

WHERE DOES INSOLVENCY LEAVE THE SHAREHOLDER?

As businesses face financial pressures due to the economic environment, insolvency, or the inability of a corporation to pay its debts as and when they fall due is of increasing concern.

In our October 2005 newsletter '*Boost to Shareholder's Rights*', we discussed how the Federal Court of Australia had in that same year, significantly expanded the rights of shareholder to recover damages in a corporate insolvency scenario. This decision was appealed to the High Court of Australia in 2007. In *Sons of Gwalia v Margaretic [2007] HCA 1 (Decision)*, the High Court of Australia upheld the earlier 2005 Federal Court decision.

Prior to this Decision, s.563A of the *Corporations Act 2001 (Act)* provided that shareholders ranked behind all other creditors and were unlikely to receive any entitlement in a corporate insolvency scenario.

Sons of Gwalia

In the 2007 Decision, it was held that the shareholder had been misled and deceived by the company because the company had breached its continuous disclosure requirements under s.674 of the Act, which entitled the shareholder to recover the difference between the purchase price that it paid for the shares and their value after the company went into administration.

Essentially, the Decision confirmed a shareholder's ability to stand alongside all other unsecured creditors to recover damages from an insolvent company.

What does this all mean?

The implications of the Decision for shareholders and companies are without a doubt very significant. Shareholders benefit from the provision of recourse against the insolvent company where the shareholder is aggrieved. For example, if the insolvent company appears to undermine the shareholder's direct rights of action to recover damages based in legislation, the shareholder will be able to stand alongside non-shareholder creditors (as contingent creditors) to recover damages when a company becomes insolvent.

Companies on the other hand take caution not to intentionally or unintentionally undermine shareholders' direct rights of action based in legislation or they may be held liable to their shareholders even during insolvency for damages.

Future Directions

It is clear that a shareholders' right to recover entitlements including dividends and damages at the time of corporate insolvency are now supported by the Decision.

This position may however change in the coming months owing to the significant pressure from the insolvency industry on the Federal Government for immediate legislative intervention with the aim of reversing the impact of the Decision.

The Corporations and Markets Advisory Committee (CMAC) released a detailed report on the issue entitled '*Claims by shareholders against insolvent companies: implications of the Sons of Gwalia decision*' in December 2008. The CMAC did not recommend that the Decision be reversed by way of legislative intervention by the Federal Government.

The insolvency industry however has not received the findings of the CMAC report well and has convinced the Federal Government to undertake further investigation into the issue. The industry considers that adding shareholders to the mix of creditors at the time of insolvency, complicates the task of managing the insolvent company, thereby forcing up liquidators' costs and increasing the costs of debt financing for corporations.

How to protect yourself

As the law stands in Australia today, a shareholder has powerful recourse available to it to hold an insolvent company to account for damages and other entitlements on equal footing as all other unsecured creditors.

For the time being, it is not clear if the Federal Government will introduce legislation to reverse the impact of the Decision. Shareholders should take advantage of the Decision's impact and review their Shareholders' Agreements to ensure that the terms of their Agreement expressly set out their rights and position in relation to recovery of damages in a corporate insolvency scenario.

Summary

Shareholders should act swiftly and obtain advice as to their rights or a restructure of the Shareholders' Agreement.

If you would like any further information on this topic, please contact Ishita Sethi on 02 8239 6514 or ishita.sethi@kreissonlegal.com.au



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