

**LITIGATION FUNDING AND SHAREHOLDERS' ACTIONS
AGAINST INSOLVENT COMPANIES**

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A seminar presented by Counsel of Gordon & Jackson's List

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**The High Court's decision in *Sons of Gwalia Inc v Margaretic*
Issues and Implications**

CORRIGENDUM

- Footnote 97 should read “Referring to (inter alia) *Turquand, Tennent* and the statements of Sir George Jessell MR in *Re Hull and County Bank* (1880) 15 Ch D 507, 509-10”.
- In the second paragraph under the heading “Conclusion” (on page 34) the two instances of the word “debt” should read “claim”.

**The High Court's decision in *Sons of Gwalia Inc v Margaretic*
Issues and Implications**

Stewart Maiden¹

*"[M]odern legislation ... has extended greatly the scope of 'shareholder claims' against corporations, with consequences for ordinary creditors who may find themselves, in an insolvency, proving in competition with members now armed with statutory rights ... Section 563A does not embody a general policy that 'members come last'. On the contrary, by distinguishing between debts owed to a member in the capacity as a member and debts owed to a member otherwise than in such a capacity, it rejects such a general policy. If there ought to be such a rule, it is not found in s. 563A."*²

A question which has attracted significant judicial debate and generated considerable media attention in recent times is what rights a shareholder has to bring an action (particularly for misrepresentation) against a company in which he or she owns shares. That question has risen to prominence in part due to the rising number of representative actions being funded by third parties to litigation, particularly professional litigation funders. On 31 January 2007, the High Court delivered much-needed certainty with its decision in *Sons of Gwalia Ltd*. This paper begins by briefly explaining the *ratio* of *Sons of Gwalia*. While the *ratio* itself is simple, the seven separate judgments touch on several complicated issues which took more than 120 years to develop. Those issues can impact on parties who claim against insolvent companies and those with the task of defending such claims. To properly understand those issues, they must be studied in their historical context. This paper undertakes that study, and then uses it as the foundation for a detailed description of the judgments in *Sons of Gwalia*. That description, in turn, informs a discussion of the potential implications of the case.

¹ Barrister, Victorian Bar. Comments and constructive criticism are welcome: please e-mail me at maiden@vicbar.com.au.

² *Sons of Gwalia Ltd (Subject to Deed of Company Arrangement) v Margaretic* (2007) 232 ALR 232; (2007) 81 ALJR 525; (2007) 60 ACSR 292; (2007) 25 ACLC 1; [2007] HCA 1 ("Sons of Gwalia"), [18]-[19] per Gleeson CJ.

Sons of Gwalia

Margaretic purchased shares in Sons of Gwalia Limited on market for \$1.31 per share. Less than a fortnight later, administrators were appointed to the company. Practically, Margaretic's shares were valueless from the time when trade in the shares was suspended following the announcement of the Administrators' appointment. The Administrators recommended to the second meeting of the company's creditors that the creditors vote to require the company to execute a deed of company arrangement. The proposed deed imported provisions of the *Corporations Act 2001* (C'th) (the "Corporations Act") dealing with the proof of debts in liquidation.

Margaretic claimed to be a creditor of the company. He alleged the company had breached its obligations under s. 674 of the Corporations Act by failing to comply with the ASX Listing Rules at the time he purchased his shares, causing him loss. He also claimed the company had engaged in misleading and deceptive conduct under s. 1041 of the Corporations Act, s. 52 of the *Trade Practices Act 1974* (C'th) (the "TPA") and s. 12DA of the *Australian Securities and Investments Commission Act 2001* (C'th) (the "ASIC Act").

The Administrators applied to the Federal Court, seeking a declaration that Margaretic's claim was not provable under the proposed deed, and alternatively, a declaration that payment of the claim under the proposed arrangement would be postponed until all debts owed to or claims made by persons other than in their capacity as members of the company had been satisfied. The other party to the litigation, ING Investment Management LLC, was a non-shareholder creditor whose interests would have been adversely affected if Margaretic's claim and those of his fellow shareholders were given equal ranking to those of the non-shareholder creditors.

Margaretic's claim was upheld by Emmett J at first instance, and subsequently by the Full Federal Court. Those decisions are discussed later. When the case reached the High Court, a 6:1 majority³ decided that:

³ Gleeson CJ, Gummow, Kirby, Hayne, Heydon and Crennan JJ; Callinan J dissenting.

1. Margaretic had a claim against the company, the circumstances giving rise to which arose before the appointment of the Administrators, and for which he was entitled to prove in the administration as if under s. 553 of the Act; and
2. the claim was not one owed to Margaretic in his capacity as a member of the company, so s. 563A of the Act did not operate to postpone his entitlement to a dividend until satisfaction of non-members' claims.

The majority's judgments were based entirely on the application of ss. 553 and 563A of the Corporations Act. In founding their decisions on the statute, their Honours rejected the approach adopted by the trial judge and the Full Federal Court, and by other first instance and intermediate appellate courts in earlier cases. That now-redundant approach rested on a line of authority usually traced back to the House of Lords' decision in *Houldsworth v City of Glasgow Bank*⁴. To properly understand why the *Sons of Gwalia* decision is said to have had such significant ramifications, one must understand the effect of that earlier line of authority. The earlier cases also bring into relief the relative rights of a company and its contributories once the company enters liquidation – concepts important to understand if one is acting on behalf of any such party in those circumstances.

The *Houldsworth* principle

The earlier line of authority rested upon the proposition that a shareholder could not bring a claim against a company in which he or she held shares for misrepresentations involved in the marketing of those shares without first rescinding the contract to purchase the shares. That gave rise to the question of when such a contract could be rescinded.

The early cases grew largely out of claims by holders of partly-paid shares, or shares in unlimited liability companies, to be relieved from the obligation to pay calls on those shares during liquidation. *Oakes v Turquand*⁵ was one such case. It is authority for the principle that a shareholder retains any liability as a shareholder notwithstanding that he

⁴ *Houldsworth v City of Glasgow Bank* (1880) 5 App. Cas. 317.
⁵ *Oakes v Turquand* (1867) LR 2 HL 325.

or she subscribed for shares pursuant to a contract which is voidable for fraudulent misrepresentation.

Oakes was allotted shares in the listing of a firm of brokers. Statements in the prospectus proved false, and the company was eventually wound up. Oakes applied for an order that his name be removed from the register of contributories, which would have had the effect that no calls could be made upon him. Oakes' argument was summarised by Lord Cranworth:⁶

"There is no doubt that the direct remedy of a creditor is solely against the incorporated company. He has no dealing with any individual shareholder, and if he is driven to bring an action to enforce any right he may have acquired, he must sue the company, and not any of the members of whom it is composed. This being so, the argument of the appellant is, that it is only to the assets of the company that the creditor can resort, and so that the only question is, of what those assets consist ... These assets, he says, consist solely of property in the actual possession of the company, or which the company can recover by means of legal proceedings. In this case the appellant contends that he was induced to become a shareholder by means of a fraud which entitles him to repudiate the status of shareholder, and to say, as between himself and the company, that he never held a share."

The House of Lords found that the prospectus contained "false and fraudulent" statements, and accepted that Oakes acted in reliance on the prospectus in subscribing for his shares. That being the case, Lord Chancellor Chelmsford held that "Oakes might originally have disaffirmed [the contract to take shares] and divested himself of his shares, and that he never did any act to affirm it, nor was aware of the true state of the firm ..."⁷ However, the Lord Chancellor went on to observe that a contract induced by fraud is not void, but voidable at the option of the innocent party.⁸ At the time the company was wound up, Oakes had not rescinded the contract. He remained a member of the company with his name upon the register of shareholders. In those circumstances, he was liable to pay calls made upon him. The liability to pay calls is a statutory one and is unaffected by any contractual claim as between shareholder and company.

⁶ *Oakes v Turquand* (1867) LR 2 HL 325, 357.

⁷ *Oakes v Turquand* (1867) LR 2 HL 325, 344.

⁸ *Oakes v Turquand* (1867) LR 2 HL 325, 346, 349-50.

Lord Cranworth adopted⁹ the following statement of Lord Campbell in *Henderson v Royal British Bank*:¹⁰

"It would be monstrous to say that the party against whom the application was made, having become a partner and a shareholder, and having held himself out to the world as such, and having so remained until the concern stopped payment, could, by repudiating the shares on the ground that he had been defrauded, make himself no longer liable."

While Lord Campbell's statement was made in relation to an earlier statute which had allowed creditors to sue shareholders directly for the shareholders' share of the company's debt, the House of Lords held that it remained apposite to the (then) new legislation.

It is important to understand that *Turquand's Case* extends only to subscription contracts which are voidable, not void. As Lord Colonsay observed "[i]t ... would be a different case, in regard to a party who had no power, no will, to give an assent, such as an insane person or a pupil."¹¹ Such a contract, being void *ab initio*, would be incapable of creating obligations in a shareholder.

The next significant case in the line of authority is *Tennent v City of Glasgow Bank*¹². A shareholder had purchased three parcels of shares in a bank: one from the bank itself, and two from individuals which, unknown to the plaintiff, held and sold the stock on trust for the bank. The shareholder alleged (and the House of Lords assumed) that the bank had fraudulently overstated its financial position prior to and following the subscription for shares. The shareholder discovered the company's insolvency, and the fraud perpetrated upon him, prior to the winding up and brought proceedings seeking to be removed from the register of members. Lord Chancellor Cairns delivered the judgment of the House. His Lordship held that *Turquand's Case* had "established that it is too late, after winding-up has commenced, to rescind a contract for shares on the ground of fraud."¹³

⁹ *Oakes v Turquand* (1867) LR 2 HL 325, 361.

¹⁰ *Henderson v Royal British Bank* (1857) 7 E & B 356; 119 ER 1279.

¹¹ *Oakes v Turquand* (1867) LR 2 HL 325, 375.

¹² *Tennent v City of Glasgow Bank* (1879) 4 App. Cas. 615.

¹³ *Tennent v City of Glasgow Bank* (1879) 4 App. Cas. 615, 621.

The Lord Chancellor went on to say:¹⁴

"Oakes v Turquand, however, while it decided negatively that a contract could not be rescinded on the ground of fraud after a winding-up had commenced, did not decide affirmatively the converse proposition; that up to the time of the commencement of a winding-up a contract to take shares could be rescinded upon the ground of fraud. Whether it can or not be so rescinded up to that time must, I think, depend upon the particular circumstances of the case."

The Lord Chancellor continued:¹⁵

"... so long as the company is a going concern, a shareholder who has been induced to take up shares by the fraud of the company has a right to throw back his shares upon the company without reference to any claims of creditors ... the company being solvent, its duty to pay the repudiating shareholder what is due to him, and to take the shares off his hands, is an affair of the company and not of its creditors. But if the company has become insolvent ... even irrespective of winding-up, a wholly different state of things appears to me to arise. The assumption of new liabilities is an affair not of the company but its creditors. The repudiation of shares ... must now of necessity inflict a serious injury on creditors."

Being careful to confine the decision to the facts of the case then at hand, his Lordship found that the acts of the company's directors in calling a meeting of shareholders to consider resolutions to wind up the company were steps taken by the directors as the agents and representatives of the shareholders. Those steps, taken prior to the commencement of the plaintiff's action against the company, prevented any creditor petitioning the Court for the winding-up of the bank. Otherwise, during the period in which the action was brought by the shareholder, a creditor could have presented a petition to wind up the bank, and upon liquidation, rescission would have become impossible. That being the case, the House of Lords held that the shareholders were unable to effect any alteration in their status which would affect the rights of the company's creditors during that period. The shareholder's action was dismissed.

Like *Tennent, Houldsworth v City of Glasgow Bank*¹⁶ arose from the liquidation of the City of Glasgow Bank. Houldsworth was a shareholder of the bank, having purchased

¹⁴ *Tennent v City of Glasgow Bank* (1879) 4 App. Cas. 615, 621.

¹⁵ *Tennent v City of Glasgow Bank* (1879) 4 App. Cas. 615, 622.

¹⁶ *Houldsworth v City of Glasgow Bank* (1880) 5 App. Cas. 317.

shares from the bank itself. He paid significant calls during the bank's liquidation, and then brought an action against its liquidators on the basis of fraudulent misrepresentations made by the bank's directors and staff inducing his subscription for shares. He claimed damages calculated as the sum of the amount he had paid for the shares, the amount he had paid in calls and the estimated amount of future calls. On the basis of *Turquand's Case*, he conceded that, the bank being in liquidation, it was too late to rescind the contract to purchase shares. The House of Lords assumed that the fraudulent misrepresentations would have given rise to a right of rescission had the bank been a going concern. The relevant question was posed by Lord Chancellor Cairns:¹⁷

"Can a man, induced by the fraudulent misrepresentations of agents of a company to take shares in the company, after he discovers the fraud, elect to retain the shares, and sue to company for damages?"

The Lord Chancellor held that a person who purchases shares from a company on the strength of a fraudulent misrepresentation may rescind the contract for that fraud (provided the rescission occurs on time), but may not affirm the contract, keep the shares, and sue for damages.¹⁸ To so "approve and reprobate" would be inconsistent with the contract between the plaintiff and the other shareholders. Lord Selborne said:¹⁹

"... it is impossible to separate the matter of the pursuer's claim from his status as a corporator, unless that status can be put an end to by rescinding the contract which brought him into it ... The loss from which he seeks to be indemnified by damages is really neither more nor less than the whole aliquot share due from him in contribution of the whole debts and liabilities of the company ... But it is of the essence of the contract between the shareholders ... that they should all contribute equally to the payment of all the company's debts and liabilities. Such an action of damages as the present is really not against the corporation as an aggregate body, but is against all the members of it except one, viz., the pursuer; it is to throw upon them the pursuer's share of the corporate debts and liabilities."

¹⁷ *Houldsworth v City of Glasgow Bank* (1880) 5 App. Cas. 317, 323.

¹⁸ *Houldsworth v City of Glasgow Bank* (1880) 5 App. Cas. 317, 325.

¹⁹ *Houldsworth v City of Glasgow Bank* (1880) 5 App. Cas. 317, 329.

Lord Jessel MR explained the ratio of *Houldsworth* in *Re Hull and County Bank*.²⁰ In two passages later to be adopted and then explained away by separately constituted High Courts of Australia, the Master of the Rolls said:²¹

"The doctrine is that after the company is wound up it ceases to exist, and rescission is impossible. There are then only creditors and co-contributories and no company, and that is the meaning of Lord Cairns' observations in Houldsworth ...

The liabilities are no longer the liabilities of the company except to the extent of the assets realized, which under [s. 38 of the Companies Act 1862] are to be appropriated towards the satisfaction of such liabilities, but they become liabilities of the shareholders who are such at the time of the winding-up, that is, of the past and present members, including those who have been shareholders within the year; and those liabilities ... are defined by [s. 38]."

In *Re Addlestone Linoleum Company*²² the *Houldsworth* ratio was expanded beyond actions for fraudulent misrepresentation. Shareholders thought they had purchased shares at a 25% discount under an option scheme. The company went into liquidation, and the liquidator made a call for the 25% remaining unpaid. The shareholders sued for "breach of contract or otherwise in respect of the issue of the preference shares", claiming the 25% discount was never payable. The quantum of the damage sought was the 25% which they had been called upon to pay.

At first instance, Kay J held that the shareholders were "practically admitting their liability to pay the [25%] per share to such other creditors and yet seeking to get part of it back out of the pockets of those very creditors themselves."²³ His Honour applied *Houldsworth* but did not decide the case on that basis, instead relying on s. 38(7) of the *Companies Act 1862* and finding "if the shareholders can claim damages at all, that claim cannot be made in competition with creditors in the winding-up whose debts are not due to them in the character of shareholders."²⁴ The descendants of s. 38(7) play a major part in subsequent decisions, and for that reason it is worth noting the words of the section:

²⁰ *Re Hull and County Bank* (1880) 15 Ch. D. 507.

²¹ *Re Hull and County Bank* (1880) 15 Ch. D. 507, 509-10, 512.

²² *Re Addlestone Linoleum Company* (1887) 37 Ch D 191.

²³ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 198.

²⁴ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 199.

"No sum due to any member of a company, in his character of a member, by way of dividends, profits, or otherwise, shall be deemed to be a debt of the company, payable to such member in a case of competition between himself and any other creditor not being a member of the company; but any such sum may be taken into account, for the purposes of the final adjustment of the rights of the contributories amongst themselves."

Kay J found that the shareholders were making their claim "in the character of members of the company."²⁵ His Honour found that the section extended to prevent the proof of debts "due to a member in that character, such as for dividends, directors' fees, or the like".²⁶ The shareholders' claim was "just as unreasonable as if it were a claim of dividends or profits" thereby coming within the scope of "or otherwise" under s. 38(7).

On appeal, the Court of Appeal followed *Houldsworth*. Lord Justice Cotton held that the shareholders could not prove, as they "come here as shareholders, and in substance retain their shares, and seek to sue the company for breach of the contract under which they took them."²⁷ His Lordship did not need to decide the applicability of s. 38(7), but stated "if they could have been admitted to prove at all, I think it would have been very difficult to come to the conclusion that they could compete with the outside creditors."²⁸ Lord Justice Cotton did not purport to generalise the ratio of *Houldsworth*, but extended it to apply to a breach of contract claim. Lord Justice Lopes merely held that there was no "substantial distinction" between a misrepresentation action and one for a breach of contract.²⁹ His Lordship agreed with Kay J's interpretation of s. 38.

In contrast, Lord Justice Lindley held that *Houldsworth's Case* established a more general principle, viz.:³⁰

"The principle on which the House of Lords decided Houldsworth v City of Glasgow Bank is that a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that it is inconsistent with his position as a shareholder, while he remains such, to claim

²⁵ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 198.
²⁶ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 198.
²⁷ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 205.
²⁸ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 205.
²⁹ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 206.
³⁰ *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 205-6.

back any of that money – he must not directly or indirectly receive back any part of it, and this appears to me to govern the present case.”

The modern application of *Houldsworth’s Case*

The rule in *Houldsworth’s Case* was abolished in the United Kingdom by the *Companies Act 1989* (UK). That statute inserted into the *Companies Act 1985* (UK) s. 11A, which read:

“A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company’s register in respect of shares.”

The section has no Australian counterpart. For reasons which I will now describe, until the High Court’s decision in *Sons of Gwalia, Houldsworth’s Case* occupied an important place in Australian company law.

The first modern Australian consideration of *Houldsworth* was the Victorian case of *Re Dividend Fund Incorporated*.³¹

Montgomery was a shareholder in an unlimited company. Under the articles of the company, shareholders had a right to redeem shares at a repurchase price fixed by the company’s directors from time to time. Montgomery gave the company a notice of redemption. The company did not redeem Montgomery’s shares. He received no payment, and his name remained on the register of members at the time the company was wound up. Montgomery commenced proceedings against the liquidators to have his name removed from the register of members but was unsuccessful, and was ordered to pay a call. He lodged a proof of debt claiming damages equal to the sum of the redemption amount and the amount of the call.

Anderson J neatly summarised the basis for the ratio in *Houldsworth’s Case*.³²

“... for a shareholder to have a right to claim damages against the company would involve his being obliged as a member of the company to satisfy, or join

³¹ *Re Dividend Fund Incorporated (in liq.)* [1974] VR 451.

³² *Re Dividend Fund Incorporated (in liq.)* [1974] VR 451, 454.

with other shareholders in satisfying, his own claim. In the case of an unlimited company ... something akin to perpetual motion would be involved for the merry carousel would go on till the end of time, the aggrieved shareholder being eventually obliged to pay call after call to meet his own claim in damages."

Anderson J found the distinction between the action in tort for misrepresentation and the action for breach of contract "immaterial", holding:³³

"everything said in Houldsworth's Case is, in my opinion, equally applicable to any claim for damages, however arising, which a shareholder qua shareholder may seek to enforce against the company, a fortiori when it is an unlimited company in liquidation."

For that reason, Montgomery was not entitled to any redress against the company in respect of calls on the shares. While his Honour found that the company had breached its articles in not redeeming Montgomery's shares, he held that Montgomery's claim for damages flowing from that breach would, by reason of s. 218 of the *Companies Act 1961* (Vic), only become relevant in the determination of the rights of contributories between themselves. That section provided, relevantly:

"(1) On a company being wound up, every present and past member shall be liable to contribute to the assets of the company to an amount sufficient for payment of its debts and liabilities and the costs charges and expenses of the winding up and for the adjustment of the rights of the contributories among themselves, subject to ... the following qualifications: ...

(d) In the case of a company limited by shares, no contribution shall be required from any member exceeding the amount, if any, unpaid on the shares in respect of which he is liable as a present or past member. ...

(g) A sum due to any member in his character of a member by way of dividends, profits or otherwise shall not be a debt of the company payable to that member in a case of competition between himself and any other creditor not a member, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves."

Montgomery had not disputed that the sum owed to him was due "in his character of a member by way of dividends, profits or otherwise."

³³

Re Dividend Fund Incorporated (in liq.) [1974] VR 451, 454.

Webb Distributors

Following *Sons of Gwalia*, it is now incontestable that the statutory provisions regarding proof and contribution provide the primary basis for the Australian law on this topic. Even before the High Court rejected the application of *Houldsworth* in *Sons of Gwalia*, the legislative provisions formed the centrepiece of the modern Australian law (although they were significantly affected by earlier case law). The High Court considered the intersection of the statutory provisions and *Houldsworth's Case* in *Webb Distributors v State of Victoria*³⁴, a case arising from the liquidation of the Pyramid Building Society.

The relevant section was s. 360(1) of the *Companies (Victoria) Code*, which was almost identical to its *Companies Act* predecessor. The section provided (relevantly):

"On a company being wound up, every present and past member is liable to contribute to the property of the company to an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of the winding up and for the adjustment of the rights of the contributories among themselves, subject to the following qualifications ... (e) in the case of a company limited by shares, no contribution is required from a member exceeding the amount (if any) unpaid on the shares in respect of which he is liable as a present or past member; ... (k) a sum due to a member in his capacity as a member by way of dividends, profits or otherwise shall not be treated as a debt of the company payable to that member in a case of competition between himself and any other creditor who is not a member, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves."

Holders of non-withdrawable shares in the Pyramid, Geelong and Countrywide Building Societies claimed that they had been induced to acquire their shares by representations on behalf of the societies that the shares were "redeemable" and "like a deposit", and that they were induced to depart from an intention to become depositors and purchase shares instead. The societies' liquidator sought directions from the Supreme Court of Victoria, asking questions which included (in summary):

1. Were the claims for damages by the shareholders provable in the liquidation of the societies?

³⁴ *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1993) 179 CLR 15.

2. Were the claimant shareholders precluded from rescinding the contracts pursuant to which they purchased their shares, and thereby precluded from maintaining a claim for damages?

The liquidator asked the Court to assume that misleading or deceptive conduct sufficient to ground a claim under s. 52 of the TPA had occurred.

The trial judge held that the damages claims were provable in the liquidation and, while the shareholders were precluded from rescinding their contracts by reason of the liquidation, they were not precluded from bringing a damages claim and were therefore in the same position as depositors and other creditors. The Appeal Division (as it then was) answered the questions differently. In *State of Victoria v Hodgson*³⁵, the Court held that the shareholders were precluded from rescinding their contracts and from maintaining an action for damages in respect of the purchase of the shares. Tadgell J published the leading judgment, holding:³⁶

“... the principle of limited liability leads inevitably to the conclusion that a member at the commencement of the winding up of the company limited by shares cannot prove in the winding up for damages designed to indemnify him for loss sustained in subscribing share capital to the company. The member's only title to such damages would depend on his having sustained loss through a subscription of share capital. If he were to obtain indemnity from the company in respect of that loss he could not logically be regarded as having subscribed the share capital for the subscription of which the company had indemnified him.”

The High Court³⁷ upheld the Full Court's reasoning. The majority identified “two related streams of authority” as crucial to the Supreme Court's conclusion. The first was “epitomised” by *Trevor v Whitworth*³⁸ and *Ooregum Gold Mining Co. of India v. Roper*³⁹, and held that a company had no power to purchase its own shares unless the Court had sanctioned the transaction. Creditors and prospective creditors were entitled to assume that a company's paid up capital would only be expended in the legitimate course of the company's business. The second line of authority was that which began with

³⁵ *State of Victoria v Hodgson* [1992] 2 VR 613.

³⁶ *State of Victoria v Hodgson* [1992] 2 VR 613, 627.

³⁷ Mason CJ, Deane, Dawson and Toohey JJ; McHugh J dissenting.

³⁸ *Trevor v Whitworth* (1887) 12 App. Cas. 409.

³⁹ *Ooregum Gold Mining Co. of India v. Roper* [1892] AC 125.

Turquand's Case and held that a shareholder cannot renounce the contract to acquire shares following the commencement of liquidation. The majority went on to analyse the ratio of *Houldsworth's Case*, finding that it had been applied or treated as applicable to limited companies in the United Kingdom, Australia and Canada. While noting that the case had been the subject of intense academic debate, the majority decided that Tadgell J was correct when his Honour had concluded (in effect) that the principle in *Houldsworth* had received statutory recognition in s. 360 of the *Code* and its predecessors.⁴⁰ In the High Court's opinion,⁴¹ s. 360(1)(k) bore the same interpretation as that which Kay J gave to s. 38(7) of the *Companies Act 1862* in *Addlestone Linoleum*⁴². Further, their Honours held that subsequent legislative provisions supported that conclusion. While s. 563A (which was the relevant section by the time the High Court handed down its judgment) was worded differently from s. 360(1)(k) of the *Code*, the explanatory memorandum to the *Corporate Law Reform Bill 1992* (which enacted the new section) asserted that it was to have the same effect as s. 525 of the *Corporations Law* (the successor to s. 360(1)(k) of the *Code*, and which was worded almost identically).

The Court held in passing that s. 360(1)(k) would not "prevent claims by members for damages flowing from a breach of contract separate from the contract to subscribe for the shares", relying on *In Re Dale & Plant Ltd*⁴³ (arrears of salary due to a managing director who was obliged by virtue of his position to be a shareholder) and *In re Harlou Pty Ltd*⁴⁴ (debt owed by a company to a former employee for breach of a contract to arrange the sale of shares which the employee was obliged to purchase as a condition of employment). That principle has also been applied to actions to recover loans made by a shareholder to the company, when the opportunity to provide the loan existed solely because of the lender's membership.⁴⁵

⁴⁰ This "chronological curiosity" was the subject of comment when *Sons of Gwalia* reached the High Court: *Sons of Gwalia*, [14] per Gleeson CJ; [86] per Gummow J; cf [250] per Callinan J.
⁴¹ *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1994) 179 CLR 15, 34.
⁴² *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1994) 179 CLR 15, 34, citing *Re Addlestone Linoleum Company* (1887) 37 Ch D 191, 197-8.
⁴³ *In Re Dale & Plant Ltd* (1889) 43 Ch. D. 255.
⁴⁴ *In re Harlou Pty Ltd* [1950] VLR 449, 454.
⁴⁵ *Re NIAA Corporation Ltd* (1993) 33 NSWLR 344, 353.

Their Honours found that s. 360(1)(k) barred the shareholders' claim, as the quantum of the claim was the purchase price of the shares (an amount directly related to the shareholding) and the shareholders sued as members, retaining the shares to which they were entitled by virtue of entry into the contract which they sought to impugn. "Accordingly", the Court held, "the claim falls within the area which s. 360(1)(k) seeks to regulate: the protection of creditors by maintaining the capital of the company."⁴⁶

Although the shareholders' claim was framed as a claim under the *Trade Practices Act*, the Court held that the TPA was not to be seen as "eliminating, by a sidewind, the detailed provisions established for more than a hundred years to govern the winding up of a company".⁴⁷

It is unnecessary for present purposes to explore McHugh J's dissenting judgment. It is sufficient to note that his Honour decided that the rule in *Houldsworth's Case* was productive of injustice, but too firmly entrenched in law to be dislodged by judicial pronouncement.

Developments leading up to *Sons of Gwalia*

The few years immediately preceding the High Court's judgment in *Sons of Gwalia* saw significant judicial consideration of the rule in *Houldsworth's Case* as it applied to the regime established by the Corporations Act. The relevant statutory provisions under that act are ss. 515, 516, 553(1) and 563A.

Section 515 provides:

"Subject to this Division, a present or past member is liable to contribute to the company's property to an amount sufficient: (a) to pay the company's debts and liabilities and the costs, charges and expenses of the winding up; and (b) to adjust the rights of the contributories among themselves."

⁴⁶ *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1994) 179 CLR 15, 35.

⁴⁷ *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1994) 179 CLR 15, 37.

Section 516 provides (relevantly)

"... if the company [in liquidation] is a company limited by shares, a member need not contribute more than the amount (if any) unpaid on the shares in respect of which the member is liable as a present or past member."

Section 553(1) provides:

"Subject to this Division, in every winding up, all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the circumstances giving rise to which occurred before the relevant date, are admissible to prove against the company."

Section 563A provides:

"[In liquidation, 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."

In *Media World Communications*⁴⁸, Finkelstein J was faced with an application for directions brought by a voluntary administrator. A draft deed of company arrangement had been proposed at the second meeting of a company's creditors. A group of shareholders claimed that the prospectus under which they subscribed for shares contained misleading information. Those shareholders claimed a right to vote as creditors of the company on the basis that they had a claim for damages against the company. The shareholders' claims were based on the torts of deceit and negligence, and for misleading and deceptive conduct under s. 9 of the *Fair Trading Act 1999* (Vic) (the "FTA") and s. 12DA of the ASIC Act.

Relying on *Webb Distributors*, his Honour held that the members could not recover damages against the company for any of the causes of action pleaded, as none of the shareholders had renounced their shareholdings.⁴⁹ Section 437F of the Corporations Act prevented any transfer of shares or alteration in the members' status as members during the voluntary administration. That being the case, the subscribing shareholders were not

⁴⁸ *Re Media World Communications Ltd; Crosbie v Naidoo* (2005) 216 ALR 105.

⁴⁹ *Re Media World Communications Ltd; Crosbie v Naidoo* (2005) 216 ALR 105, 109.

creditors of the company and had no entitlement to vote at the second meeting of creditors.

Interestingly, his Honour noted that the shareholders had not argued that they might be contingent creditors on the basis that the contracts to acquire shares were wholly void (for example, under s. 158 of the FTA). In *obiter dicta* his Honour suggested that “the possibility that such an order could be made might ... sidestep the rule in *Houldsworth's* case.”⁵⁰

While the administrator sought analogous declarations relating to the position of shareholders who had acquired their shares on market, no such shareholders were parties to the action, and the administrator was not aware of any transferee shareholders who made a claim against the company. Nevertheless, his Honour proffered an opinion on the issue. His Honour pointed out that *Houldsworth's Case* was not concerned with a claim by a transferee. Further, in his Honour's view, the *Houldsworth* reasoning did not easily fit the situation of a transferee. There could be no “approbation and reprobation” by a transferring shareholder as he or she has no right to renounce the shareholding against the company except in unusual circumstances.⁵¹ His Honour cited *Soden v British Commonwealth Holdings plc*⁵² as authority for the principle that a claim for damages by a defrauded subscribing shareholder (who claims for the return of his or her capital) is not the same as a claim by a defrauded transferee shareholder (who makes a civil claim against the company which will neither directly or indirectly procure a capital reduction).

Finkelstein J considered *Houldsworth's Case* again in *Cadence Asset Management v Concept Sports*.⁵³ A trustee had subscribed for shares in a company and later sold them at a loss. The trustee sued the company for the difference between the subscription price and the price it received upon the sale of the shares. The alleged cause of action arose under s. 729 of the Corporations Act, which creates a cause of action sounding in damages against a person who offers for sale shares via a prospectus which does not comply with the Act. Although the company was not in liquidation, rescission of the

⁵⁰ *Re Media World Communications Ltd; Crosbie v Naidoo* (2005) 216 ALR 105, 110.

⁵¹ *Peek v Gurney* (1873) LR 6 HL 337.

⁵² *Soden v British Commonwealth Holdings plc* [1998] AC 298.

⁵³ *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 55 ACSR 145.

subscription contract was impossible because the shareholder had sold the shares. The company argued that the cause of action could not be maintained. The plaintiff argued that the introduction of a company as a potential defendant to the s. 729 action implicitly abrogated the rule in *Houldsworth's Case* insofar as an action under that section was concerned. Finkelstein J considered the question as a preliminary point, and decided that the rule in *Houldsworth's Case* applied to prevent the subscribing shareholder's action, for three reasons:⁵⁴

1. Parliament could have, but had not, explicitly overturned the rule in *Houldsworth's Case*. His Honour held that Parliament is aware of the rule, and if it wishes to overturn it, will do so in clear language.
2. A similar argument made in relation to the operation of s. 52 of the TPA had been rejected by the Full Court of the Supreme Court of Victoria in *Victoria v Hodgson*⁵⁵ (the decision upheld by the High Court in *Webb Distributors*).
3. If s. 729 overturned *Houldsworth's Case*, it would create an anomaly whereby the action could be maintained against a company prior to liquidation, but not thereafter: s. 563A.

In *obiter*, his Honour applied *Soden v British Commonwealth Holdings plc*⁵⁶ to hold that the rule did not prevent transferee shareholders from bringing a claim under s. 749.⁵⁷

The plaintiff appealed to the Full Federal Court. Merkel, Weinberg and Kenny JJ delivered a joint judgment setting aside Finkelstein J's ruling.⁵⁸ The Court examined the wording and context of ss. 728 and 729 of the Corporations Act and decided that the rule in *Houldsworth's Case* did not preclude subscribing shareholders from bringing an action under s. 729. Their Honours' reasons were:

⁵⁴ *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 55 ACSR 145.

⁵⁵ *State of Victoria v Hodgson* [1992] 2 VR 613.

⁵⁶ *Soden v British Commonwealth Holdings plc* [1998] AC 298.

⁵⁷ *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 55 ACSR 145, 148.

⁵⁸ *Cadence Asset Management Pty Ltd v Concept Sports Limited* [2005] FCAFC 265.

1. The Corporations Act provides a number of defences to an action under s. 729, and those defences do not include the rule in *Houldsworth's Case* or any analogous rule.
2. There is nothing in the section which suggests its operation is qualified by anything outside the Corporations Act.
3. To allow the action is consistent with the object for which s. 729 was enacted, which was to ensure full disclosure in prospectuses.
4. The Corporations Act provides a statutory remedy equivalent to rescission for other offences in the same division of the act as s. 728, but does not provide such a remedy for a breach of s. 728 (although, under s. 729(4), rescission at general law might still be available to a person with a s. 728-9 action).
5. To apply the rule in *Houldsworth's Case* would create an anomaly if the company subsequently entered liquidation. Section 563A recognises *Houldsworth's Case*, but modifies it slightly, because the section does not require rescission before the shareholder becomes entitled to be a creditor (albeit one whose claim is postponed to those of non-shareholder creditors). If *Houldsworth's Case* applied to actions under s. 729(1), the subscribing shareholder wishing to become a creditor by virtue of s. 729 could not do so until it rescinded the share acquisition contract: something impossible once the shares had been sold or the company had entered liquidation. Their Honours held (at [39]):

"The simple answer to that anomaly would appear to be that the legislature has modified the rule in Houldsworth by providing for the vice the rule was designed to avoid by enacting s 563A, thereby rendering it unnecessary for the legislature to provide for the rule to be applied in relation to claims under s 729(1)."

The theoretical basis for the Full Court's reasons is found in two points. First, the legislature now provides for capital to be returned to shareholders in certain circumstances. Second, the statutory regime governing shareholders' claims in insolvency now allows such claims to be made but preserves the creditors' entitlement to

the company's capital by deferring any claim brought by a shareholder *qua* shareholder until satisfaction of other creditors' claims. In their Honours' view, *Concept Sports* was unlike *Webb Distributors*, where the plaintiffs sought to prove as shareholder creditors whose claims did not defer to those of other creditors.

The Court summarised its reasons thus:⁵⁹

“Under the present statutory regime all of the shareholders in Concept Sports are entitled to bring and prosecute their claims under s 729(1) but, in the event of a liquidation, the rights of subscribing shareholders (other than those who may have rescinded their contract prior to liquidation) are to be governed by s 563A. Accordingly, there is no reason for qualifying any entitlement to claim under s. 729 by the rule in Houldsworth. Indeed, to do so is inconsistent with s 563A as the qualification would preclude a subscribing shareholder from obtaining a judgment that would give that shareholder the postponed entitlement provided by s 563A if the company was later placed in liquidation.

We would add that, in the above context, s 729 could hardly be said to be abrogating the rule in Houldsworth by a ‘side-wind’. In so far as the rule might have any contemporary application that application must be in the context of the Act, including ss 563A and 729. That is a quite different situation to the appellant’s claim in Hodgson and Webb, which was to have the TPA claims of subscribing shareholders prevail over, or be treated equally with, the claims of creditors, notwithstanding s 360(1)(e) and (k) of the Code.

It follows from the foregoing that we do not agree with the reasons given by the primary judge for qualifying the appellant’s entitlement to bring its claim under s 729(1) of the Act by the rule in Houldsworth. In particular, we are of the view that the legislature has made clear its intention that a subscribing shareholder is entitled to recover damages under s 729(1) against a company issuing a prospectus, provided that the statutory conditions set out in the section, which do not include the rule in Houldsworth, are satisfied. Further, there was no need for the legislature to state it was overturning the effect of the rule because it had already both recognised and modified the rule by enacting s 563A of the Act (and earlier by enacting ss 360(1)(e) and (k) of the Companies Code). As we have explained, s 563A makes it unnecessary for the rule to be applied to a claim under s 729(1). Indeed, to do so would be inconsistent with the entitlement given to subscribing shareholders under s 563A to prove in the liquidation, but behind other creditors, without having rescinded their contracts of acquisition.”

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Cadence Asset Management Pty Ltd v Concept Sports Limited [2005] FCAFC 265, [44]-[46].

Finkelstein J had an opportunity to critique the basis for the Full Court's decision in *Concept Sports* in the subsequent *Sons of Gwalia* appeal,⁶⁰ where his Honour proffered the following *obiter dicta*:⁶¹

*"In Cadence Asset Management Pty Ltd v Concept Sports Limited the Full Court said that according to the High Court s 563A "modifies the rule [in Houldsworth's case]" by permitting a proof for damages by "[a shareholder] whose rights were postponed to the rights of creditors." That is, on this view, dependent upon the type of claim being put forward, a claim which is incapable of being maintained against a company while it is a going concern -- because the shareholder has no cause of action -- is revived on and may be proved in its liquidation, provided the proof is not in competition with other creditors. There are, of course, several difficulties with this approach. For one thing s 563A cannot "modify" Houldsworth's case. Section 38(7) of the 1862 Companies Act, which is the forerunner of s 563A, is one of the provisions that produced the rule in Houldsworth's case.^[62] Second, the approach is directly inconsistent with cases such as *In re Addlestone Linoleum Company and State of Victoria v Hodgson*, the reasoning in which was approved by the High Court in *Webb Distributors*. Finally, the result of the approach may be capricious. It would give to a member of a company that is being wound up the ability to recover his subscription money while denying the same ability to a member of a company that is a going concern. And the latter member could not advance his position by forcing a winding up because the approach carries with it the implicit assumption that the defrauded member is not a creditor before liquidation and therefore has no standing to petition for a winding up. Fortunately, the correctness of the Full Court's reasoning on these and other aspects can await another day."*

It is interesting to consider the contrasting opinions of the trial judge and the full bench in light of the High Court's subsequent reasons in *Sons of Gwalia*, which did not specifically consider *Concept Sports*, but touched on each of the points made in the passages extracted above.

The result of the cases described above seemed erratic: *Houldsworth's Case* remained authority for the principle that an existing shareholder who obtained his or her shares by subscription could not bring a cause of action against the company for misrepresentation, breach of contract or damages under s. 52 of the TPA. However, that principle could be avoided by rescinding the subscription contract. However, rescission was impossible in

⁶⁰ *Sons of Gwalia Ltd v Margaretic* [2006] FCAFC 17, discussed fully below.

⁶¹ *Cadence Asset Management Pty Ltd v Concept Sports Limited* [2005] FCAFC 265, [33] (citations omitted).

⁶² This is the "chronological curiosity" referred to in footnote 40 above.

liquidation (*Turquand*), in administration (s. 437F of the Corporations Act) and, in certain circumstances, in the pre-liquidation period (*Tennent*). Notwithstanding those principles, shareholders who claimed under ss. 728-9 of the Corporations Act were not hindered by *Houldsworth*. *Sons of Gwalia* has now clarified the law in so far as it related to companies in liquidation, by recognising that the Corporations Act leaves no room for the operation of *Houldsworth's Case*. However, the path to that conclusion was a winding one.

The difference between subscribers and transferees comes to the fore: *Sons of Gwalia* and *Johnston v McGrath*

Sons of Gwalia came before Emmett J at first instance. His Honour held that the debt was not one owed to Margaretic in his capacity as a member of the Company.⁶³

"If it is a debt at all, it is a debt arising as a result of the operation of the consumer protection provisions referred to above, which prohibit misleading and deceptive conduct in various circumstances. Section 563A would not require postponement of that debt until debts owed to, or claims made by, persons otherwise than as members have been satisfied."

The Administrators appealed. The Full Federal Court upheld Emmett J's decision, on slightly different grounds. Before dealing with their Honours' decision, it is necessary to consider the intervening decision of Gzell J in *Johnston v McGrath*⁶⁴.

Johnston had purchased 40,000 shares in HIH Insurance Ltd on market for 25.5c per share on 2 January 2001. Provisional liquidators were appointed to the company on 15 March 2001. Johnston alleged that misleading and deceptive statements made by the company to the press had caused him to purchase the shares and thus to suffer loss. While Gzell J found that statements to the press were not causative of the plaintiff's loss, he went on to consider in *obiter dicta* the issue of whether the plaintiff's claim would have been postponed to those of other creditors.

In deciding that the claim would have been postponed, his Honour held that the *Houldsworth* principle applied equally to transferees.⁶⁵ A transferee, bound to contribute

⁶³ *Sons of Gwalia Limited v Margaretic* [2005] FCA 1305, [43].

⁶⁴ *Johnston v McGrath & Ors* [2005] NSWSC 1183.

any unpaid capital on shares, could not by claiming damages receive back any part of the capital subscribed on the shares by the original allottee, and could not be relieved of liability to pay calls. His Honour disagreed with the comments made by Finkelstein J to the contrary in *Media World* and *Concept Sports*. According to his Honour, the underlying principles discussed in *Webb Distributors* applied equally to transferee shareholders.

Gzell J's reasoning was the subject of detailed analysis by the Full Federal Court on the *Sons of Gwalia* appeal.⁶⁶ Finkelstein J delivered the leading judgment. In deciding that the principle in *Webb Distributors* was confined to subscribing shareholders and did not extend to transferees, his Honour analysed the judgment in *Webb Distributors*, the earlier cases on which the High Court relied, and the consideration of *Webb Distributors* by the Court of Appeal of England and Wales in *Soden v British Commonwealth Holdings plc*⁶⁷. Gyles and Jacobsen JJ agreed with Finkelstein J's reasons:⁶⁸ as Margaretic purchased his shares on market, *Houldsworth's Case* did not deprive him of an action against the company.

On the question of whether Margaretic's claim was made "in his capacity as a member", Finkelstein J adopted the test propounded by Lord Browne-Wilkinson in *Soden*:

*"In the absence of any other indication to the contrary, sums due in the character of a member must be sums falling due under and by virtue of the statutory contract between the members and the company and the members inter se constituted by s. 14(1) of the Companies Act 1985 ... To the bundle of rights and liabilities created by the memorandum and articles of the company must be added those rights and obligations of members conferred and imposed on members by the Companies Acts ... as the 'statutory contract' ... In my judgment, in the absence of any contrary indication sums due to a member 'in his character of a member' are only those sums the right to which is based by way of cause of action on the statutory contract ..."*⁶⁹

⁶⁵ *Johnston v McGrath & Ors* [2005] NSWSC 1183, [73]-[82].

⁶⁶ *Sons of Gwalia Ltd v Margaretic* [2006] FCAFC 17.

⁶⁷ *Soden v British Commonwealth Holdings plc* [1998] AC 298.

⁶⁸ *Sons of Gwalia Ltd v Margaretic* [2006] FCAFC 17, [56], [108]-[115].

⁶⁹ *Soden v British Commonwealth Holdings plc* [1998] AC 298, 323.

“[C]laims based on having paid money to the company under the statutory contract which the member says that he is entitled to have refunded by way of compensation ... are claims necessarily made in his character as a member.”⁷⁰

In contrast, membership is not the foundation for claims brought by transferee shareholders.

Applying his Lordship’s test, Finkelstein J concluded that Margaretic’s claim was not one brought in his capacity as a member. Gyles J held that an action in tort for misleading conduct in connection with the purchase of shares from third parties has nothing to do with the return of subscribed capital, and has no relevant connection with the rescission of any contract with the company (as the contract is with a third party).⁷¹ Jacobsen J agreed with Gyles J.

Houldsworth falls: The High Court’s decision in Sons of Gwalia

The Administrators appealed to the High Court. Hayne J gave the leading judgment.⁷² His Honour found there were two determinative questions:⁷³

1. Was Margaretic’s claim admissible to proof under the Corporations Act?
2. Did that claim rank with the claims of other creditors, or was it postponed to them?

His Honour held that the resolution of those two questions was to be determined by reference to the statutory regime prescribed by the Corporations Act and not any principle of judge-made law (in particular, the ruling in *Houldsworth’s Case*).⁷⁴

⁷⁰ *Soden v British Commonwealth Holdings plc* [1998] AC 298, 325.

⁷¹ *Sons of Gwalia Ltd v Margaretic* [2006] FCAFC 17, [61].

⁷² Gummow, Heydon and Crennan JJ agreed with his Honour.

⁷³ Although his Honour expressed the issues the opposite order: *Sons of Gwalia*, [135]; see too Gummow J at [45].

⁷⁴ *Sons of Gwalia*, [136]. See similarly Gleeson CJ at [11], Gummow J at [35]-[37] and Kirby J at [114]-[115].

Was Margaretic's claim admissible to proof?

Of principal relevance to the determination of the first question was s. 553(1) of the Act, which provides:

"Subject to this Division, in every winding up, all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the circumstances giving rise to which occurred before the relevant date, are admissible to prove against the company."

His Honour saw as particularly important the fact that until the commencement of the *Corporate Law Reform Act 1992* (C'th) (the "CLRA") proof of debt in corporate insolvency was governed by much the same rules as governed the proof of debts in bankruptcy. Those rules provided that demands in the nature of unliquidated damages arising other than from contract, promise or breach of trust were not provable. Following *Coventry v. Charter Pacific Corporation*⁷⁵ it is clear that a statutory claim for unliquidated damages arising from misleading or deceptive conduct inducing the claimant to make a contract with the third party is not provable in bankruptcy. Thus, such a claim would not have been provable in the liquidation of a company prior to the commencement of the CLRA. However, since then, the issue of what debts are provable in liquidation has been governed by what is now the Corporations Act (most relevantly, s. 553). In liquidation, the fact that a claim is for unliquidated damages is now irrelevant to its status as a provable debt.⁷⁶ What matters under the "new" regime is whether the circumstances giving rise to the debt or claim sought to be proved occurred before the "relevant date". The relevant date is calculated according to a mechanism set out in the Act.⁷⁷ Because the High Court's decision in *Webb Distributors* concerned the pre-CLRA provisions, *Webb Distributors* did not dictate the outcome in *Sons of Gwalia*.⁷⁸

⁷⁵ (2005) 80 ALJR 132.

⁷⁶ Although Hayne J speculated as to whether it might make a difference in the operation of s. 563A: *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1, [166].

⁷⁷ Section 9 defines the "relevant date" as the day on which the winding-up is taken to have commenced because of Division 1A of Part 5.6 of the Corporations Act.

⁷⁸ *Sons of Gwalia*, per Hayne J at [192]. See too Gummow J at [97].

Hayne J decided that Mr Margaretic's claim arose before the appointment of the administrators (the relevant date in this case):⁷⁹

"Had the facts upon which Mr Margaretic now relies been known [at the time the administrators were appointed], they would have been known to the whole market, not just him, and he would have had the same claim he now makes.⁸⁰ His knowledge of the relevant facts bears only upon whether he makes a claim; his knowledge of those facts does not bear upon whether he has a claim. His claim is of a kind that is within s. 553 of the [Corporations] Act."

His Honour therefore held that Mr Margaretic had a claim provable in the winding up.

His Honour also recognised that the CLRA repealed s. 525 of the *Corporations Law* (the provision derived from s. 38(7) of the 1862 UK Act) and replaced it with what are now ss. 553A and 563A of the Act. According to Hayne J, this new statutory regime "took a very different form from the provisions of s. 38 of the 1862 UK Act".⁸¹ His Honour said:⁸²

"Against a background where formal rules limiting the kind of claims that were admissible to proof were removed, and the class of admissible claims thus extended, provision was made by the 1992 Act for the condition on which [a member's] debt might be admitted to proof (the previous payment of sums due to the company in the capacity of member) and provision was also made for the priority to be accorded to the satisfaction of such debts."

Section 553A of the Corporations Act assumes that a debt owed by a company to a person in the person's capacity as a member of the company could be admitted to proof under s. 553.⁸³ It provides:

"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 not admissible to proof against the company unless the person has paid to the company or the liquidator all amounts that the person is liable to pay as a member of the company."

⁷⁹ *Sons of Gwalia*, [176] (citations and emphasis preserved).

⁸⁰ *HTW Valuers* (2004) 217 CLR 640, 657-8 [37].

⁸¹ *Sons of Gwalia*, [165].

⁸² *Sons of Gwalia*, [165].

⁸³ *Sons of Gwalia*, [163].

Section 563A provides:

“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.”

It was to section 563A that Hayne J turned to determine the second question: whether Mr Margaretic’s claim ranked with the claims of other creditors or was postponed to them. To answer that question, the Court needed to establish what s. 563A meant, in order to determine whether the claim by Mr Margaretic was a debt owed by Sons of Gwalia to him “in his capacity as a member”.

Was Margaretic’s claim owed “in his capacity as a member?”

Hayne J pointed out that the question had been dealt with differently in the Full Court of the Federal Court to the way that it had been argued before the High Court. In the Full Court, the central question was whether a purchaser (as opposed to an allottee) of shares could in the winding up prove for damages against the company for the misrepresentation which induced the purchase. Hayne J pointed out that the way in which the issue was framed in the Full Court did not direct attention immediately to questions of proof under s. 553 or the appropriate interpretation of s. 563A. Rather, the issue in the Federal Court was seen as turning on the proper understanding of the High Court’s decision in *Webb Distributors*, and consideration of the House of Lords’ decision in *Soden*.⁸⁴

Before explaining how the High Court interpreted s. 563A, it is worthwhile examining how those members of the majority who considered *Webb Distributors* dealt with it.

The Court’s attitude to *Webb Distributors*: a passing glance, but a withering look

When Sons of Gwalia reached the High Court, ING argued that the principle from *Houldsworth’s Case* (as applied by *Webb Distributors*) operated to prevent a shareholder

⁸⁴ *Sons of Gwalia*, [178].

claim such as *Margaretic's* from arising in the first place, with the effect that the statutory issues as to admissibility and ranking of proofs would never arise.⁸⁵

According to Hayne J, *Webb Distributors* was distinguishable. *Webb Distributors* concerned whether the claims which the shareholders sought to make were admissible to proof (and not the priority of those claims once proved). Arguments on that issue were based on what was said to be the rule in *Houldsworth's Case* and whether that rule had received statutory recognition in the *Companies (Victoria) Code*. His Honour said that the High Court's reasons in *Webb Distributors* are to be understood as responding to those arguments.⁸⁶

The cases following *Houldsworth*, particularly *Addlestone Linoleum*, had explained *Houldsworth* as resting on the proposition that claims made by members arising from misrepresentations inducing subscription were in fact claims to recover a dividend in respect of the share of capital which they were bound to pay upon winding up, and were therefore sums due to members in their capacity as members.⁸⁷ Hayne J pointed out that in *Houldsworth*, no distinction was drawn between claims for unliquidated damages for deceit by the company causing a person to acquire shares from a third party (which were excluded from proof because of the then-applicable rules for proof in bankruptcy) and claims for damages for deceit causing a person to subscribe for shares (which would not have been excluded, deriving as they did from breaches of contract or promise).⁸⁸ Rather, *Houldsworth* examined what remedies were available under the general law of deceit where the property acquired in consequence of the deceit had not been given up at the time the deceiving company was wound up.⁸⁹ It is in that context that his Honour made the following comments about *Webb Distributors*:⁹⁰

"The Court held in Webb Distributors that the provisions of s 360 of the Companies (Victoria) Code (the provisions of the Code that were based on s 38 of the 1862 UK Act) precluded the shareholders from rescinding the contracts under

⁸⁵ The argument was so summarised in *Sons of Gwalia Ltd (Subject to Deed of Company Arrangement) v. Margaretic* [2007] HCA 1, by Gleeson CJ at [13] and by Gummow J at [48].
⁸⁶ *Sons of Gwalia*, [182].
⁸⁷ *Sons of Gwalia*, [184].
⁸⁸ *Sons of Gwalia*, [185]-[186].
⁸⁹ *Sons of Gwalia*, [186]-[187].
⁹⁰ *Sons of Gwalia*, [189]-[190].

which they acquired their shares and precluded them from maintaining an action for damages in respect of that acquisition. The proposition that a shareholder could not, either directly or indirectly, receive back any part of the amount contributed by that shareholder to the capital of the company was said to have received statutory recognition in that provision of the Code (s 360(1)(k)) which was the then equivalent of s. 38(7) of the 1862 UK Act. It followed that the shareholders could not prove in the liquidation of the societies.

The conclusion reached in Webb Distributors concerned, and concerned only, the rights of a member who had subscribed for shares, as distinct from having acquired shares by contract from a person other than the company itself.”

His Honour pointed out the distinction between claims made by subscribing shareholders and transferees, and the inapplicability of the “maintenance of capital” and “unavailability of rescission” arguments in the case of transferee shareholders.⁹¹ “Neither *Webb Distributors* nor *Houldsworth*”, his Honour said, “established any common law ‘principle’ that no shareholder, no matter how the shares were acquired, can have a claim of the kind now in issue against a company whose assets were to be administered as on a liquidation.”⁹² Further, the asserted common law “principle” could not deny the operation of the relevant consumer protection or investor protection provisions.⁹³

While Hayne J distinguished *Webb*, Gummow J (with whom Kirby J agreed on the issue⁹⁴) went further, stating⁹⁵

“in Australia the existence of any such common law ‘principle’ of company law based upon Houldsworth should be rejected. Further, Houldsworth did not supply the support relied upon for the reasoning in Webb.”

While *Webb Distributors* concerned subscribing shareholders, not transferees, and while *Soden* had distinguished *Webb Distributors* on that basis, Gummow J saw that distinction as “difficult to maintain in principle” unless the means by which a person became a member was relevant to the characterisation of the debt as one owed to the person in his capacity as a member or otherwise.⁹⁶ For that reason, *Webb Distributors* needed to be tackled. Gummow J found that the majority’s decision in *Webb Distributors* stood on the

⁹¹ *Sons of Gwalia*, [190].

⁹² *Sons of Gwalia*, [190].

⁹³ *Sons of Gwalia*, [190].

⁹⁴ *Sons of Gwalia*, [104].

⁹⁵ *Sons of Gwalia*, [49].

⁹⁶ *Sons of Gwalia*, [51]- [52].

unavailability of rescission, and four other propositions. Each was susceptible to criticism (at least).

First, his Honour re-examined the unavailability of rescission following winding up.⁹⁷ His Honour pointed out that since Sir George Jessell MR had explained the unavailability of rescission following winding-up on the basis that the company had ceased to exist⁹⁸, the law had recognised that winding up had no direct bearing on the existence of the company.⁹⁹ Further, rescission being an equitable remedy, it was difficult to state that it would never be available in such circumstances.¹⁰⁰ Finally, it was unclear why, in *Houldsworth*, Earl Cairns LC relied upon the non-existence of the corporation in explaining why damages for deceit were not available.¹⁰¹ For those reasons, the unavailability of rescission could not be determinative of the availability of the action for damages.

Secondly, his Honour turned to the principle in *Houldsworth* itself, which the High Court in *Webb* had identified as “a shareholder may not, directly or indirectly, receive back any part of his or her contribution to the capital of the company.”¹⁰² Gummow J saw *Houldsworth* as manifesting “the gradual development of legal thought respecting the nature of corporate personality ... and the use of inapt analogy drawn from established areas of the law.”¹⁰³ His Honour pointed out that, on then-accepted principles of agency, *Houldsworth* had failed to prove that he had an action against the City of Glasgow Bank. That being the case, the litigation in *Houldsworth* was not even determined by reference to the law regarding admission or ranking of claims in winding up – and the resultant “principle” does not even hold the rank of authority.¹⁰⁴ In *Houldsworth*, the House of Lords found an exception to the general principle that a plaintiff may retain goods purchased under a contract of sale and sue for damages arising out of misrepresentations

⁹⁷ Referring to (inter alia) *Truant, Tenant* and the statements of Sir George Jessell MR in *Re Hull and County Bank* (1880) 15 Cd D 507, 509-10.

⁹⁸ Set out against footnote 21 above.

⁹⁹ *Sons of Gwalia*, [57].

¹⁰⁰ *Sons of Gwalia*, [58] - [59].

¹⁰¹ *Sons of Gwalia*, [57].

¹⁰² *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1994) 179 CLR 15, 33.

¹⁰³ *Sons of Gwalia*, [63].

¹⁰⁴ *Sons of Gwalia*, [67].

inducing the purchase. That exception, resting as it did on the alleged inconsistency between attacking the contract for the misrepresentation while at the same time being bound by its terms to contribute as a “partner” with the other shareholders, “bears the marks of its time” according to Gummow J. So too does the principle upon which the case was actually decided – that the company was not liable for the misrepresentations of its directors. Neither, according to Gummow J, should be regarded as established principles of Australian law.¹⁰⁵ His Honour posited that the majority in *Webb* attempted to rationalise *Houldsworth* on the basis that it concerned the preservation of capital – a conceptualisation based on academic writings, and which Gummow J saw as unmeritorious.¹⁰⁶

Thirdly, Gummow J disposed of the proposition that the principle attributed to Houldsworth had been recognised by s. 360(1) of the *Corporations (Victoria) Code*, pointing out that that provision had its origins in a statute which preceded the decision in *Houldsworth*.¹⁰⁷

Fourthly, his Honour questioned a third point accepted by the High Court in *Webb* – that s. 360(1)(k) of the *Companies (Victoria) Code* bore the same meaning as that ascribed to s. 38(7) of the *Companies Act 1862* by Kay J in *Addlestone Linoleum*. Kay J had regarded s. 38(7) as analogous to the then-prevailing principle of English partnership law that a partner could not prove in competition with the creditors of the partnership. His Honour had relied on that reasoning in determining that the shareholders’ claim for damages equivalent to the 25% unpaid on their shares was a claim as members “by way of dividends, profits or otherwise” (Kay J found that the claim was “otherwise”). According to Gummow J, in so doing, Kay J was not interpreting s. 38(7), but incorrectly assimilating it with the earlier common law pertaining to partnership. Gummow J declined to find that Kay J was incorrect at the time that *Addlestone Linoleum* was decided, but held that “doubt must be entertained as to the appropriateness of perpetuating this construction with respect to modern statutes.”¹⁰⁸

¹⁰⁵ *Sons of Gwalia*, [79].

¹⁰⁶ *Sons of Gwalia*, [83] - [86].

¹⁰⁷ *Sons of Gwalia*, [86].

¹⁰⁸ *Sons of Gwalia*, [93].

Finally, because of the conclusions his Honour had reached in regard to *Houldsworth's Case*, the Court's conclusion in *Webb Distributors* that the TPA could not whisk *Houldsworth* away by a "side-wind"¹⁰⁹ was also open to question.

Because each of the five propositions upon which *Webb* was determined was questionable, Gummow J doubted whether the result in that case was correct. However, as *Webb Distributors* concerned the *Companies (Victoria) Code* and *Sons of Gwalia* concerned the Corporations Act, that determination was not material to the result of the case at hand.

The lesson to be taken from Gummow J's careful analysis of *Houldsworth* and *Webb Distributors* is best expressed by his Honour himself:¹¹⁰

"There are no 'general principles of company law' applicable in a winding up and to which there must be reconciled those provisions of the Act and its predecessors ... which stipulate a particular system of proof of debts and the ranking of debts and the placement of 'shareholder claims' in that system. Further, in any quest to locate such general principles, the older case law is not always a satisfactory guide. Excessive significance should not be attributed to statements in nineteenth century British cases, decided at a time of endeavours to 'flesh out' the developing body of statute law by use of principles derived from a range of sources in the general law ... It later was recognised that some of those endeavours miscarried."

Kirby J reiterated that sentiment, saying:¹¹¹

"Webb Distributors is proof once again (if further proof is needed) of the dangers of attributing undue weight to what was said in England in the 19th century when attempting to construe contemporary Australian legislation."

As with the remaining members of the majority, Gummow J decided *Sons of Gwalia* by accepting that Margaretic's claim was acceptable to proof, and determining that 563A did not postpone it to the claims of non-shareholder creditors. It is to that latter point that I now turn.

¹⁰⁹ *Webb Distributors (Aust) Pty Ltd v State of Victoria* (1994) 179 CLR 15, 37.

¹¹⁰ *Sons of Gwalia*, [36] - [37].

¹¹¹ *Sons of Gwalia*, [104].

The operation of section 563A of the Corporations Act

Hayne J carefully noted that the final issue was one of statutory interpretation, and decisions concerning the interpretation of other statutory schemes were of little or no assistance in that task.¹¹² Decisions concerning the interpretation of other legislation were more to do with the construction of particular instruments, and not observations about “some immutable policy.”¹¹³ It is perhaps for that reason that, while his Honour took note of the House of Lord’s decision in *Soden*,¹¹⁴ he did not specifically apply it in reaching his decision. His Honour made two important observations about the characterisation of debts as owing “in the person’s capacity as a member” or otherwise:

1. the words “by way of dividends, profits or otherwise” are examples of the kinds of obligation, not words limiting or defining the obligations in question;¹¹⁵ and
2. while in some cases, the Corporations Act itself will make clear that the obligation in question is one owed to members, definition of the obligation will often require resort to the company’s constituent documents.¹¹⁶

His Honour said the following in conclusion of the issue:¹¹⁷

“[I]f money is paid to the company to create the relationship of member (as will be the case when a person subscribes for shares) the company’s obligation to pay damages for a fraudulent misrepresentation inducing that subscription, or to pay damages because loss was occasioned by the company’s misleading or deceptive conduct, will not, in the absence of specific legislative provision to the contrary, be an obligation whose foundation can be found in the legislative prescription of the rights and duties of members. In this respect, absent specific legislation giving subscribing members particular remedies as members, no distinction is to be drawn between shareholders who complain that a company’s deceit or misleading or deceptive conduct induced them to acquire shares in the company according to whether that acquisition was by subscription or transfer.”

¹¹² *Sons of Gwalia*, [200].

¹¹³ *Sons of Gwalia*, [200]. See generally the observations made by Gummow J about the interpretation of the legislative regimes of the United States and the United Kingdom at [39]-[42].

¹¹⁴ *Sons of Gwalia*, [191].

¹¹⁵ *Sons of Gwalia*, [201].

¹¹⁶ *Sons of Gwalia*, [193].

¹¹⁷ *Sons of Gwalia*, [205]-[206]. The constituent documents are given force as a contract by s. 140 of the Corporations Act.

In the present case, the obligation which Mr Margaretic seeks to enforce is not an obligation which the [Corporations] Act creates in favour of a company's members. The obligation Mr Margaretic seeks to enforce, in so far as it is based in statutory causes of action, is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct and the company's liability to suffer an order for damages or other relief at the suit of any person who has suffered, or is likely to suffer, loss and damage as a result of the contravention. In so far as the claim is put forward in the tort of deceit, it is a claim that stands altogether apart from any obligation created by the [Corporations] Act and owed by the company to its members."

Gleeson CJ (with whom Kirby J agreed on the point¹¹⁸) reached the same conclusion.¹¹⁹

"What determines the present case is that the claim made by the respondent is not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of the first appellant. He does not seek to recover any paid-up capital, or to avoid any liability to make a contribution to the company's capital. His claim would be no different if he had ceased to be a member at the time it was made, or if his name had never been entered on the register of members. The respondent's membership of the company was not definitive of the capacity in which he made his claim. The obligations he sought to enforce arose, by virtue of the first appellant's conduct, under one or more of the statutes mentioned in the earlier description of the respondent's claim."

Gummow J resolved the case in a similar fashion, and agreed generally with Hayne J's reasons.¹²⁰

Conclusion: what does the future hold?

Sons of Gwalia is authority for the proposition that a claim for misleading and deceptive conduct inducing the purchase of shares at an overvalue arises at the time the shares are purchased. When the company against which the claim is made subsequently enters liquidation, the claim is one which "occurred before the relevant date".

More controversially, the case is binding authority for the principle that a person with a claim for misrepresentation against a company in which he or she owns shares has a debt provable in the liquidation of the company, and that debt ranks aside those of the company's other unsecured creditors. The principle will extend to other statutory and

¹¹⁸ *Sons of Gwalia*, [134].

¹¹⁹ *Sons of Gwalia*, [31].

¹²⁰ *Sons of Gwalia*, [45] - [46].

general law claims against the company, so long as the shareholder's membership of the company is not definitive of the claim.

The point of law is an important and far-reaching one which has been the subject of much public comment (and more than a little scaremongering). The Court itself was alive to the conflicting policy objectives which it faced, and the implications which its decision might have. Gleeson CJ said¹²¹

"Corporation 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. This raises issues of legislative policy. On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The spectre of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors."

Callinan J held:¹²²

"Shareholders' ample and superior statutory rights, their voluntary abdication of control over their investment in favour of their appointees, the directors, who have large statutory and constitutional discretions and obligations in the application of it, their rights of intervention, their rights to proceed against the directors personally as well as the company in some circumstances, their statutorily mandated limited liability, especially that, and their rights to participate in the bounty of any successes, sit uncomfortably with the notion that s. 563A gives them equal billing, on the failure of the company, with ordinary creditors."

Similarly, Kirby J held:¹²³

"One can readily conceive why, as a matter of policy, strong arguments can be mounted that claims by persons such as the respondent should be postponed to claims made by the general creditors of an insolvent company. Putting it broadly, most general creditors, although not all, will be innocent of the business and

¹²¹ *Sons of Gwalia*, [18].
¹²² *Sons of Gwalia*, [242].
¹²³ *Sons of Gwalia*, [109].

entrepreneurial decisions of the company that led to its insolvency. Most will have dealt with the company as outsiders in good faith on the basis of its incorporation and, where applicable its listing on the Stock Exchange and its subjection to regular and rigorous legal obligations. On the other hand, persons such as the respondent are investors. As such, they are not involved in the provision of goods and services to the company, as ordinarily creditors generally are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks, albeit risks increasingly informed by mandatory disclosures. In particular, were, as here, the company was involved in the extraction of gold, the acquisition of which notoriously and historically involves substantial risks and a significant degree of chance, the purchase of shares will commonly entail a measure – even a high measure – of speculation. 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.”

The Court’s decision did not give force to the salient observations made by Kirby and Callinan JJ. Certain stakeholders will probably lobby to have Parliament do so instead.

Commentators have been quick to react to the decision, highlighting its implications. Most obviously, the decision may encourage shareholders (and more particularly those who fund them) to bring similar claims against other companies.¹²⁴ The decision has toppled a major obstacle to representative proceedings against companies in liquidation for damages resulting from conduct which induced the purchase of shares (or more accurately, proofs of debt in respect of claims the potential subject of such proceedings). It is likely that such claims will be common in future, particularly in relation to large public companies which enter external administration without prior public warning.

It has been argued in the media that the *Sons of Gwalia* decision may increase the likelihood of that company’s liquidators seeking damages against the company’s former directors.¹²⁵ Even if that were the case in that particular administration, it is difficult to see how the existence of a shareholders’ claim would encourage a liquidator to commence action against directors. While an action by shareholders, underwritten by litigation funders, might make the process of gathering and organising evidence against directors easier for the liquidators, if a cause of action was available and the liquidator

¹²⁴ See e.g. D Loxton, M Quinlan and G Crafti, ‘Sons of Gwalia The High Court Decision’ (2007) 1 *Australian Insolvency Journal* 39, 40.

¹²⁵ Bryan Frith, ‘Parliament should clarify creditors’ position after Gwalia decision’, *The Australian*, 2 February 2007.

was funded, the action would likely be brought whether shareholders brought a claim against the company or not. Further, if such an action was available, there is a good chance the directors would already be co-defendants to the shareholders' claim.

It is trite to observe that where shareholders' claims are successful, the pool of funds for distribution among creditors will be diminished. It is important to note that "success" from the shareholders' point of view does not necessarily require the shareholders to prove their claims in court, as it is the liquidator's responsibility to assess proofs of debt and admit them to proof for an assessed value.¹²⁶ Where the shareholder claimants do not contest the value admitted to proof by the liquidator or the liquidator does not seek directions as to issues involved in the claim, the courts may never become involved.

In cases where a *Sons of Gwalia* type claim is made, the cost and time involved in the process of assessing and admitting proofs of debt will increase, with a corollary further reduction in the amount available for distribution among creditors. It is not just the claimant shareholders whose claims need to be determined: it is the responsibility of liquidators and administrators to identify and notify creditors of claims against the company.¹²⁷ An administrator or liquidator must be alive to the potential of a *Sons of Gwalia* type claim and must pro-actively determine whether such a claim is available, and to whom it is available. He or she must then add each such potential claimant of them to the list of creditors. The boundaries of the class of potential claimants will differ from case to case.

The case also has implications which extend beyond the insolvency profession. A perceived increase in the risk of lending caused by the potential for greater competition for dividends in liquidation may encourage financiers to increase their security requirements, reduce loan amounts, tighten lending criteria, increase margins or increase

¹²⁶ See Gronow, *McPherson The Law of Company Liquidation* (5th Ed, 2006), [8.2160].

¹²⁷ In relation to liquidators, see Gronow, *McPherson The Law of Company Liquidation* (5th Ed, 2006), [8.2160]. Administrators' duties under ss. 438A, 438D and 439A of the Corporations Act are similar but more restricted by virtue of the limited time available to the administrator. See generally Anderson and Morrison, *Crutchfield's Corporate Voluntary Administration* (3rd Ed, 2003), 92-112.

the intensity of their monitoring and control over borrowers' management.¹²⁸ I am yet to see any empirical data or hear of anecdotal evidence against which to test that claim. However, it is not uncommon for unsecured creditors (including unsecured lenders) to receive no return in liquidation. For that reason, I am unsure whether the *Sons of Gwalia* decision will have a real impact on lending decisions, except in distressed lending scenarios. Further, the decision has no capacity to impact on the position of secured creditors.

Given the public exposure of the *Sons of Gwalia* case, the increasing involvement of litigation funders in large corporate collapses and the propensity of those parties to fund test cases (as in *Sons of Gwalia*), Parliament might step in to provide certainty via legislation. On 7 February 2007, the decision was referred to the Corporations and Markets Advisory Committee ("CAMAC") for consideration and advice.¹²⁹ Whether CAMAC is likely to recommend change is difficult to predict. Any real adverse impact of the decision will be felt by unsecured creditors – typically trade creditors and frequently the Commissioner of Taxation. The stakeholders who have driven past changes to legislation regarding the ranking of proofs – employees, secured creditors and insolvency practitioners – are largely unaffected by the decision. Those factors, together with the usual vicissitudes of governmental activity and the likely interposition of a federal election make it impossible to predict any legislative outcome.

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¹²⁸ Media Release, Australian Bankers' Association Inc, *Sons of Gwalia Decision*, 2 February 2007, <<http://www.bankers.asn.au/default.aspx?ArticleID=1063>>

¹²⁹ CAMAC's terms of reference can be found at <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/\\$file/Ref_Sons_of_Gwalia.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/$file/Ref_Sons_of_Gwalia.pdf)>

CAMPBELL'S CASH AND CARRY

LITIGATION FUNDING

1. The gravamen of this paper is to provide an overview with respect to some aspects of litigation funding. This paper does not purport to provide a critical analysis of the High Court's reasoning in **Campbell's Cash and Carry** ("Fostif")¹.
2. In Fostif "There were a number of proceedings before the court. Each involved tobacco retailers who had brought representative proceedings in the New South Wales Supreme Court, seeking compensation in respect of tobacco licensing fees that had previously been invalidated by the High Court as unconstitutional excises."²
3. The High Court made a determination with respect to whether or not the proceedings before it had been properly constituted under the applicable New South Wales rules germane to representative actions. By way of obiter, each of the judges sanctioned litigation funding. Gleeson CJ and Kirby J dissented but not with respect to the notion of permitting litigation funding. Callinan and Heydon JJ did not cavil with the concept of litigation funding but concluded that the proceedings before the Court had been fostered and structured for the primary purpose of generating profits for the litigation funders and that was an abuse of process³.
4. *From March 2002 a litigation funder, which had described itself as providing "advice and assistance in relation to indirect tax matters, including with respect to the recovery for tobacco retailers of amounts*

¹ *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* (No S514/2005); *Australian Liquor Marketers Pty Lim v Berney* (No S515/2005); *IGA Distribution (Vic) Pty Ltd v Whelan & Hawking Pty Ltd* (No S516/2005); *Queensland Independent Wholesalers Pty Ltd v Murray & Anor* (No S517/2005); *IGA Distribution (SA) Pty Ltd v Neindorf & Anor* (No S518/2005); *Composite Buyers Pty Ltd v Williamson & Anor* (No S519/2005); and *IGA Distribution Pty Ltd v Gow & Ors* (No S520/2005) (2006) 229 ALR 58.

² Fostif head note p. 58.

³ Fostif at [287].

referrable to state tobacco licence fees paid by tobacco retailers to tobacco wholesalers"⁴, wrote to tobacco retailers asking for authority to act on the retailers' behalf in recovering amounts. The letters took various forms but all said that Firmstones' (the funder) "success fee" was 33% of any money received by the retailer from the tobacco wholesaler⁵. If costs were awarded to the retailer, Firmstones would retain the sum awarded; if costs were awarded against the retailer, Firmstones would bear those costs⁶.

5. In about middle of September 2002 Firmstones retained a solicitor to act in what Mr. Firmstone described to the sole principal of that firm as, "Our tobacco licence fee recovery project". Mr. Richards was to be the "project's solicitor"⁷.
6. In effect, Fostif was initiated by the litigation funder itself which canvassed potential plaintiffs and offered a total package which included the provision of a legal team and protection against an adverse costs order for a percentage of the recovery.
7. In the joint judgment of Gummow, Hayne and Crennan JJ, their Honours traced the history of the prohibition against litigation funding and concluded that there was no overarching rule of public policy that would prohibit claims being so funded.
8. The rule can be traced back to 3EDW.i.c.25 passed in the year 1275 which provided that:

"No officer of the King by themselves, nor by other, shall maintain pleas, suits or matters hanging in the King's courts, the land's tenements, or other things, for to have part or profit

⁴ Fostif at [25]

⁵ Fostif at [26]

⁶ Fostif at [26]

⁷ Fostif at [27]

*thereof by covenant made between them; and he that doth, shall be punished at the King's pleasure.*⁸

The rule was restated over the centuries.

9. Maintenance was defined in *Hawkins, Pleas of the Crown*⁹, as being:

"Where one officiously intermeddles in a suit depending in any such court which no way belongs to him, by assisting either party with money, or otherwise, in the prosecution or defence of any such suit."

Lord Finlay noted that *Hawkins*:

*"Goes on to point out, however, that acts of this kind may be justified in various cases – eg, if there is an interest in a thing at variance, in respect of kindred or affinity, in respect of other relation as lord and tenant or master and servant, or in respect of charity."*¹⁰

10. The prohibition against maintenance was a statutory and common law rule. In *Re Trepca Mines Ltd (No. 2)*¹¹ Lord Denning MR said:

"The reason why the common law condemns champerty is because of the abuses to which it may give rise. The common law fears that the champertous maintainer might be tempted, for his own personal gain, to enflame the damages, to suppress evidence or even to suborn witnesses. These fears may be exaggerated; but, be that so or not, the law for centuries has declared champerty to be unlawful, and it cannot do otherwise than enforce the law ..."

⁸ *Neville v London "Express" Newspaper, Limited* [1919] AC 368 at 407.

⁹ (8th Ed., published in 1824, Vol. I, C.27(6), S.3 at p. 454.)

¹⁰ *Neville* at 379.

¹¹ *Re Trepca Mines Ltd (No. 2)* [1963] CH 199 at 219-220.

In contrast, the concept or the enforcement of the prohibition against maintenance and champerty had been shunned by Courts of Equity:

"Courts of Equity from the earliest times thought the doctrine of [maintenance as applied to preclude assignment of choses in action] to observe for them to adopt; and therefore they always acted in direct contradiction to it."¹²

11. Offences with respect to maintenance were abolished in New South Wales by the *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW). By the *Abolition Act* the offence of maintenance, including champerty that, but for section 3 of the Act, would be punishable by the common law, was abolished. Section 4 of the *Abolition Act* provided that: *"An action in tort no longer lies on account of conduct known as maintenance (including champerty)."*

12. The Victorian equivalent is found at section 32 of the *Wrongs Act*¹³.

Section 32 provides that:

"No persons shall be liable in tort for any conduct on account of its being maintenance or champerty as known to the common law except in the case of a cause of action accruing before the commencement of the Abolition of Obsolete Offences Act 1969."

The abolition is subject to the following:

"The abolition of criminal and civil liability for maintenance and champerty shall not affect any rule of law as to the cases in which a contract is to be treated as contrary to public policy or as being otherwise illegal and any contract which would have been illegal and void before the commencement of the Abolition of Obsolete Offences Act 1969 on the ground that its making or performance involved or was in aid of maintenance or

¹² *Master v Miller* (1791) 4 TR 320 at 340; 100 ER 1042 at 1053 per Buller J.

¹³ *Wrongs Act*(Vic) 1958

champerty shall continue to be illegal and void after the said commencement."

Interestingly, the Victorian equivalent did not abolish the tort of "barratry".

13. In **Fostif** the appellants had submitted that:

"The proceedings, funded by Firmstones, amounted to "trafficking in litigation", which was an abuse of process per se. As well, particular aspects of the arrangement were criticised, namely the control over the litigation enjoyed by Firmstones as the funder; the alleged subservience to the individual litigants' interest to those of an "intermeddling" stranger; the role assumed by the funder in "buying and selling rights" to litigate before the Court; and the consequential involvement of those Courts in the facilitation of what was described as an offensive and champertous (spoil's sharing) scheme."¹⁴

14. In the NSW Court of Appeal in **Fostif Pty Ltd v Campbells Cash and Carry Pty Ltd**¹⁵, Mason P, in support of litigation funding, had said:

"These changes in attitude to funders have been influenced by concerns about access to justice and heightened awareness of the cost of litigation. Governments have promoted the legislative changes in response to spiralling costs of legal aid. Courts have recognised these trends and the matters driving them "ambulance chasing" still has negative connotations in many quarters, but it is now widely recognised that there are some types of claim that will simply never get off the ground unless traditional attitudes are modified. These include cases involving complex scientific and legal issues. The largely factual account in the book and film "A Civil Action" has demonstrated the social utility of funded proceedings, the financial risks

¹⁴ *Fostif* at [126] per Kirby J.

¹⁵ *Fostif Pty Ltd v Campbells Cash and Carry Pty Ltd*, (2005) 218 ALR 166 at [100].

assumed by funders, and the potential conflicts of interest as between group members in mass tort claims propounding difficult actions against deep-pocketed and determined defendants.”

15. Callinan and Heydon JJ considered the Court of Appeal's reasoning, in particular “champertous intermeddling”¹⁶, relevance of “access to justice”¹⁷, “trafficking in litigation”¹⁸, and recognised the conflict of interest between the litigation funder and the litigant.¹⁹

16. Callinan and Heydon JJ said:

“The Court of appeal downplayed the significance of Firmstone & Fiel’s profit motive by saying the many people seek profit from assisting the process of litigation – lawyers, expert witnesses, forensic accountants, printers and couriers. There is no analogy. Those classes of people either have no desire to foment litigation which would not otherwise exist, or are ethically barred from doing so ... Those ethical constraints prevent lawyers stipulating for a share of the fruits of victory. In the circumstances of this case there were in the end no competitive forces, and there are no ethical restraints on litigation funders.”²⁰

“To some extent Firmstone & Feil and the trial judge explored methods of judicial control of the proceedings which could prevent there being an abuse of process, for example the offering of undertakings to the Court in relation to costs. The respondents did not suggest any specific regime, using the Court’s powers under the rules or otherwise, for overcoming the

¹⁶ Fostif at [255].

¹⁷ Fostif at [256].

¹⁸ Fostif at [257].

¹⁹ Fostif at [281].

²⁰ Fostif at [284].

problems described above, and in truth there are none available."²¹

*"Conclusion: In short, the proceedings are structured by Firmstone & Feil depended on a harnessing of the alleged wrongs of the plaintiffs and of the curial process established to remedy alleged wrongs for the primary purpose of generating profits for Firmstone & Feil. This was an abuse of process."*²²

17. Gummow, Hayne and Crennan JJ said of the bargain between the plaintiffs and the funder:

*"To ask whether the bargain struck between a funder and intended litigant is "fair" assumes that there is some ascertainable objective standard against which fairness is to be measured, and that the courts should exercise some (unidentified) power to relieve persons of full age and capacity from bargains otherwise untainted by infirmity. Neither assumption is well founded."*²³

18. Notwithstanding the stance adopted by Gummow, Hayne and Crennan JJ, courts frequently scrutinise funding agreements in an insolvency context. However, courts do not scrutinise the percentage charged by the litigation funder.

19. The disquiet expressed by Callinan and Heydon JJ has been considered in various cases. For instance, in **Clairs Keeley (A Firm) v Treacy & Ors.**²⁴, the plaintiffs made several attempts to satisfy the Court that the plaintiffs' solicitor was sufficient independent of the funder or alive to the possibility of abuse of conflict between the

²¹ **Fostif** at [286].

²² **Fostif** at [287].

²³ **Fostif** at [92].

²⁴ **Clairs Keeley (A Firm) v Treacy & Ors.** [2005] WASCA 86

plaintiffs and the funder. In **Clairs Keeley No. 3**²⁵ the Court of Appeal was satisfied that the proceedings no longer constituted an abuse of process.

20. In corporations matters, funding agreements have been monitored by the Courts by the use of section 477(2B) of the *Corporations Act*. That section requires approval of the Court, of the Committee of Inspection or of a resolution of the creditors for a liquidator to enter into an agreement which requires more than three months for its implementation. Traditionally, liquidators have applied to the courts for the approval of funding arrangements.

21. In a liquidation context, Finkelstein J in **Anstella Nominees Pty Ltd v St. George Motor Finance Ltd**²⁶ said:

"Now such agreements have become commonplace in virtue of two exceptions of the rules against maintenance and champerty, those exceptions being:

*(1) A person with a genuine commercial interest in an action may fund it (**Trendtex Trading Corp v General Suisse** [1982] 679); and*

*(2) The statutory power of sale of property given to a trustee in bankruptcy and to a liquidator is beyond the reach of rules (**UTSA Pty Ltd (In Liq.) v Ultra Tune Australia Pty Ltd** [1997] 1VR 667, 685 and the cases cited at 682).*

*Strictly speaking, the funding agreement proposed by the liquidator falls outside the rules because it involves a sale of the recoveries of the action and not a sale of a bare cause of action: **Glegg v Bromley** [1912] 3 KB 474."²⁷*

²⁵ [2005] WASCA 86

²⁶ **Anstella Nominees Pty Ltd v St. George Motor Finance Ltd** [2003] FCA 466.

²⁷ **Anstella** at [2].

*"There is a view that, while a liquidator may listen to the opinion of others on what steps he should take in a particular situation, in the end he must exercise his own judgment on what is or is not in the best interests of the creditors or contributories. For this reason he cannot give up control of litigation in which his company is a party."*²⁸

Insolvency practitioners owe duties by virtue of the nature of their office and by virtue of the relevant statutes. The ability to delegate some duties is not open. Ordinary litigants are not subject to the same constraint.

22. In *Submissions on State Regulation of Litigation Funding*²⁹, John Walker set out a submission in support of litigation funding generally. The Standing Committee of the Attorneys-General released a discussion paper in May of 2006. No doubt there will be further developments. From 1997 to 2001 IMF's business and the business of its predecessor was limited to funding insolvency practitioners. In 2001 IMF listed on the Australian Stock Exchange and broadened its funding to also include non-insolvency related commercial litigation conducted solely in the Supreme Courts and Federal Court with claim values over \$2 million ... and (b) multi-party commercial claims usually involving breaches of the Corporations Act and Trade Practices Act ("group actions")³⁰.

23. Walker in relation to the consideration for the funding noted that IMF's return over the last two years was "nil" and a 7% average over the last four years, noting that funders' fees may be too low and premiums may be too high.³¹

²⁸ Anstella at [7].

²⁹ John Walker, Managing Director of IMF (Australia) Ltd, *Submissions on State Regulation of Litigation Funding*, 16 September 2005.

³⁰ At 2.1.

³¹ At [6.2].

24. The submission filed by Walker recognised the argument that the litigation funder may seek to circumvent the prohibition on lawyers charging contingency fees.³² While noting the argument, he propounds that the position is safeguarded by the involvement of legal practitioners who are prohibited from charging contingency fees and, who have a fiduciary relationship with their clients and, these days are officers of the Court.
25. In **Clairs Keeley**³³ the Full Court of Western Australia said: *“There can be no doubt that one of the most important considerations in this context, is the position of the solicitors. The Court can be more confident that its processes will not be abused by the litigation funder if the solicitor acting for the funded party is independent, is alive to the possibility of abuse of conflict and is fully aware of his fiduciary obligations to the client. That point is made very clearly in **De Crittenden v Bayliss** [2002] EWCA 50, where the Court of Appeal emphasised the distinction between solicitors controlling litigation as officers of the Court who are subject to its rules, and lay litigation funders who are subject to no such constraint.”*
26. Walker argued that the relationship is sufficient to control any perceived abuses. He rejected the submission by the Legal Services Commissioner that litigation funding be controlled by the ASIC.³⁴ Obviously it would be an expansion and, arguably foreign expansion, of the role of ASIC to regulate funding.
27. The submission by the Law Council of Australia on litigation funding³⁵ recommended litigation funding as a service which improves access to justice and should therefore be encouraged in the public interest³⁶. As

³² [12]

³³ (2004) WASCA 277 at [75].

³⁴ [19]

³⁵ *Litigation Funding Submission to the Officers, Standing Committee of Attorneys-General*, New South Wales Attorney-General's Department, 6 October 2005.

³⁶ At Executive Summary.

to control over the litigation, the Law Council recommended that lawyers retain a direct retainer with the clients.

"It is suggested that concerns over the involvement of non-lawyers may be assuaged by lawyers respecting the obligation in their Legal Profession Acts to have a direct retainer between them and their clients and by the introduction of rules of the court (or even by way of practice note) whereby the Court is empowered to consider and approve, if appropriate, the litigation funding agreement between the claimants and the litigation funder. Such a power is consistent with the obligation of a court to ensure the process of the court is conducted in the interest of justice."³⁷

28. The Law Council noted that a fee of 35% was deemed to accord with the rate generally applied in the market. However, it was submitted that market forces should prevail.³⁸ Although litigation funding may lead to expanded court access, there is a seemingly lack of competition in the market. In reality, there appears to be an inequality in bargaining positions exacerbated by the inability to shop around for a favourable percentage. Litigation funding is usually extended at the rate fixed by the litigation funder. Notwithstanding the Walker submission, there needs to be the implementation of some regulatory regime. The Canadian legal practitioner model ought to be considered and each agreement should require the appointment of a legal practitioner as a "guardian" to oversee the terms of any agreement and its implementation.

29. The Law Council also noted that in October 1999, the ALRC, in its review of the Federal Civil Justice System³⁹ indicated that the concern over contingency fee arrangements may be misplaced. However, the

³⁷ [5]

³⁸ [14]

³⁹ Discussion paper 62.

ALRC stopped short of recommending the removal of barriers to charging fees based on percentage of damages.⁴⁰

30. The Civil Justice Council's submission⁴¹ advocated the relaxing of the legislative prohibition against contingent fees. The submission usefully summarises the position in other jurisdictions. The paper refers to McKinnon in setting out the position in the USA⁴²:

"In general under a contingent fee arrangement the lawyer's right to a fee depends upon the success of his efforts and the amount of his fee is commonly proportional to the amount of his client's recovery or to the amount of a contribution to a common fund. Also the size of a fee is designed to be greater than the reasonable value of the services in the individual case, the difference reflecting the fact that the lawyer will realise no return for his investment of time and office expenses in the case he loses..."

The paper recognised that in some US states such as New York, the court regulates the fairness of the conditional fee agreement and the percentage recoverable by the lawyer.⁴³

31. The prohibition against contingency fees must be considered in the light of statements and observations set out in paragraphs 32 to 37 hereof.

32. In **Clyne v NSW Bar Association**⁴⁴, the Court cited **Ladd v London Road Car Co.** (1900) 110 LTJo 80 as follows:

"In reference to the subject of speculative actions generally, I think it right to say, on the part of the profession and the class of

⁴⁰ See paragraphs 38 and 39 of the Law Council's *Litigation Funding Submission*

⁴¹ *Improved Access to Justice – Funding Options and Proportionate Costs*, Michael Napier CBE, Senior Costs Judge Peter Hirst, Robert Musgrove and Professor John Peysner – August 2005.

⁴² McKinnon, *Contingent Fees for Legal Services*, Chapter 3

⁴³ At 36.

⁴⁴ **Clyne v NSW Bar Association** (1960) 104 CLR 186.

*persons who were litigants in such cases, that it was perfectly consistent with the highest honour to take up a speculative action in this sense – viz, that if a solicitor heard of an enquiry to a client and honestly took pains to inform himself whether there was a bona fide cause of action, it was consistent with the honour of the profession that the solicitor should take up the action. ... Justice would very often not be done if there were no professional men to take up their cases and take the chance of ultimate payment; but this was on the supposition that the solicitor had honestly satisfied himself by careful enquiry that an honest case existed.*⁴⁵

33. Of funding representative actions, Bernard Murphy⁴⁶ said:

“There are only two firms of solicitors in Australia who are either large enough, courageous enough or perhaps silly enough to regularly act for applicants in large class actions on a contingency basis. As the partner in charge of the largest class action practice in Australia, I can tell you that it is a difficult area in which to profitably practice. Whilst the media tends to focus on a sometimes large costs orders obtained at the end of a class action, there is a massive expenditure on barristers, experts and solicitor time involved and these are carried for four to five years before payment. If the case is unsuccessful, that expenditure is lost. As a result, few firms are prepared to practice in this area.”

34. In **Korda, In the Matter of Stockford Limited (Subject to Deed of Company Arrangement)**⁴⁷ Finkelstein J. had before him an application which had been precipitated by ASIC’s concern that the

⁴⁵ Clyne at 204.

⁴⁶ “*Practical difficulties for applicants in class actions, 2004*”

⁴⁷ **Korda, In the Matter of Stockford Limited (Subject to Deed of Company Arrangement)** [2004] FCA 1982

administrators' remuneration had not been fixed either by the creditors or by the Court. Albeit, that the case concerns the remuneration of insolvency practitioners, Finkelstein J's comments are germane.

35. Finkelstein J. considered the evolution from a percentage fee (in an insolvency context) to the charging of an hourly fee. His Honour said:

"The difficulty with the conservation approach is that insolvency practitioners might forsake liquidations and administrations if they can earn higher incomes in other fields. These specialists, who by and large allow an insolvency administration to operate smoothly, efficiently and expeditiously would then be lost. On the other hand, it is difficult to ignore the criticism that Easterbrook J makes on fees based on hourly rates. ..."

Easterbrook J., with the concurrence of Posner CJ said (at 33-34) in relation to fees claimed by an attorney:

"The market for legal services used three principal plans of compensation: the hourly fee, the fixed fee, and the contingent fee. The contingent fee serves in part as a financing device, allowing people to hire lawyers without paying them in advance (or at all, if they lose). It also serves as a monitoring device. In any agency relation, the agent may pursue his own goals at the expense of the principals. A fixed fee creates the incentive to shirk; a lawyer paid a lump sum, win or lose, may no longer work hard enough to present his client's case. Fixed fees therefore are used only in cases where the client can monitor the results of the lawyer's work (did the lawyer secure the divorce or not?) or where the client (or the client's general counsel) is sufficiently sophisticated to assess what the lawyer has accomplished.

An hourly fee creates an incentive to run up hours, to do too much work in relation to the stakes of the case. An hourly fee

*may be appropriate where it is hard to define output (in litigation, for example, the outcome turns on the merits and not simply on the lawyer's skill and dedication), so the hourly method measures and prices the inputs, the attorney's hours. Again, however, it is necessary to monitor the lawyer's work.*⁴⁸

36. Finkelstein J. also referred to a 1997 working party report referred to in **Mirror Group Newspapers Plc v Maxwell (No. 2)**⁴⁹ where it was noted that practitioners working on a time costing have increased the remuneration they receive by engaging in practices such as:

- Spending time on speculative investigations and recovery probabilities which would not be contemplated if funds were more limited;
- Assigning either too many or too highly qualified staff to task; and
- Taking too long to perform tasks.⁵⁰

37. Finkelstein J. advocated the application of the "lodestar" amount. That is the amount reached by the number of hours reasonably spent by the insolvency practitioner multiplied by a reasonable hourly rate. *"... This step will require the tribunal to decide whether the work performed was necessary to the administration, whether it was performed within a reasonable time and whether the rate is reasonable having regard to what the practitioner, and other practitioners, usually charge their clients. The lodestar amount should then be adjusted (up or down) to reflect other factors including the quality of the work performed, the complexity in the administration over and above the normal complexity of such work, the novelty and difficulty of the issues that confronted the administrator as well as the ultimate result obtained by him.*⁵¹

⁴⁸ Korda at [39], in *Kirchoff v Flynn* 786 F2d 320 (7th Cir. 1986)

⁴⁹ *Mirror Group Newspapers Plc v Maxwell (No. 2)* [1998] 1 BCLC 638

⁵⁰ *Mirror Group* at [42]

⁵¹ *Mirror Group* at [47]

38. The concerns about hourly costing might be persuasive in leading to an eventual endorsement of contingency fees if the tension created by the overriding fiduciary duty owed by legal practitioners can be resolved. Unlike the current position with respect to litigation funders, there is more scope for regulation of agreements between litigants and legal practitioners. Firstly, legal practitioners cannot avoid the fiduciary duty owed to clients. Secondly, the professional regulatory bodies are in a position to oversee the implementation and carrying out of contingency agreements. The courts in Canada closely monitor the terms of an agreement. With respect to most litigation funding agreements, they are determinable at the will of the litigation funder. Legal practitioners are constrained from terminating retainers in circumstances where there could be a breach of the fiduciary duty owed to the client. When litigation has progressed, leave of the Court is often required to terminate a retainer. Competition and the ability to effectively regulate overcomes some of the objections which are pertinent to litigation funding.
39. In Victoria, legal practitioners are entitled to enter into costs agreements which are dependent upon the successful outcome of the matter⁵² and such conditional costs agreements may provide for the payment of a reasonable premium on the legal costs not to exceed 25%⁵³. However, contingency fees are prohibited and a penalty applies.⁵⁴ Those provisions are somewhat surprising given the resistance to contingency fees and uplift fees in 1989⁵⁵.
40. In October 1999, the Law Reform Commission of Western Australia issued its final report "*Review of the Civil and Criminal Justice System*". GiGi Visscher⁵⁶ noted that the Commission: "... advocates that limited

⁵² *Legal Profession Act* 2004, section 3.4.27(1)

⁵³ *Legal Profession Act* 2004, section 3.4.28.

⁵⁴ *Legal Profession Act* 2004, section 3.4.29.

⁵⁵ *Funding Litigation, The Contingency Fee Option* – Legal Fees Committee of the LIV – July 1989.

⁵⁶ *Contingency Fees in Western Australia* – Murdoch University, Electronic Journal of Law, Vol. 7, No. 1 (March 2000).

*contingency fee arrangements should be permitted in all cases, except in criminal law and family law matters, where two conditions are satisfied. The first condition is that the contingency fee arrangement must be used as a last resort and that all other means of avoiding this fee arrangement have been exhausted. Additionally, the lawyer must be satisfied that the client is financially unable to conduct the litigation without the use of contingency fee arrangement.*⁵⁷

41. Visscher noted the argument that contingency fee agreements (uplift) should not be limited to certain income categories or to natural persons⁵⁸. Once there is an expansion of the categories of litigants it is difficult to argue that the legislature has not prohibited contingency fees per se. It has merely put a ceiling on how much can be charged. That is, it is a percentage of the fees which would normally be imposed rather than a percentage of the outcome.

42. The Law Reform Commission of Hong Kong consultation paper⁵⁹ in its proposals:

“Considered the arguments for and against the introduction of conditional fees ... and believes that conditional fee agreements have an important role to play in ensuring access to justice for all. It is important to ensure that making a civil claim should not be the preserve of the wealthy (who can afford to fund legal proceedings by their own resources) or the poor (who are eligible for legal aid) but open to all with good cause. ... The fact that the claimant can litigate with less concern for costs is balanced by the fact that only cases with good and reasonable prospects of success will be taken on by lawyers on a conditional fee basis. The sub-committee believes that problems relating to unethical conduct, satellite litigation,

⁵⁷ Visscher at [3].

⁵⁸ Visscher at [6].

⁵⁹ Law Reform Commission of Hong Kong, Conditional Fees Sub-Committee, *Consultation Paper, Condition Fees, September 2005*,

*increases in frivolous litigation, and excessive fees can be avoided if the conditional fee regime is properly structured.*⁶⁰

43. The Green paper on contingency fees⁶¹ was devoted wholly to the subject of contingency fee arrangements in England. The English Bar was strongly opposed to any change, primarily on ethical grounds⁶². The Law Society was also opposed to contingency fees on ethical grounds. However, it supported the second option of the speculative fee plus a percentage uplift for costs by way of a success fee.⁶³
44. Further discussion papers, debate and reforms continued after 1997. It would be fair to say that the development of contingency fees in the UK is seen as a way to alleviate the pressures on legal aid. In September 2005, The Civil Justice Council released a report on Improved Access to Justice – Funding Options & Proportionate Costs. The report deals with the introduction of Conditional Funding Agreements and the removal of legal aid for personal injury caused satellite litigation.
45. In Canada, contingency fees have been applied using lodestar principles⁶⁴. In Ontario in 2002, amendments were made to the Solicitors Act to regulate contingency fee agreements. The amendments allowed the Court to review contingency fee contracts and to endorse negotiated fees above the prescribed standard where it is fair to do so.⁶⁵

⁶⁰ At [7.1].

⁶¹ Lord Chancellors' Department, CMND 571

⁶² General Council of the Bar, *Quality of Justice: The Bar's Response*, (1989 at 258-264).

⁶³ Law Society, *Striking the Balance, The Final Response of the Council of the Law Society on the Green Paper* (1989)

⁶⁴ See Vince Morabito – *Federal Class Actions, Contingency Fees, and the Rules Governing Litigation Costs*, 21 Monash UL Rev 231 of 1995.

⁶⁵ Civil Justice Council *Submission* at [37].

46. The Alberta Law Reform Institute⁶⁶ recommended that fee arrangements ought to be submitted for approval prior to certification (of the legal issues in a class action) and that the Court should also be able to revisit the agreement at the conclusion of the proceeding to ensure that it is fair and reasonable to class members as well as class council.⁶⁷

47. On 2 March 1990, the Benches voted in favour of setting maximum contingency fee rates of 33⅓% of the amount recovered in plaintiff motor vehicle actions and 40% of the amount recovered in other types of plaintiff personal injury actions. The Bulletin noted that:

"There is a safeguard in the scheme, should contingent fee limits be unfair in a particular case. Once amended, section 78(3.2) of the Legal Profession Act will permit a lawyer, before having entered into a contingent fee agreement with a client, to apply to the Supreme Court for remuneration in excess of the maximum contingency rates. The Court may approve the application if both the lawyer and client agree and if the Court is satisfied the proposed remuneration is reasonable."⁶⁸

48 If it transpires that there is a successful regime to foster and regulate litigation funding, the question of contingency fees being negotiated by legal practitioners might be revisited. The availability of competition and the opportunity to effectively regulate professional conduct weigh in favour of further reform in the legal profession with respect to contingency fees in circumstances where litigants had exhausted other means of initiating suit to redress wrongs.

R.S. Randall

⁶⁶ Alberta Law Reform Institute, Edmonton, Alberta, *Class Actions, Final Report No. 85*, December 2000

⁶⁷ Alberta Law Reform Institute at [410].

⁶⁸ Law Society of British Columbia: *Benches Bulletin 1990 No. 3 April*