NE 441 (1931) at p 444, per Cardozo CJ. See also: Todd "Negligence: The Duty of Care" *The Law of Torts in New Zealand,* 206, at [5.8].
[247] Richmond P's dissent in *Scott Group Ltd v McFarlane* [1978] 1 NZLR 553, 566 (*"Scott Group")*; *Caparo Industries Plc v Dickman and Ors* [1990] 1 All ER 568; *Boyd Knight v Purdue* (1999) 8 NZCLC 261 (*"Boyd Knight"); Jagwar Holdings Ltd v Julian* (1992) 6 NZCLC 68,040.
[248] *Al-Nakib Investments (Jersey) Ltd v Longcroft* [1990] 3 All ER 321 (*"Al-Nakib Investments").* See generally: S Todd and J Burrows "Deliberate Falsehoods" *The Law of Torts in New Zealand* (Brookers Ltd, 2009), 707, at [15.2].

and for many purposes."[249] Accordingly, it may not be easy to prove the company intended a specific purpose in relation to shareholders in X's position. Secondly, the company will not be liable if shareholder X simply glanced at the financial statement and relied upon it in a general way. He or she must prove they actually looked at the inaccurate financial statement and relied upon its basic features: for example on the profit level or current assets/liability ratio; and that this reliance was the cause of his or her loss.[250] Finally, a court may be reluctant to recognise a duty of care here, as doing so would cut across the alternative remedies in the Securities Markets Act 1988 and Fair Trading Act 1986.[251] Thus it will be very difficult indeed for shareholder X to successfully prove a claim for negligent misstatement.

3.3 The tort of deceit

To succeed in an action for deceit shareholder X must first show the company made a false representation of a past or existing fact.[252] Like the claim under section 9 of the Fair Trading Act 1986 in part 3.1 above, shareholder X may face difficult territory here.[253] Secondly, shareholder X must show the company made the representation knowing it to be untrue or without belief in its truth or with reckless disregard to its truth, and intending shareholder X to rely upon it.[254] This may be quite onerous, as shareholder X must also show that either the primary rules of attribution apply,[255] or that the maker can be held vicariously liable.[256] In addition, shareholder X must also show actual reliance upon the representation to his or her detriment; with the corresponding problems detailed above. Thus again the scope of this type of claim is quite narrow, so allowing shareholder X to claim is unlikely to spur a flood of litigants.

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[249] *Scott Group,* 566.
[250] *Boyd Knight,* at [57].
[251] *Rolls-Royce New Zealand Ltd v Carter Holt Harvey Ltd* [2005] 1 NZLR 324. On the other hand, section 65 of the Securities Act specifically provides that nothing in the Act shall limit or diminish any liability that any person may incur under any rule of law or enactment.
[252] The elements of deceit are set out in *Amaltal Corporation Ltd v Maruha Corporation* [2007] 1 NZLR 608 at [46] and [55] (*"Amaltal Corporation").*
[253] For example if the representation is an opinion, belief, statement of intention or silence.
[254] *Amaltal Corporation,* at [46] and [55].
[255] *Meridian Global Funds Management Asia v Securities Commission* [1995] 3 NZLR 7; 2 AC 500 (PC). A director, board of directors or other corporate agent may be liable under the primary rules of attribution. Note if their fraudulent and dishonest behaviour adversely affects the company it cannot be attributed to the company: S Watson "Corporate Liability for Criminal and Civil Wrongs" in *Company and Securities Law in New Zealand* (Brookers, 2008), 176-177.
[256] *Ibid,* 178.

3.4 Conclusion: Scenario (b)

If shareholder X brings a claim here, overcoming the above difficulties will likely entail significant delay in the administration process, to the detriment of the other unsecured creditors. However this does not justify subordinating shareholder X, as a mass of shareholder claims is unlikely even if class actions do become established in New Zealand. A proprietary company must have sufficient unsecured assets for litigation to be worthwhile, and litigation funders would be unlikely to support a class action unless the proprietary company had a large number of shareholders.[257] Furthermore, it is quite possible that shareholders of proprietary companies might attempt to save the business by putting the company into voluntary administration rather than pursuing a claim for misleading or deceptive conduct.[258] Finally, as Harris and Hargovan point out, another limitation is that "controlling shareholders of proprietary companies may have difficulty establishing a cause of action given that they are likely to have been involved in the process leading up to the information being disclosed."[259]

4 Scenario (c): Shareholder X subscribes for shares in a listed company on the basis of a misrepresentation, and claims compensation under the Securities Act 1978.

Whether shareholder X can rank equally with creditors in this scenario is ultimately of little consequence. The relevant statute in this scenario is the Securities Act 1978, however it does not allow shareholder X to claim compensation from his or her company. Although section 56 allows an award of compensation to be made if a "person" is found civilly liable for distribution of an advertisement or registered prospectus that includes an untrue statement, section 56(1)(a) requires that "person" to be an "individual,"[260] while sections 56(1)(a) and (b) require that "person" to be a director. These sections clearly exclude a company from liability. However a company may be liable under section 56(1)(d) if it is a "promoter," as section 2(1) of the Securities Act 1978 includes companies as promoters, *as well as* "every person who is a

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[257] A Hargovan & J Harris "Sons of Gwalia Ltd v Margaretic: The shifting balance of shareholder's interests in insolvency: Evolution or revolution?" 611.
[258] *Ibid,* 612.
[259] *Ibid.*
[260] While "individual" is not defined in the Securities Act 1978, given the context of the section it may be safely presumed to intend a human individual.

director thereof."[261] In my view, given the preceding sections only apply to individual human persons, it seems somewhat inconsistent for section 56(1)(d) of the Securities Act 1978 to also allow companies to become liable. However this exception (if it applies) is quite narrow, and is unlikely to lead to a flood of claims.

A similar barrier exists to shareholder X claiming compensation under the Fair Trading Act 1986. As noted above, the company cannot be liable under the Fair Trading Act 1986 unless it is found liable under the Securities Act 1978 or the Securities Markets Act 1988.[262] However shareholder X's company is unlikely to be criminally liable for misstatement under the Securities Act 1978, as aside from the possible exception for "promoter," section 56 only applies to human individuals.[263] Neither will section 13 of the Securities Market Act 1988 impose liability, as it does not apply to offers of securities of the public for subscription under the Securities Act 1978.[264] It is possible that shareholder X may have a successful cause of action for negligent misstatement here, as the company made the prospectus with the particular purpose of inviting a subscription for shares.[265] However as discussed above, establishing shareholder X relied on that prospectus may be very difficult, and the listed company must be worth claiming against. Thus whether a *Soden*-type distinction is made in New Zealand to subordinate subscribing shareholders will be of little practical import.

5 Scenario (d): In each of the above scenarios the company only commits the wrong after shareholder X had bought the shares.

This scenario again is unlikely to impact on the efficiency of the insolvency regime, as shareholder X is likely to have great trouble showing the company's conduct caused his or her loss. As CAMAC explains, the main problem lies in determining the price of the shares. This will not be easy. The majority in *Sons of Gwalia* awarded damages to

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[261] Given the preceding sections only apply to individual human persons, it seems somewhat inconsistent for section 56(1)(d) of the Securities Act 1978 to also allow companies to become liable.
[262] Fair Trading Act 1986, s 5A.
[263] Note it is uncertain in New Zealand whether issuing a prospectus, authorised advertisement or investment statement is actually "engaging in conduct" under the Fair Trading Act 1986. Thus it will be up to a future court to decide whether to follow the Australian position that the definition of "conduct" does cover this area: *Fraser v NRMA Holdings Ltd* (1994) 12 ACLC 855.
[264] Securities Market Act 1988, s 16.
[265] Such a duty was held to have been owed in *Al-Nakib Investments.* Further, *Houghton v Saunders* French J thought it "highly arguable" that a sufficiently proximate relationship existed to potential investors.

Mr Margaretic for the difference between the price of the shares and their value on a properly informed market.[266] A New Zealand court will almost certainly quantify shareholder X's damages in the same way. Since the breach may have resulted in an artificially high market price, shareholder X must show that the shares in a properly informed market would still have sold at a price higher than the eventual value of the market.[267] Yet as Duffy points out, without that misleading statement the high price may not have been available.[268] Thus shareholder X may not have considered selling his or her shares anyway. Indeed, they may have been unable to sell them. As Callinan J stated in *Sons of Gwalia,* "in a properly informed market [those] shares would also have been valueless: nobody would have wanted to have had any part of them."[269]

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[266] *Sons of Gwalia,* at [266].
[267] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 29.
[268] M Duffy "After Sons of Gwalia: Some perspectives on the position of shareholders and creditors and the question of law reform," 23.
[269] *Sons of Gwalia,* per Callinan J at [256].

CONCLUSION

From the discussion above it is clear that classing shareholder X as a creditor is unlikely to be a "corporate bombshell" and cause an exponential rise in shareholder litigation in New Zealand. None of the claims are easily established, and shareholder X will only bother claiming if the company has sufficient unsecured assets. A further deterrent is the possibility that shareholder X may face adverse cost orders if unable to prove his or her claim.[270] The impact of ranking shareholder X equally with unsecured creditors is further lessened when it is considered that most companies fall victim to insolvency due to business risk or an unfavourable economic environment such as the recent financial crisis, and are unaccompanied by misleading or deceptive practices. The issues raised by *Sons of Gwalia* will of course have no effect on such "innocent" corporate failures.[271] Furthermore, Kendall points out that "an important aspect of S*ons of Gwalia*, often glossed over, is that the issue of subordination only ever arises in the event of corporate failure. Fortunately few companies go down this path, particularly those that are publicly listed."[272]

However while the circumstances in which shareholder X will bring a claim may be rare, it is clear from the discussion above (and indeed from the *Sons of Gwalia* case itself) that such a claim is not impossible. None of the *Sons of Gwalia*-type scenarios posed above are remarkable, and similar cases are bound to come before the courts in the future. Indeed, French J in *Houghton v Saunders* stated recently that "[h]aving regard to developments in other jurisdictions, it is highly likely claims of the type…will become increasingly common in New Zealand."[273] Due to the costs of litigation it is hard to imagine when an individual shareholder would claim against a company in the scenarios above, particularly in respect of breach of continuous disclosure. Thus establishment of class actions in New Zealand is a realistic prospect; in which case the

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[270] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 32

[271] A Hargovan & J Harris "Sons of Gwalia Ltd v Margaretic: The shifting balance of shareholder's interests in insolvency: Evolution or revolution?" 611.

[272] K Kendall "Subordination of shareholder claims in Australia: A comparison with the United Kingdom post-Sons of Gwalia" (2009) 1 JIBLR 13, 19.

[273] *Houghton v Saunders,* [228]. It is likely that his Honour was referring to the rise in numbers of class actions in Australia, and the increased levels of investor protection such as section 13 of the Securities Markets Act 1988.

liquidation of a company will be considerably delayed. However for the reasons given in chapter three, it is likely that even in a class action, a New Zealand court would agree with CAMAC that "although aggrieved shareholder claims may add a layer of complexity to external administrators...making external administrations simpler, quicker or more expedient does not justify postponing a category of shareholder creditors."[274]

Yet though a claim by shareholder X may not have dire consequences, this area is overdue for reform. As this paper has argued, if and when a *Sons of Gwalia* type scenario does arise in New Zealand, a court will face the formidable task of determining both X's substantive claim and the procedural issues outlined in chapters two and three. As discussed in chapter three, it is likely the legislature did not overtly consider the difficult implications arising from the operation of investor protection law in insolvency. This has led to a troublesome gap in the law that has only been widely recognised in light of the *Sons of Gwalia* decision;[275] and is perhaps illustrative of the dangers of making law in a vacuum without close regard to neighbouring policy areas. As CAMAC bluntly puts it, 'this is an area where certainty is required."[276] The way in which this conflict between insolvency and investor protection law is resolved has crucial implications for allocation of shareholder and creditor property rights upon insolvency. In my view, the legislature should insert a section into the Companies Act 1993 which makes it clear that shareholders may claim in the capacity of a creditor in this type of scenario. This would render extensive debate over the issues discussed in chapters two and three unnecessary, and improve certainty and efficiency in both the insolvency law and investor protection regimes. Furthermore, as Austin J of the New South Wales Supreme Court comments:

> …the law in this area often has to be administered, day to day, by insolvency practitioners rather than senior counsel. They should not be left in a position where they find it necessary to obtain legal advice whenever shareholder claims

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[274] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 51.
[275] See part 3.1 of chapter two.
[276] Australian Government Corporations and Markets Advisory Committee, *Shareholder claims against insolvent companies: Implications of the Sons of Gwalia decision*, 63.

> are made, regardless of the size of the company that is subject to administration. In other words, there is a very strong case for simplification.[277]

Thus the legislature needs to also consider how these procedural difficulties may be ameliorated. Ultimately however the best and most efficient way to deal with these *Sons of Gwalia*-type scenarios may only be determined by future litigation and first hand practical experience.[278]

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[277] R Austin, J "'Implications of the Sons of Gwalia Decision' A commentary on the paper by Konrad de Kerloy" Law Council of Australia Business Law Section Corporations Workshop, (20-22 July 2007), <http://www.lawlink.nsw.gov.au/lawlink/supreme_court/ll_sc.nsf/pages/SCO_austin200707> (accessed 20 August 2009).

[278] L. Griggs "Sons of Gwalia paves road for trade practices issues for shareholder investments" (2007) 23 AMLB 1, 9.

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