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Scope of Services:

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Contractual + commercial litigation
Directors' + officers' cover
Discrimination law
Employment contracts
Employment law
Equal opportunity
Financial services
General insurance
Life insurance
Medical defence
OH+S
Policy drafting + interpretation
Professional indemnity
Public + products liability
Self insurance
Superannuation
Trade + transport + aviation

SONS OF GWALIA
High Court of Australia
31 January 2007

INTRODUCTION

The *Sons of Gwalia* decision was greeted by commentators as an important win for aggrieved shareholders. The decision allows misled shareholders to rank alongside unsecured creditors in the administration of a failed company.

However, the effect of the decision on certainty for investors and unsecured investors in the administration may not be as positive.

BACKGROUND

Sons of Gwalia (*"SOG")* was a publicly listed gold mining company. The Respondent in this matter, Mr. Luka Margaretic, paid $26,200 for 20,000 shares in SOG eleven days before the company went into voluntary administration.

The Respondent argued that when he bought his shares, SOG was in breach of the *Australian Stock Exchange Rules* as its gold reserves were insufficient to meet its gold delivery contracts. Mr. Margaretic argued that this information should have been reported to the market.

SHAREHOLDER'S CLAIM

The Respondent made a claim for the difference between the cost of his shares and their value (nil) on the basis of misleading and deceptive conduct under *Section 52 of the Trade Practices Act 1974 (Cth)* ("*TPA*") and *Section 12DA* of the *Australian Securities and Investments Commission Act 2001 (Cth)* ("*ASIC Act*").

FINDINGS

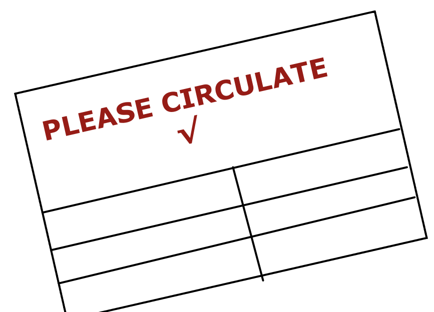
In the Federal Court, the administrators of SOG (Ferrier Hodgson) argued that by reason of *Section 563A* of the *Australian Corporations Act,* the Respondent's shareholder claim must be subordinate to the claims of unsecured creditors *("Corporations Act.").* Under this section shareholders or members of failed companies rank behind creditors.

"… shareholders may now initiate litigation that will substantially delay the administration process …"

The Administrators failed in this argument both at the Federal Court level and in the High Court.

The High Court found that the Respondent's loss occurred before the company went into administration and was, therefore, a debt against the company under *Section 553* of the *Corporations Act.* It found that *Section 563A* of the *Corporations Act* was not applicable to the Respondent's claim arising from misleading and deceptive conduct.[1]

This finding resulted in the Respondent receiving the same ranking as other unsecured creditors in the administration.



CONSEQUENCES OF THE DECISION

Under *Section.435A* of the *Corporations Act,* the purpose of voluntary administration is to "*maximise the chances of the company, or as much of its business as possible, continuing in existence*."

This aim will, in our view, be undermined by the High Court's decision, as shareholders may now initiate litigation that will substantially delay the administration process and introduce major uncertainty for both unsecured creditors and administrators.

Under voluntary administration legislation, the administrator is obliged to produce a report before the second meeting of creditors, which includes an estimate of return to creditors.

Misleading and deceptive conduct claims are complex and normally require a significant amount of time to investigate and resolve. It will be difficult for administrators to estimate the potential of such claims in this timeframe. This will make it difficult for creditors to assess the future of the company. Delays in the administration will also, in our opinion, diminish the likelihood of the company being revived through the use of a *Deed of Company Agreement.*

"… From an insurance perspective, it is possible that this may be another trigger for a hardening of the D&O liability insurance market …"

Shareholder actions will also add expenses to the administration process.

LEGISLATIVE INTERVENTION

There have been calls for legislative intervention to clarify the position of unsecured creditors and misled shareholders in relation to their ranking in an administration.

[1] Under Section 563A of the Corporations Act shareholders or "*members*" of failed companies rank behind creditors.

One view (which we would endorse), is that shareholders who have sustained a loss due to misleading and deceptive conduct should perhaps rank ahead of other shareholders but that for the sake of certainty and efficiency, all shareholders should still rank behind unsecured creditors.[2]

PREDICTIONS

Some commentators have seen the emphasis on disclosure obligations in this decision as significant, as it emphasises increased scrutiny of directors and officers. From an insurance perspective, it is possible that this may be another trigger for a hardening of the D&O liability insurance market.[3]

There has also been speculation that the decision may encourage litigation funders (such as IMF who funded this claim) to speculate further in this type of claim.

CONCLUSION

This recent decision by a majority of the High Court, will have far reaching ramifications. The decision may interfere with voluntary administrations and make the resuscitation of failing companies more difficult to achieve.

It now remains to be seen if (and how) the issue of misled shareholder ranking in administrations will be dealt with by the legislature.

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[2] Mark Korda, *Gwalia ruling creates need for new legal category of aggrieved shareholder*, The Age, 2 February 2007.
[3] Colin Biggers & Paisley, Legal Update, 1 February 2007.

HOUGHTON & ANOR v. ARMS
High Court of Australia
13 December 2006

The following case received significant press late last year. The High Court found that employees were personally liable under the *Fair Trading Act* for work carried out in the course of their employment.

THE FACTS

Mr Arms had an idea for the direct marketing of products to small to medium independent wineries. He engaged WSA Online Limited to develop an internet website – www.austcellardoor.com.au. Arms's expectation was that direct sales would attract a lower range of sales tax and would avoid the need for the payment of a retail margin which is normally in the order of 30%.

Arms was introduced to two employees of WSA, Mr Student and Mr Houghton. At a meeting in late January 2000, Houghton told Arms that he was aware of a financial transaction product called "*ANZ Egate*" that was "*perfect*" for Mr Arms's requirements. Arms was told that this facility would enable customers to pay by means of credit card. Customers could be added to the Aust Cellar Door website incorporating the ANZ Egate facility by simply filling in a form and paying a small set up fee.

"… to maintain the price expectations that he represented to his customers, Arms operated his business at a loss for 12 months …"

But nothing is ever simple with the banks. In February 2000, Houghton and Student came to learn that the ANZ facility required customers to have an ANZ credit card merchant facility and each customer would be subject to an approval process consisting of application forms, financial data and possibly a business plan.

In June 2000, Student and Houghton broke this news to Arms and confessed that they were mistaken about the operation of the ANZ facility. By that time, Arms had already enrolled about thirty wineries and the website was to be launched within 5 days. It was therefore impossible for Arms to arrange for the wineries to comply with the bank's conditions.

To maintain his credibility and goodwill, Arms converted Australian Cellar Door into a retailer with a small mark up. Sales tax was now payable at a higher rate but to maintain the price expectations that he represented to his customers, Arms operated his business at a loss for 12 months.

After a year in business, he adopted a different business structure that permitted him to make a profit.

FEDERAL COURT

Arms commenced proceedings against WSA, Houghton and Student alleging misleading and deceptive conduct. Arms recovered judgment against WSA but his claims against Houghton and Student were dismissed. WSA was subsequently subject to a Deed of Company Arrangement.

"… Arms relied on Section 9 of the Fair Trading Act alone in his claim against the employees of WSA …"

FULL COURT

Arms appealed against the dismissal of his claims against Houghton and Student. The Full Court allowed his appeal and entered judgment against Houghton and Student.

HIGH COURT

Houghton and Student appealed to the High Court.

In a unanimous joint decision of Gleeson CJ., Gummow, Heydon and Crennan JJ, Houghton's and Student's appeal was dismissed.

What is significant about this litigation is that Arms did not rely on the accessorial liability provisions under the _Trade Practices Act_ which make individuals knowingly concerned in misleading and deceptive conduct of a company personally liable. Furthermore, at the relevant time (1999-2003), the _Fair Trading Act_ did not include an accessorial liability provision. Arms relied on Section 9 of the _Fair Trading Act_ alone in his claim against the employees of WSA. Section 9 provides:-

> *"a person must not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive*".

The two issues confronting the High Court were firstly, did the Appellants answer to the description of "*a person*" and secondly, were the Appellants acting "*in trade or commerce*".

"… The High Court held that an employee is not excused for wrongful acts because of their employment status …"

Confirming the decision in *Concrete Constructions (NSW) Pty Ltd v. Nelson*, the High Court found that the representations by the Appellants in respect to the ANZ facility were made in trade or commerce. Further, statements made by a person not himself or herself engaged in trade or conduct may satisfy the statutory expression if they are designed to encourage others to invest or to continue investment in a particular trading entity.

The High Court held that an employee is not excused for wrongful acts because of their employment status. There was no good reason for treating the text of section 9 to read "*a person (as principal) must not …*". The High Court also held that the main purpose of the _Fair Trading Act_ was to promote fair trading practices and to exclude employees from the operation of the Act would not promote that object.

As such, the Appellants were "*persons*" under the Act, even though at all times they were employees of WSA.

Employees be on your guard!

By Mark Attard
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Interesting Fact !

In 1897, Herbert Hoover, aged 23, arrived on the WA goldfields. He stayed two years, working as a manager of the Sons of Gwalia mine. In 1929, he became the 31st President of the United States.

Courtesy of MX News

M+R NEWS UPDATE

This month, two new staff members join M+R. We welcome **Sean Millard**, Special Counsel, working primarily with Bruce Butler in the areas of employment law and worker's compensation, as well as **Adam Meyer**, Lawyer, who will be joining Patrick Monahan and Andrew Probert in the area of Professional Indemnity Insurance Litigation.

UPCOMING SEMINARS

Wednesday 2 May 2007

AM session
Boardroom Forum— Is Self Insurance For You?

PM session
- The role and function of Medical Panels
- Employment issues and worker's compensation
- Stress! - Interaction with bullying and harassment
- Lies and video tape: The progression of witness evidence

If you are interested in attending either session, please contact Cheryl Asquith (03 8624 2056) or casquith@mrlaw.com.au

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